



IN THE SUPREME COURT OF THE STATE OF DELAWARE

RICHARD SCHOON,

Plaintiff Below, Appellant

v.

DARYL D. SMITH, JOHN F. BECKERT,
MARK C. GWILLIM, CONRAD A.
PLIMPTON, and TROY CORPORATION, a
Delaware corporation,

Defendants Below, Appellees.

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)
)
) No. 554, 2006
)
) On Appeal from the Court of
) Chancery of the State of
) Delaware in and for New Castle
) County, C.A. No. 1753-N
)
)
)

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NATURE OF PROCEEDINGS

Plaintiff-Below, Appellant, Richard Schoon ("Schoon") is a director of nominal defendant Troy Corporation ("Troy"). He is not a shareholder of Troy. Disliking decisions made by the majority of Troy's board, Schoon purported to bring a derivative action in the Court of Chancery on behalf of Troy against his fellow board members.

Defendants-Below/Appellees filed a motion to dismiss under established Delaware law -- that derivative suits belong to shareholders who meet certain statutory and Court of Chancery Rule requirements. Directors, however, lack standing to bring such suits absent share ownership.

On September 7, 2006, the Court of Chancery concurred, and issued its opinion granting the motion to dismiss because Schoon, who owns no economic stake in Troy, has no standing to pursue his claims. On October 12, 2006, Schoon filed his notice of appeal. On November 27, 2006, Schoon filed his opening brief in support of his appeal.

On December 7, 2006, Appellees filed their motion to affirm. Thereafter, the parties filed several joint motions to stay while they sought settlement, which settlement has not concluded. On August 2, 2007, this Court issued its order denying the Appellees' motion to affirm and the matter is proceeding to full briefing.

SUMMARY OF ARGUMENT

1. DENIED. The Court of Chancery correctly held that directors do not have standing to bring derivative claims. That is the law of Delaware and no strong policy reason exists to change it. The requirements of 8 Del. C. § 327 ("Section 327") and Court of Chancery Rule 23.1 ("Rule 23.1") apply to derivative actions. A party must be a shareholder at the time of the challenged transaction and maintain that status throughout the litigation to have and to retain standing to pursue derivative claims. Plaintiff points to no Delaware statute, rule or case granting derivative standing to directors *qua* directors. Schoon, who has no stake in Troy, but who was appointed to the Troy board by Steel Investment Corporation ("Steel"), a minority stockholder who has the right to make such an appointment and who could bring such derivative claims itself, lacks standing to pursue this case.

STATEMENT OF FACTS

Schoon spends about fifteen pages reciting his version of the "facts" in an effort to color his brief and the opinion of this Court, when the relevant facts for purposes of the issue on appeal can be spelled out in a few pages. Schoon starts with the unsupported and conclusory allegation that "Smith dominates Troy" and continues thereafter to berate the decision-making of his fellow board members. (OB. at 4.)¹ The place for Schoon to have made his arguments about the merits of those decisions was in the boardroom, not before this Court.

Schoon is not a stockholder of Troy. (OB at 7, 17-19.) Steel used its right as the owner of 95% of Troy's Series B common shares to elect Schoon as its one designated director to Troy's five-member board. (OB at 6-7.) Schoon does not dispute that all of the claims in his amended complaint are derivative. (OB at 7.) Schoon brought this case to further Steel's efforts to achieve liquidity for its shares. (Cf. OB 11.) Schoon has been found by the Court of Chancery to have conflicts of interest motivating his actions.²

The Court of Chancery correctly held that Schoon lacked standing to pursue his claims. (See OB Ex. A.)

¹ Schoon's Opening Brief on appeal is cited as "OB ____".

² See *Schoon v. Troy Corp.*, 2006 WL 1851481, at *1 (Del.Ch.), *reargument denied*, 2006 WL 2162036 (Del. Ch.) (denying initially Schoon's request for inspection of Troy's books and records because of his "undisclosed conflict of interest" in assisting Steel's efforts to achieve liquidity for its minority interest in Troy).

ARGUMENT

I. THIS COURT SHOULD AFFIRM THE TRIAL COURT'S DISMISSAL OF THE CASE BECAUSE SCHOON LACKS STANDING TO BRING DERIVATIVE CLAIMS

A. Question Presented

Did the trial court err by granting defendants' motion to dismiss on the ground that a director of a Delaware corporation, who is not also a stockholder of that corporation, lacks standing to pursue derivative claims? (See Op. at 2.)³

B. Standard and Scope of Review

The Court of Chancery's ruling that directors, who are not also shareholders, lack standing to pursue derivative claims is an issue of law that this Court reviews *de novo*. *Rosenbloom v. Esso Virgin Islands, Inc.*, 766 A.2d 451, 458 (Del. 2000).

C. Schoon Lacks Standing to Bring Derivative Claims

Schoon argues that the trial court erred in relying on "the contemporaneous ownership requirements of Section 327 and Court of Chancery Rule 23.1" to justify "its determination that a director cannot assert a derivative claim." (OB at 25 (citing Op. at 2.)) Schoon incorrectly contends that "[t]hese authorities apply only to derivative actions brought *by stockholders*, and they function to limit the universe of *stockholders* who can bring a derivative action." (*Id.*) Well-settled Delaware law, including 8 *Del. C.* § 327, Court of Chancery Rule 23.1, *Moran v. Household International, Inc.*, 490 A.2d 1059, 1071 (Del. Ch. 1985), *aff'd*, 500 A.2d 1346 (Del. 1985), and *Harff v. Kerkorian*, 324 A.2d

³ The trial court's letter opinion, which was attached to the Notice of Appeal as Exhibit A, is cited as "Op. at ___."

215, 218 (Del. Ch. 1974), *aff'd in part, rev'd in part on other grounds*, 347 A.2d 133 (Del. 1975), however, all support the trial court's determination that Schoon, a non-stockholder director, lacks standing to bring this case. The trial court's opinion should be affirmed.

1. The Trial Court Properly Relied on Section 327

It is fundamental Delaware law that a plaintiff must be a shareholder of the Delaware corporation on behalf of which he seeks to prosecute a derivative action:

In any derivative suit instituted by a stockholder of a corporation, it shall be averred in the complaint that the plaintiff was a stockholder of the corporation at the time of the transaction of which such stockholder complains or that such stockholder's stock thereafter devolved upon such stockholder by operation of law.

8 Del. C. § 327 ("Section 327"). Schoon nevertheless quotes *Harff* out of context to support his contention that "[t]here is . . . nothing in the plain language of Section 327 that would prevent a director from bringing a derivative suit, and the implication of Section 327 is that there are parties other than stockholders (presumably directors) who can bring a derivative suit." (OB at 26 (citing *Harff*, 324 A.2d at 218.)) He also argues that any other reading is "contrary to well-established canons of statutory interpretation." (*Id.*) Schoon's argument mirrors the plaintiffs' failing argument in *Harff*, 324 A.2d 215, and grossly misreads the "well-established canons of statutory interpretation" to which he refers.

First, Schoon splits a quotation from *Harff* to support his misguided assertion that Section 327 "does not provide that only stockholders have

standing to sue derivatively." (OB at 26.) To the contrary, the Court of Chancery actually said in *Harff* that:

[i]t is noted, as plaintiffs have asserted, that when read *literally* s 327 does not provide that only stockholders have standing to sue derivatively. *It must be recognized, however, that s 327 does not create the right to sue derivatively but rather restricts that right.*

Harff, 324 A.2d at 218 (emphasis added.) The court in *Harff* went on to dismiss a derivative action brought by a "party other than a stockholder" stating:

But it has been generally accepted under Delaware law that only one who was a stockholder at the time of the transaction or one whose shares devolved upon him by operation of law may maintain a derivative action. For purposes of a derivative action, an equitable owner is considered a stockholder. *But Delaware law seems clear that stockholder status at the time of the transaction being attacked and throughout the litigation is essential.*

Harff, 324 A.2d at 218-19 (emphasis added) (citations omitted). *Harff's* holding is inescapable: while Section 327 and Rule 23.1 may not literally say that no one other than a stockholder can bring a derivative action, they effectively restrict the universe of derivative plaintiffs to those who are stockholders who maintain that status. *Id.* at 218. The Legislature's use of the phrase "derivative suit instituted by a stockholder," therefore, defines those who may bring such actions. No support exists for the proposition that every other person not expressly mentioned in the statute might also be able to bring derivative actions. See *Norman v. Goldman*, 173 A.2d 607, 610 (Del. Super. 1961) (discussing maxim of *expressio unius est exclusio alterius* as applicable "where a form of conduct, the manner of its performance and operation, and the persons

and things to which it refers are affirmatively or negatively designated, there is an inference that all omissions were intended by the legislature") (emphasis original). Thus, the stock ownership requirement is strictly construed and every case in which someone other than a stockholder sought to bring such an action has been rejected, and Schoon's treatment should be no different. See *7547 Partners v. Beck*, 682 A.2d 160, 163 (Del. 1996) (applying strict statutory construction); *Harff*, 324 A.2d at 218-19 (holding that convertible debenture holder lacks standing)⁴.

This Court has interpreted Section 327 -- "the only provision of the Delaware General Corporation Law that speaks to the question of standing to maintain a derivative action," *Lewis v. Anderson*, 477 A.2d 1040, 1045 (Del. 1984), -- consistently as requiring a derivative plaintiff to be a stockholder in the corporation on whose behalf he purports to bring suit. See, e.g., *Leighton v. Lewis*, 577 A.2d 753 (Del. 1990) (ORDER) (granting motion to affirm and reasoning that "Section 327 provides that a plaintiff cannot maintain a derivative action challenging corporate mismanagement unless he was a stockholder at the time of the transaction complained of or had his stock devolved upon him by operation of law.") (emphasis added); *7547 Partners*, 682 A.2d at 161 (affirming trial court's dismissal of derivative complaint on grounds that Section 327 requires derivative plaintiff to be a stockholder of the corporation); *In re*

⁴ The exception to this construction has been permitted only where the stockholders are replaced by the creditors as the ultimate beneficiaries of the residual value of the firm. See *North American Catholic Educational Programming Found., Inc. v. Gheewalla*, ___ A.2d ___, 2007 WL 1453705, at *7 (Del. Supr.); see also *infra* Argument I.C.4.

Beatrice Companies, Inc. Litig., 522 A.2d 865 (Del. 1987) (ORDER) (same); *In re First Interstate Bancorp Consol. S'holders Litig.*, 729 A.2d 851, 867-68 (Del. Ch. 1998), *aff'd*, *Bradley v. First Interstate Corp.*, 748 A.2d 913 (Del. 2000) (holding that plaintiff who ceases to be a stockholder as a result of a merger or for any other reason loses standing to continue a derivative suit).

Leighton, 7547 Partners, Beatrice, and *First Interstate* do not stand for the proposition -- as Schoon suggests -- that Section 327 requires "that before a *stockholder* can bring a derivative action, the stockholder must have owned stock at the time of the transaction of which such stockholder complains" (OB at 26), but rather interpret Section 327 as requiring *all derivative plaintiffs* to be stockholders at the time of the transaction of which they complain. Schoon can cite no Delaware case granting to directors the right to sue derivatively. Thus, well-settled Delaware law defeats Schoon's strained interpretation of Section 327.

Similarly strained is Schoon's assertion that "well-established canons of statutory interpretation" support his argument that Section 327 "expressly contemplates that there could be a 'derivative suit' instituted by a party other than 'a stockholder of the corporation.'" (OB at 26.) The glaring absence of any mention of director standing to bring derivative claims in Sections 141 and 327, contrasted with the clear language in several other sections of the Delaware General Corporation Law that expressly confer standing upon directors, leads to the logical conclusion that the General Assembly did not intend to extend derivative standing to directors. Compare 8 Del. C. §§ 327 and 141 (containing no provision granting director standing) with 8 Del. C. § 211

(providing directors with standing to petition court to summarily order annual meeting of stockholders under certain circumstances); with 8 Del. C. § 220(d) (expressly providing directors with standing to demand inspection of their corporation's stocklist and books and records); and with 8 Del. C. § 225 (bestowing standing upon directors so that they may contest the validity of any election, appointment, removal or resignation of any member of the board of directors).

The trial court correctly found that "[a]ny decision to alter those [individual director standing] arrangements is properly left to the collective judgment of the General Assembly." (Op. at 3.) See *Giuricich v. Emtrol Corp.*, 449 A.2d 232, 238 (Del. 1982) (stating that when a provision is expressly included in one section of a statute but omitted from another, it is reasonable to assume that the legislature was aware of the omission and intended it, and that "[t]he courts may not engraft upon a statute language which has been clearly excluded therefrom by the Legislature."); see also *Norman*, 173 A.2d at 610. This Court similarly should decline to read non-shareholder director standing into Section 327.

2. The Trial Court Properly Relied on Rule 23.1

Schoon applies his same flawed analysis of Section 327's stock ownership requirement for derivative standing to Rule 23.1⁵ to support his

⁵ Rule 23.1(a) provides as follows:

In a derivative action brought by one or more shareholders . . . the complaint shall allege that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiffs' share or membership thereafter devolved on the plaintiff by operation of law. The complaint shall also state with particularity the

contention that "Rule 23.1 does not provide that only stockholders can bring derivative actions." (OB at 28.) Schoon contends that because Rule 23.1 explicitly refers to "a derivative action brought by 1 or more shareholders," it "implies that there could be derivative actions brought by other corporate constituents who are not 'shareholders,'" otherwise the Rule's language would be superfluous. (OB at 28.) As Schoon acknowledges, however, Rule 23.1 "simply implements the statutory requirements of Section 327." (*Id.*) As discussed above, this Court consistently has interpreted Section 327 and the rule implementing it to mean that a derivative plaintiff must be a stockholder, not only at the time of the transaction about which he complains, but throughout the course of the derivative litigation.

Citing both Section 327 and Rule 23.1, this Court recognized that

[w]hen a merger eliminates a plaintiff's shareholder status in a company, it also eliminates her standing to pursue derivative claims on behalf of that company. Those derivative claims pass by operation of law to the surviving corporation, which then has the sole right and standing to prosecute the action. This Court and the Court of Chancery have consistently applied these well-established precepts of Delaware corporate law.

Lewis v. Ward, 852 A.2d 896, 901 (Del. 2004); see also *First Interstate*, 729 A.2d at 867 ("The Delaware Supreme Court has held that once a plaintiff 'ceases to be a shareholder, whether by reason of a merger or for any other reason, [he] loses standing to continue a derivative suit.'). The holdings in *Lewis* and *First Interstate* are premised upon

efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort.

Section 327 and Rule 23.1's requirement that a derivative plaintiff be a stockholder in the first instance -- it logically follows that if a plaintiff loses derivative standing because she "ceases to be a shareholder," she had to own stock to have derivative standing to lose. Again, Schoon cites no Delaware authority to support his argument otherwise.

Moreover, Schoon's argument logically means that the stringent particularized pleading requirements of Section 23.1 are inapplicable to directors. After all, he relies on the fact that directors as the plaintiffs in derivative suits are not expressly mentioned in Rule 23.1, and therefore, by a plain reading of the Rule, the additional pleading requirements are not applicable to directors. Thus, the fact that "[t]he complaint **shall also** allege with particularity" efforts made to obtain action or excuse for not making the effort would not apply to directors if Schoon is correct. Ch. Ct. Rule 23.1 (emphasis added).⁶

Accordingly, Schoon's argument disturbs the careful balance that Delaware has struck between a board's right to manage the affairs of the corporation and to conduct litigation on its behalf and a stockholder's right to seek redress for managerial wrongs. See *infra* Argument I.C.5. The Rule was designed to eliminate frivolous derivative litigation at the outset by limiting who may sue (stockholders meeting certain

⁶ Schoon wants the benefit of the lack of the word "director" in Section 327 and Rule 23.1 to mean he has standing to sue, but then he also wants to read into the Rule the word "director" to accept the demand futility requirements contained in Rule 23.1. (OB at 21) (stating that he must meet the test for demand futility contained in Rule 23.1). Schoon's self-serving attempt to construe the Rule tortures any plain reading thereof.

requirements) and by requiring additional pleading requirements beyond Rule 8's notice pleading (demand excuse allegations). This case is a classic example of failure of such pleading by a plaintiff. The trial court, however, did not, and need not, have reached the issue of whether the Supreme Court, were it to grant derivative standing to directors *qua* directors, would also imply as a requirement the further pleading obligations contained in Rule 23.1 to suits initiated by directors. The absurdity of Schoon's position is that he would undo the careful balance to standing adopted by the General Assembly and the courts merely by means of faulty implication.⁷

3. The Trial Court Properly Relied on *Moran*

Despite criticizing the trial court for "citing a single case," *Moran v. Household International, Inc.*, 490 A.2d 1059, 1071 (Del. Ch. 1985), *aff'd*, 500 A.2d 1346 (Del. 1985), as the well-settled authority controlling a director's standing to sue derivatively (OB at 31), Schoon offers no Delaware authority to support his own argument that a director can circumvent the decision-making process of the board and sue derivatively. Indeed, no Delaware case has ever granted a right to a director to usurp the entire board's power to bring an action not authorized by the full board. Schoon claims that because the Court in *Moran* "did **not** dismiss Moran from the case or deny Moran's right to assert derivative claims," *Moran* "at least implicitly . . . **supports** the

⁷ Were the Court to adopt a different view and grant standing to Schoon, it must further determine whether on remand the Court of Chancery must also imply Rule 23.1's particularized pleading requirements as applicable to Schoon or whether he need not meet them.

right of a director to bring claims derivatively." (OB at 32.) Schoon misreads *Moran*.

In *Moran*, the board of directors of Household International, Inc. ("Household") had adopted a complex preferred stock purchase rights plan. *Id.* at 1067. Upon the adoption of the rights plan, Moran and his company filed suit against Household and the thirteen directors who approved the rights plan, alleging that the rights plan restricted the alienability and marketability of Household shares and limited the stockholders' ability to run proxy contests. *Id.* at 1063. Significantly, Moran brought suit derivatively, and argued that he had standing, as a director, to bring claims to protect the rights of the other Household stockholders. *Id.* The court flatly rejected Moran's director standing argument:

This is a novel argument but it lacks authority. Whatever may be the law in other states, there is no Delaware statute which authorizes an individual action by a director, *qua* director, to correct wrongs [which have been] alleged to have been inflicted on shareholders. Nor can such a right be inferred from the language of § 141 of the Delaware General Corporation Law (DGCL) which defines the powers and duties of directors. Moran's attempt to act as a surrogate to enforce the rights of shareholders merely emphasizes the derivative nature of plaintiffs' claims. In sum, because the plaintiffs' claims set out causes of action which are essentially derivative, they must comply with Chancery Rule 23.1

Id. at 1071. The court found that Moran had no standing as a director to bring claims on behalf of Household's stockholders, but did not dismiss the action because proper shareholder plaintiffs were present.⁸

⁸ John A. Moran was also a stockholder of Household. See *Moran v. Household Int'l., Inc.*, 1984 WL 8259, at *1 (Del. Ch.)

Schoon ignores the court's holding that "Moran's attempt to act as a surrogate to enforce the rights of shareholders merely emphasize[d] the derivative nature of plaintiffs' claims" and that Moran did not have standing as a director to pursue them. *Id.* If the court had wanted to extend Delaware's well-regarded body of case law to include director derivative standing, it could have done so expressly in *Moran*. It did not do so. Thus, *Moran* reinforces the notion that a director may only sue derivatively in his capacity *qua* stockholder (and not *qua* director).

Moreover, contrary to Schoon's contention that *Moran* "supports the right of a director to bring claims derivatively" (OB at 32), *Moran's* holding makes clear that if the General Assembly had wanted directors to have standing as directors to bring suit on behalf of stockholders -- either derivatively or individually -- such an intention would be manifest in 8 Del. C. § 141, which defines the powers and duties of directors, or in 8 Del. C. § 327, which defines who may sue derivatively. As noted above, contrary to other statutes that expressly grant rights and powers to directors, such as the right to inspect books and records or to sue to enforce that right, the Delaware General Corporation Law does not grant a right to directors to sue derivatively.

4. Derivative Actions Are by their Very Nature the Right of a Stockholder when the Corporation Is Solvent

Appellees' interpretation of Section 327 and Rule 23.1 is entirely consistent with the very notion of a derivative suit itself, which has consistently been described as an action by stockholders on behalf of a Company. See, e.g., *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1036 (Del. 2004) (derivative action "enables a stockholder to bring suit on behalf of the corporation for harm done to the

corporation"); 2 David A. Drexler, et al., *Delaware Corporation Law and Practice* § 42.01 at 42-2 (2006) ("Derivative lawsuits are actions brought by a stockholder"); 2 Edward P. Welch, et al., *Folk on the Delaware General Corporation Law* § 327.2 at GCL-XIII-43 (2007-2 Supp.) (derivative suit "permits a stockholder to bring an action"); 1 R. Franklin Balotti, et al., *Delaware Law of Corporations and Business Organizations* § 13.9 at 13-20 (2006 Supp.) ("[t]he derivative action was developed to enable stockholders to sue").

The historical origin of the derivative action, discussed by the United States Supreme Court in *Hawes v. City of Oakland*, 104 U.S. 450, 452-462 (1881), demonstrates that equity came to the aid of stockholders to create the action, not to the aid of disgruntled directors who did not vote with the majority of their fellow board members. See also *Sohland v. Baker*, 141 A. 277, 281-282 (Del. 1927); 4 Pomeroy's *Equity Jurisprudence* § 1095 (5th ed. 1941). Even Black's Law Dictionary (6th ed. 1990) defines a "derivative action" as "[a] suit by a shareholder to enforce a corporate cause of action." Thus, the use of the phrase "derivative suit instituted by a stockholder" in Section 327 defines exactly who may bring such suits and the "by a stockholder" portion of the phrase is not at all superfluous as Schoon suggests, but plainly sets forth the nature of a derivative action under our law.

In light of the foregoing, it is not surprising that Schoon cites no Delaware case that holds a non-stockholder director has standing to bring such a derivative action. The ultimate beneficiaries of the corporate decision-making process, the stockholders, are afforded a means to protect their interests by a derivative action when the board, acting as

a whole, does not protect those interests. *North American Catholic*, 2007 WL 1453705, at *7 ("[w]hen a corporation is solvent, those duties may be enforced by its shareholders, who have standing to bring derivative actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation's growth and increased value") (emphasis added). But Schoon is no such beneficiary.

Thus, contrary to Schoon's suggestion, a director's fiduciary duties simply do not afford to him the unilateral right to bring an action upon the corporation's behalf.⁹ A single director, who is not an owner and thus not a beneficiary of the duties owed by other directors, and who also has no economic interest in the outcome of the action that he seeks to pursue, plainly stands in a different position than the stockholders for whom the derivative action was developed to protect. Such stockholders are owed duties and have economic stakes. Lacking any economic interest in the outcome, Schoon's own interests cannot be directly aligned with the stockholders, and his adequacy as a representative plaintiff can (and in this case will, if the case proceeds), also be called into question. The basic principle of standing that prevents persons who have suffered no direct or indirect injury from bringing civil actions are applicable to Schoon and are in

⁹ Schoon's suggestion that fiduciary duties obligate directors to bring suits means that board members should disrespect the very deliberative decision-making process of which they are a part and places directors in untenable positions. Directors who abstain or vote against a transaction later found to have been a breach of duty may have no liability in connection with that transaction. See, e.g., *In re Tri-Star Pictures, Inc. Litig.*, 1995 WL 106520, at *2 (Del.Ch.). Would such a director, who does not bring his own derivative action, be subject to suit or to be held accountable to stockholders for failure to bring such an action?

accord with the trial court's ruling and the Appellees' reading of the statute. See *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560-61 (1992) ("Irreducible constitutional minimum of standing requires that plaintiff have suffered an injury in fact, which is an invasion of a legally protected interest which is concrete and particularized and actual or imminent"); see also *Stuart Kingston, Inc. v. Robinson*, 596 A.2d 1378, 1382 (Del. 1991) (observing that courts apply the concept of standing as a matter of self-restraint to avoid the rendering of advisory opinions).

Schoon's attempt to analogize to trust law fails on this same point because of his lack of status as a beneficiary. He admits that "[t]he Court of Chancery has noted that the derivative action 'is analogous to the right of a trust *beneficiary* to call his trustee to account for the management of the trust corpus.'" (OB at 23 (emphasis added.)) Beneficiaries would stand in the same analogous relation to trustees as stockholders do to directors, which status provides the standing for such beneficiaries to redress wrongs. Schoon is no such "beneficiary." Further, "the duties of a trustee to trust beneficiaries (those of loyalty, good faith, and due care), while broadly similar to those of a corporate director to his corporation, are different in significant respects." *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134, 1148-49 (Del. Ch. 1994), *aff'd*, 663 A.2d 1156 (Del. Supr. 1995). While the "caretaking" nature of the classic trusteeship may support the notion of co-trustees suing one another to enforce express terms of a trust instrument, granting directors -- who are charged with entrepreneurial risk-taking --

standing to second-guess the entire board's business decisions would chill directors' deliberative and collective decision-making process as well as the pursuit of maximization of value for the corporation and its stockholders. *Id.* Imagining the potential free-for-all that could be created at the board level by individual director-instituted derivative suits, with potentially resulting corporate counterclaims alleging that the unilateral action brought by that director is, itself, a breach of that suing director's fiduciary duty, demonstrates that Schoon is endorsing an ill-advised rule.

5. The ALI Principles for Director Standing Are at Odds with Delaware Law and the Court Should Not Adopt Them

It is a fundamental principle of Delaware law that the board of directors manages the business and affairs of a corporation, including decisions of whether to bring suit on behalf of the corporation. 8 *Del. C.* § 141(a); see also *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993); *Levine v. Smith*, 591 A.2d 194, 200 (Del. 1991), overruled on other grounds, *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); *Spiegel v. Buntrock*, 571 A.2d 767, 773 (Del. 1990). "Consequently, the decision to pursue or refrain from undertaking a claim on behalf of the corporation is entrusted to the board of directors as within the ambit of its management responsibility." *Levine*, 591 A.2d at 200; *Spiegel*, 571 A.2d at 773; *Zapata Corp. v. Maldonado*, 430 A.2d 779, 782 (Del. 1981). "Thus, 'by its very nature, the derivative action impinges on the managerial freedom of directors.'" *Stone v. Ritter*, 911 A.2d 362, 366 (Del. 2006) (citations omitted). As this Court has observed, the contemporaneous stock ownership requirement embodied in Section 327 and Rule 23.1, like the

demand requirement of Rule 23.1, recognize the power of the board to manage the business and affairs of the corporation:

Essentially, a shareholder is permitted to intrude upon the authority of the board by means of a derivative suit only because his status as a shareholder provides an interest and incentive to obtain legal redress for the benefit of the corporation. Once the derivative plaintiff ceases to be a stockholder in the corporation on whose behalf the suit was brought, he no longer has a financial interest in any recovery pursued for the benefit of the corporation.

Alabama By-Products Corp. v. Cede & Co., 657 A.2d 254, 265 (Del. 1995).¹⁰

Thus, the present statutory hurdle of Section 327 and the procedural hurdle embodied in Rule 23.1, which a plaintiff must overcome before initiating a derivative suit, serve "an important policy function of promoting internal resolution, as opposed to litigation, of corporate disputes and grants the corporation a degree of control over any litigation brought for its benefit." *Rattner v. Bidzos*, 2003 WL 22284323, at *7 (Del. Ch.).

Adopting Section 7.02 of the ALI Principles, as Schoon advocates (OB at 24-25), would, as noted above, improperly impinge on the fundamental right of the **board as a whole** to manage the business and affairs of the corporation. Granting individual directors standing to bring derivative actions would shift the power to manage the corporation out of the hands of the board and into the hands of a single director, even if that single

¹⁰ Given the widespread corporate practice of granting stock or stock options to compensate directors for board service, it is unlikely that a director would "be forced to go hat in hand to the stockholders in order an effort to find a stockholder champion," as Schoon suggests (OB at 29.) The argument is absurd on these facts, as Schoon is Steel's board appointee. (OB at 7.)

director -- like Schoon -- owns no stock in, and therefore has no financial stake in, the corporation.¹¹ Any time a single director disagreed with a business decision by the board, he could file a derivative suit to seek to thwart the will of the majority of the board of directors. Use or threatened use of derivative litigation could be a tactic to negotiate a different decision than the disgruntled director's voting power and ability to persuade at a board meeting could otherwise obtain. Such leverage should not be given to a single director and, in any event, it is contrary to well-established Delaware law. This Court, therefore, should decline to adopt the minority director derivative standing rule embodied in Section 7.02 of the ALI Principles -- particularly because Delaware's General Assembly has declined to adopt the ALI Principles in the decade and a half since their final promulgation in 1992. See, e.g., *Grimes v. Donald*, 673 A.2d 1207, 1218 n.21 (Del. 1996), *overruled on other grounds*, *Brehm*, 746 A.2d 244 (recognizing that the ALI Principles are of no import where they are at odds with established Delaware jurisprudence).

Schoon further claims that "as a practical matter, a director is likely to be a superior derivative plaintiff than a stockholder" because, among other things, "he has greater information rights and the ability to access historically privileged information." (OB at 30.) This argument fails for several reasons. First, to the extent that a stockholder suspects corporate mismanagement and wants to investigate it, she can use

¹¹ One can easily imagine a scenario in which a non-stockholder director becomes a "hired gun" for any special interest constituency group of the corporation -- much as Schoon is for Steel in this litigation.

the "tools at hand" to obtain books and records of the company under 8 Del. C. § 220. See, e.g., *Seinfeld v. Verizon Communications, Inc.*, 909 A.2d 117, 122 (Del. 2006); *Rales*, 634 A.2d at 934-35 n.10. Additionally, granting individual directors standing to bring derivative suits would discourage risk taking for fear that candid discussion among disagreeing board members would create a risk of time-consuming litigation or potential liability brought by a single fellow director with the power to second-guess board decisions. Further, threatening to use otherwise privileged communications to gain advantage in litigation against other board members is hardly the kind of conduct this Court should condone.

The Court of Chancery recognized this potential harm in *Disney v. Walt Disney Co.*, 2005 WL 1538336, at * 4 (Del. Ch.):

Balanced against that benefit [of disclosure of board information] is the potential great harm to the deliberative process of the board, and the boards of directors of all Delaware corporations. If any shareholder can make public the preliminary discussions, opinions, and assessments of board members and other high-ranking employees, it would surely have a chilling effect on board deliberations. At the foundation of Delaware General Corporation Law is the presumption that, in making a business decision, the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the Company and that, absent an abuse of discretion, the courts will respect that judgment. Concomitant to this grant of deference to the directors of a corporation is the need to allow the directors the ability to deliberate openly and candidly with each other. The preliminary deliberations of a corporate board of directors generally are non-public and should enjoy "a reasonable expectation that they [will] remain private." (internal citations omitted.)

Consequently, extending individual director standing to non-stockholder directors would chill the collegial resolution of intra-corporate

disputes, and potentially result in the increased cost and frequency of derivative litigation.¹²

Furthermore, adopting Section 7.02 of the ALI Principles would inject an undesirable degree of uncertainty into Delaware law.¹³ As this Court noted in *Williams v. Geier*, 671 A.2d 1368, 1385 n.36 (Del. 1996), "[d]irectors and investors must be able to rely on the stability and absence of judicial interference with the State's statutory prescriptions." Granting individual directors standing to bring derivative actions leaves open many significant questions. For example, as noted above, will the Court adopt a rule requiring a director to make a demand upon the board? If no demand is made, what allegations

¹² The derivative litigation provisions of the ALI Principles came under attack almost immediately after they were finalized in 1992:

The derivative litigation provisions in *Principles of Corporate Governance: Analysis and Recommendations* are based upon a rejection of the otherwise well-settled principle that 'the decisions of a corporation - including the decision to initiate litigation - should be made by the board of directors or the majority of shareholders,' a distrust of corporate managers and the outside directors that oversee corporate managers, and a belief that litigation 'is ultimately a failsafe remedy' and a 'safety net for instances when other mechanisms fail.'

Dennis J. Block, Stephen A. Radin and Michael J. Maimone, *Derivative Litigation: Current Law Versus the American Law Institute*, 48 Bus. Law. 1443, 1482 (1993) (internal citations omitted).

¹³ Delaware "has a large body of case law on the intricacies of derivative litigation," E. Norman Veasey, *An Economic Rationale for Judicial Decisionmaking in Corporate Law*, 53 Bus. Law. 681, 698 (1998) (cited as Veasey). "The ALI Reporters' Proposals deviate from the Delaware model from the very inception of the [derivative] lawsuit." Michael P. Dooley and E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 Bus. Law. 503, 515 (1989).

sufficiently excuse that demand? What will happen if a director files a derivative suit and then later resigns or is removed from the board? Does the standing in such circumstances lapse and is notice required to be given to stockholders? Should standing be granted to directors for all manner of derivative claims?¹⁴ Should a stockholder be able to take over prosecution of derivative claims initiated by a director? Do any officers have a similar ability to bring such claims? No Delaware case has ever granted to non-stockholder directors the standing to sue derivatively, and holding so would require each of these questions to be addressed, either now or in the future. The General Assembly should do so in the first instance.

Finally, this is not a "paradigmatic case for director standing" as Schoon contends (OB at 32-33). Even if this Court were to accept the minority rationale espoused in Section 7.02 of the ALI Principles, this is not an appropriate "test case" in which to extend derivative standing to non-stockholder directors like Schoon. Schoon cannot represent adequately the interests of all of Troy's stockholders, given his longstanding ties as a financial advisor to non-party Steel and his efforts at Steel's behest to extract a liquidity plan from Troy.

In sum, Delaware's present body of derivative law is "strong enough to rein in directors who would flirt with an abuse of [stockholder] trust." *Veasey*, at 694. If the stockholders are not complaining about board decisions, why then should a single, disgruntled director be

¹⁴ Compare 8 *Del. C.* § 327 (setting forth narrow criteria limiting derivative standing to shareholders) with N.Y. Business Corporation Law § 720(b) (McKinney 2007) (allowing derivative suits by directors for certain actions).

afforded that right? He should not. This Court should decline to step into the shoes of the legislature by adopting the minority director standing provision found in Section 7.02 of the ALI Principles. Consistent with Delaware's "large body of case law on the intricacies of derivative litigation," *see supra* n.13, this Court should affirm the trial court's decision because Schoon does not have standing to bring derivative claims.

CONCLUSION

For the reasons set forth herein, this Court should affirm the trial court's judgment dismissing the action.

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