
Note

The Problem with Waste: Delaware's Lenient Treatment of Waste Claims at the Demand Stage of Derivative Litigation

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In 2006, Citigroup was the United States' largest financial institution.¹ Its assets were worth \$244 billion,² its share price hovered around \$54,³ and it employed over 332,000 people.⁴ Then the subprime mortgage crisis began.⁵ Starting in 2007, Citigroup posted significant losses in consecutive quarters due, in large part, to its investments in subprime mortgage-backed debt.⁶ By November 2008 Citigroup was worth only \$20.5 billion, its once significant share price settled at a measly \$3.77, and it had lost around 75,000 employees.⁷

In November 2007 while the financial crisis decimated Citigroup, its chief executive officer (CEO) and chair of the board of directors, Charles Prince, resigned.⁸ Despite Prince reigning

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1. Cf. Eric Dash & Julie Creswell, *Citigroup Pays for a Rush to Risk: Bank Saw No Red Flags Even as It Made Bolder Bets*, N.Y. TIMES, Nov. 23, 2008, at A1, available at 2008 WLNR 22348662.

2. See *id.* at A34.

3. See James Doran, "Everything on Table" in *Citigroup Crisis Talks*, GUARDIAN (London), Nov. 21, 2008, <http://www.guardian.co.uk/business/2008/nov/21/citigroup-banking>.

4. *Fortune Global 500 2007: Citigroup*, CNNMONEY, <http://money.cnn.com/magazines/fortune/global500/2007/snapshots/2927.html> (last visited Apr. 10, 2011).

5. See Dash & Creswell, *supra* note 1.

6. See Doran, *supra* note 3.

7. See Dash & Creswell, *supra* note 1.

8. See Press Release, Citigroup Inc., Robert E. Rubin to Serve as Chairman of the Board of Citi; Sir Win Bischoff to Serve as Acting Chief Executive

over Citigroup during a time when the corporation lost billions of dollars, Citigroup's board of directors granted him the substantial resignation package of "a \$10 million bonus, \$28 million in unvested stock options and \$1.5 million in yearly perks."⁹ Given Citigroup's decline and the timing and size of the departing CEO's golden parachute, it is not surprising that some of Citigroup's stockholders wanted to hold the members of its board of directors, who are the statutorily designated managers of the corporation,¹⁰ personally liable for the corporation's disastrous change of circumstances.¹¹

Citigroup is incorporated in Delaware.¹² Under Delaware corporate law, members of a board of directors owe fiduciary duties to their corporation and its shareholders.¹³ One method for shareholders to bring a lawsuit against a board of directors for a breach of these fiduciary duties is through shareholder derivative litigation, meaning that the shareholders sue the directors on behalf of the corporation.¹⁴ Delaware corporate law does not, however, make it easy to hold directors personally liable for breaches of their fiduciary duties.¹⁵ One of the protections against personal liability for directors of Delaware corporations is an exculpation clause in the corporation's certificate of incorporation.¹⁶ Exculpation clauses protect directors from liability for their business decisions on behalf of the corporation, except for, among other things, acts that violate their fiduciary duty of

Officer; Charles Prince Elects to Retire from Citi (Nov. 4, 2007), *available at* <http://www.citigroup.com/citi/press/2007/071104a.htm>.

9. See Brian Wingfield, *Puzzling Pay Packages*, FORBES, Mar. 7, 2008, http://www.forbes.com/2008/03/07/congress-executive-compensation-lead-comp-cx_bw_0307ceopay.html.

10. See DEL. CODE ANN. tit. 8, § 141(a) (2001).

11. See *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 111 (Del. Ch. 2009) (providing background on the shareholder action against Citigroup directors and officers).

12. See *id.* at 112. This Note focuses on Delaware corporate law, as most major corporations are incorporated in that state. See, e.g., Mark J. Loewenstein, *The SEC and the Future of Corporate Governance*, 45 ALA. L. REV. 783, 787 (1994).

13. See, e.g., *In re Citigroup*, 964 A.2d at 114 n.6.

14. See, e.g., *id.* at 111 (noting that the action in question was brought by shareholders "on behalf of Citigroup Inc.").

15. See, e.g., *Gagliardi v. TriFoods Int'l, Inc.*, 683 A.2d 1049, 1051–52 (Del. Ch. 1996) (acknowledging that directors are generally not responsible for corporate losses).

16. See D. GORDON SMITH & CYNTHIA A. WILLIAMS, *BUSINESS ORGANIZATIONS* 695–96 (2d ed. 2008); see also DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 2010) (providing for exculpation clauses in Delaware corporation law).

loyalty, are not in good faith, or “involve intentional misconduct or a knowing violation of law.”¹⁷ If a plaintiff does not successfully plead one of these exceptions to the coverage of an exculpation clause against directors shielded by such a clause, Delaware courts dismiss the case.¹⁸

In February 2009 the Delaware Court of Chancery decided *In re Citigroup Inc. Shareholder Derivative Litigation*, a derivative suit by Citigroup stockholders against, amongst others, directors of the corporation.¹⁹ The only claim that survived the defendants’ motion to dismiss was that the directors committed corporate waste by approving the resignation package for Charles Prince.²⁰ Given that Citigroup’s certificate of incorporation contains an exculpation clause,²¹ the survival of the waste claim suggests that waste is now a part of the obligation of good faith.²² If true, then a successfully pled waste claim will allow shareholders to hold directors personally liable for any business decisions that constitute waste, even if they are protected by an exculpation clause.²³

This Note argues that the Delaware courts should explicitly place waste under the obligation of good faith. Part I describes fiduciary duties and shareholder derivative litigation under Delaware corporate law. Part II examines the evolving procedural placement of waste within the Delaware fiduciary duty framework and the factual requirements for waste to survive a motion to dismiss for failure to make demand. Part III suggests that waste should be placed under the duty of good faith, but that a uniform heightened factual requirement is necessary to prevent the Delaware courts from infringing upon the power of directors to manage their corporations. This Note concludes that directors who commit corporate waste should not be

17. *In re Citigroup*, 964 A.2d at 124–25 (citing tit. 8, § 102(b)(7)).

18. *See, e.g.*, *Guttman v. Huang*, 823 A.2d 492, 503–07 (Del. Ch. 2003) (dismissing a complaint for failing to allege facts sufficient to support a claim that, among other things, a corporation’s officers and directors breached their duty of good faith by failing to adequately oversee the preparation of financial statements).

19. *See In re Citigroup*, 964 A.2d at 111, 139–40.

20. *See id.* at 111–12, 139–40.

21. *See id.* at 124.

22. *See id.* at 139 n.113 (“The Delaware Supreme Court has implicitly held that committing waste is an act of bad faith.” (quoting *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 749 (Del. Ch. 2005), *aff’d*, 906 A.2d 27, 75 (Del. 2006) (internal quotation marks omitted))).

23. *See DEL. CODE ANN.* tit. 8, § 102(b)(7) (Supp. 2010) (noting the obligations that directors and officers cannot evade via exculpation clauses).

afforded the protections granted by their corporation's section 102(b)(7) exculpation clause. Additionally, the Delaware courts should uniformly apply a particularized factual requirement to waste claims at the demand stage of litigation to ensure that only worthwhile claims reach discovery.

I. FIDUCIARY DUTIES AND SHAREHOLDER LITIGATION UNDER DELAWARE CORPORATE LAW

Under Delaware corporate law, members of the board of directors of a corporation are protected from many types of liability flowing from their business decisions.²⁴ While the directors are bound by numerous fiduciary duties, only some are viable bases for liability available to shareholders who desire to bring suits against individual directors.²⁵ This Part describes the protections granted to directors under Delaware corporate law, the fiduciary duties that bind the directors, and a prominent mechanism for shareholders to pursue litigation against directors.

A. THE BUSINESS JUDGMENT RULE

The directors of a Delaware corporation are protected by the judicially created business judgment rule.²⁶ This rule operates as a presumption that, in making business decisions, the board of directors acts "on an informed basis, in good faith," and with the best interests of the corporation in mind.²⁷ The rationale for the business judgment rule is that boards of directors are granted the authority to manage the corporation under Delaware law.²⁸ As such, the courts, which are considered ill

24. See Claire A. Hill & Brett H. McDonnell, *Stone v. Ritter and the Expanding Duty of Loyalty*, 76 *FORDHAM L. REV.* 1769, 1772 (2007) ("[T]he business judgment rule . . . shields corporate managers from judicial scrutiny of their decisions."); see also *In re Walt Disney (Disney V)*, 906 A.2d at 52 (describing the presumptions undergirding the business judgment rule).

25. See tit. 8, § 102(b)(7) (providing for exculpation clauses that eliminate the liability of directors for violations of their duty of care).

26. See *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985), *overruled on other grounds*, *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009).

27. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds*, *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000). *But see* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 *VAND. L. REV.* 83, 87–88 (2004) (arguing in favor of viewing the business judgment rule as an abstention doctrine).

28. See *Polk v. Good*, 507 A.2d 531, 536 (Del. 1986) (citing *DEL. CODE ANN.* tit. 8, § 141(a) (1974)).

equipped to second-guess the substantive business decisions of the board, should generally defer to their judgment.²⁹

In order for plaintiffs to rebut the presumption of the business judgment rule, they must show that the director-defendants violated one of their fiduciary duties.³⁰ If plaintiffs succeed in demonstrating such a violation, the director-defendants can only avoid liability by demonstrating that the transaction in question was “entirely fair” to the corporation.³¹ If, however, the plaintiffs fail to rebut the presumption, then Delaware courts will invoke the business judgment rule and rule in favor of the director-defendants.³²

B. DIRECTORS’ FIDUCIARY DUTIES

Directors of Delaware corporations are bound by a series of fiduciary duties. Any violation of their duty of loyalty or care, or a transaction that constitutes waste, is a basis of liability to hold the offending directors personally liable.

1. Directors’ Duty of Loyalty

Directors of Delaware corporations are under a duty of loyalty to their company.³³ The traditional aspect of the duty of loyalty obliges directors to avoid transactions that involve a financial conflict of interest.³⁴ Directors violate this duty if they act for their own benefit in a transaction that is not “substantively fair to the corporation.”³⁵ If the conflict-of-interest transaction is not ratified by fully informed directors or shareholders,³⁶ the transaction will be subject to the “entire fairness” analysis.³⁷ This analysis has two prongs: fair dealing and fair

29. See, e.g., *In re J.P. Stevens & Co. S’holders Litig.*, 542 A.2d 770, 780 (Del. Ch. 1988) (noting that the policy behind the business judgment rule provides “good reasons to minimize . . . substantive review”).

30. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 958 (Del. 1985) (stating that the business judgment rule may be rebutted by a showing that the directors violated their fiduciary duties or made a decision primarily to “perpetuate themselves in office”).

31. See, e.g., *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 371 (Del. 1993).

32. See, e.g., *Unocal Corp.*, 493 A.2d at 958–59; *Aronson*, 473 A.2d at 812.

33. 1 EDWARD P. WELCH ET AL., *FOLK ON THE DELAWARE GENERAL CORPORATION LAW*, at GCL-IV-27 (5th ed. 2006 & Supp. 2011).

34. See, e.g., *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1345 (Del. 1987); *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939).

35. 1 WELCH ET AL., *supra* note 33, at GCL-IV-29.

36. See DEL. CODE ANN. tit. 8, § 144 (2001 & Supp. 2010).

37. See, e.g., *In re Walt Disney Co. Derivative Litig. (Disney I)*, 731 A.2d 342, 367 (Del. Ch. 1998). *But see* Julian Velasco, *How Many Fiduciary Duties*

price.³⁸ The fair dealing prong requires the court to analyze the process under which the directors made the decision to approve the transaction.³⁹ Under the fair price prong, the court analyzes whether the transaction was substantively fair to the corporation.⁴⁰ It is only if the conflict of interest transaction satisfies the “entire fairness” test that the directors avoid liability for a breach of their duty of loyalty.⁴¹

Recently, the Delaware Supreme Court expanded the duty of loyalty to include the duty of good faith.⁴² Good faith was previously considered one part of a “triad” of fiduciary duties, on par with the duties of loyalty and care.⁴³ In *Stone ex rel. AmSouth Bancorporation v. Ritter*, the Delaware Supreme Court held that the duty of good faith is not a separate basis for personal liability, but, instead, is a part of the duty of loyalty.⁴⁴ As such, a violation of the duty of good faith creates personal liability for directors under the duty of loyalty.⁴⁵

The exact contours of the duty of good faith are anything but clear. In *In re Walt Disney Co. Derivative Litigation (Disney V)*, the Delaware Supreme Court established that an “intentional dereliction of duty” or a “conscious disregard for one’s responsibilities” constitutes bad faith.⁴⁶ The court was clear, however, that this definition was not exclusive of what would

Are There in Corporate Law?, 83 S. CAL. L. REV. 1231, 1242–43 (2010) (discussing some financial conflict-of-interest transactions that are not subject to the “entire fairness” test).

38. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

39. *See id.*

40. *See id.*

41. *See, e.g., id.* at 710–11. The “entire fairness” test is not an evaluation between two completely “bifurcated” factors, but rather “[a]ll aspects of the issue must be examined as a whole.” *Id.*

42. *See Stone ex rel. AmSouth Bancorp. v. Ritter*, 911 A.2d 362, 370 (Del. 2006). The duty of good faith was not the only basis for liability added to the duty of loyalty since the early 1980s. *See, e.g., Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) (introducing the standard to be applied when a board attempts to sell the corporation); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954–55 (Del. 1985) (introducing a different standard for when a board attempts to prevent a hostile takeover); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 788 (Del. 1981) (addressing the situation where the directors decide whether to pursue derivative litigation).

43. *See Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993).

44. *See Stone*, 911 A.2d at 370.

45. *See id.*

46. *Disney V*, 906 A.2d 27, 62 (Del. 2006) (quoting *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 755 (Del. Ch. 2005), *aff'd*, 906 A.2d 27, 62–67 (Del. 2006)).

constitute bad faith.⁴⁷ Thus, while the Delaware courts provided some notion of what constitutes bad faith, the full extent of the doctrine remains vague.⁴⁸

2. Directors' Duty of Care and Section 102(b)(7) Exculpation Clauses

Directors of Delaware corporations are also bound by the fiduciary duty of care.⁴⁹ The most prominent duty of care case is *Smith v. Van Gorkom*, where the Delaware Supreme Court held the director-defendants liable for a violation of their duty of care for inadequately informing themselves during the procedure to sell the corporation.⁵⁰ *Van Gorkom* established that directors violate their duty of care if they are "grossly negligent" in making a decision.⁵¹ In *Van Gorkom* and subsequent duty of care cases, the Delaware courts' duty of care analysis focused on the board's decisionmaking process, rather than the substantive decisions of the directors.⁵²

Following the Delaware Supreme Court's decision in *Van Gorkom*, liability insurance for directors rose dramatically in price, and many feared that qualified directors would avoid membership on boards due to the increased potential for incurring personal liability.⁵³ The Delaware state legislature responded to this situation by adding section 102(b)(7) exculpa-

47. See *id.* at 67 (citing *In re Walt Disney Co. Derivative Litig.*, 907 A.2d at 755–56). The *Stone* court also included a *Caremark* failure to institute monitoring and reporting systems, or to "act in the face of a known duty to act," under the bad faith rubric. *Stone*, 911 A.2d at 370 (citing *Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003)). See generally *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996) (introducing the *Caremark* fiduciary standard).

48. Cf. Andrew S. Gold, *A Decision Theory Approach to the Business Judgment Rule: Reflections on Disney, Good Faith, and Judicial Uncertainty*, 66 MD. L. REV. 398, 421–32 (2007) (stating that "[i]n light of the confusion that has surrounded the duty of good faith, *Disney V* [sic] creates a degree of clarity," but the decision "fails to discuss the appropriate standard of review").

49. See, e.g., 1 WELCH ET AL., *supra* note 33, at GCL-IV-25.

50. *Smith v. Van Gorkom*, 488 A.2d 858, 893 (Del. 1985), *overruled on other grounds*, *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009).

51. See *id.* at 874.

52. See 1 WELCH ET AL., *supra* note 33, at GCL-IV-25 to -27. Delaware courts rejected subsequent challenges to the substantive decisions of directors under the duty of care analysis. See, e.g., *Grover v. Simmons (In re Sea-Land Corp. S'holders Litig.)*, 642 A.2d 792, 807 (Del. Ch. 1993); *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 600 (Del. Ch. 1986).

53. See 1 WELCH ET AL., *supra* note 33, at GCL-I-28.

tion clauses to Delaware's corporate law.⁵⁴ If a corporation includes such a clause in its certificate of incorporation, the directors of the corporation are indemnified from personal financial liability for many violations of their fiduciary duties, including any breach of their duty of care.⁵⁵ Directors protected by an exculpation clause are not, however, protected from liability arising from, among other things, a breach of their duty of loyalty, or "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law."⁵⁶

The emergence of section 102(b)(7) exculpation clauses limits the mechanisms whereby shareholders can hold directors personally liable for their business decisions.⁵⁷ As exculpation clauses indemnify directors for a violation of their duty of care, Delaware courts dismiss any due care claims against protected directors.⁵⁸ To survive such a dismissal, the plaintiffs must properly allege that the director-defendants had a conflict of interest in the challenged transaction or acted in bad faith.⁵⁹ If the plaintiffs succeed in showing either of these, the director-defendants will lose both the protection of the business judgment rule and indemnification from the corporation's section 102(b)(7) exculpation clause.⁶⁰ As most Delaware corporations now have section 102(b)(7) exculpation clauses in their certificates,⁶¹ plaintiffs who wish to hold directors personally liable for their business decisions must find ways to properly allege a violation of the duty of loyalty, including bad faith, to survive the director-defendants' motion to dismiss.⁶² While a violation

54. See Hill & McDonnell, *supra* note 24, at 1772.

55. See DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 2010).

56. *Id.*

57. See *id.*

58. See *Emerald Partners v. Berlin*, 787 A.2d 85, 91 (Del. 2001) (noting that "Delaware courts have consistently held" that exculpation clauses protect directors against due care claims). A claim that is not *solely* based upon the duty of care, on the other hand, is not subject to dismissal due to the presence of a section 102(b)(7) exculpation clause in the corporation's certificate. See *Malpiede v. Townson*, 780 A.2d 1075, 1095 (Del. 2001).

59. See, e.g., *In re LNR Prop. Corp. S'holders Litig.*, 896 A.2d 169, 178–79 (Del. Ch. 2005) ("[An exculpation clause] does not provide protection against claims based on . . . acts or omissions not in good faith and violations of the fiduciary duty of loyalty.").

60. Cf. Hill & McDonnell, *supra* note 24, at 1773.

61. Clark W. Furlow, *Reflections on the Revlon Doctrine*, 11 U. PA. J. BUS. L. 519, 564 (2009).

62. See Gold, *supra* note 48, at 432–33 ("An allegation of bad faith may be the sole route to director liability in many instances of corporate litigation, assuming directors do not have a conflict of interest.").

of the duty of loyalty is now clearly a viable claim for plaintiffs to hold directors liable, the question remains as to the types of loyalty claims available to shareholders to bring suit against directors.

3. The Waste Standard

Directors of Delaware corporations are under an obligation not to waste corporate assets.⁶³ Plaintiffs meet the waste standard if they demonstrate that the director-defendants authorized an exchange that was “so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.”⁶⁴ A Delaware court will only find waste in the “rare, ‘unconscionable case where directors irrationally squander or give away corporate assets.’”⁶⁵ This exacting standard is extremely difficult, if not impossible, to meet.⁶⁶ If the shareholder-plaintiffs succeed in demonstrating waste, the business judgment rule will no longer protect the director-defendants.⁶⁷

63. See, e.g., *Rogers v. Hill*, 289 U.S. 582, 591–92 (1933); *Gottlieb v. Heyden Chem. Corp.*, 90 A.2d 660, 663–64 (Del. 1952); *Saxe v. Brady*, 184 A.2d 602, 610 (Del. Ch. 1962).

64. *Disney V*, 906 A.2d 27, 74 (Del. 2006) (quoting *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000)). For a claim of corporate waste to survive a motion to dismiss, the complaint must allege “facts showing the corporation received no consideration, or that a transfer of corporate assets served no corporate purpose.” Official Comm. of Unsecured Creditors of Integrated Health Servs., Inc. v. Elkins, No. Civ. A. 20228-NC, 2004 WL 1949290, at *17 (Del. Ch. Aug. 24, 2004). See generally *Brehm*, 746 A.2d at 263 (“If . . . there is *any substantial* consideration received by the corporation, and if there is a *good faith judgment* that in the circumstances the transaction is worthwhile, there should be no finding of waste, even if the fact finder would conclude *ex post* that the transaction was unreasonably risky.” (quoting *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997))).

65. *Disney V*, 906 A.2d at 74 (quoting *Brehm*, 746 A.2d at 263).

66. See *Gagliardi v. TriFoods Int’l, Inc.*, 683 A.2d 1049, 1051–52 (Del. Ch. 1996) (describing waste as “theoretical”); *Steiner v. Meyerson*, Civ. A. No. 13139, 1995 WL 441999, at *5 (Del. Ch. July 19, 1995) (“But rarest of all—and indeed, like Nessie, possibly non-existent—would be the case of disinterested business people making non-fraudulent deals (non-negligently) that meet the legal standard of waste!”). But see *Brehm*, 746 A.2d at 263 (“[W]e do not foreclose the possibility that a properly framed complaint [alleging waste] could pass muster.”); *Fidanque v. Am. Maracaibo Co.*, 92 A.2d 311, 321 (Del. Ch. 1952) (holding that a salary decision by directors was a gift of corporate funds “amounting to waste”). See generally *Velasco*, *supra* note 37, at 1235 (“[Waste is] the most deferential standard of all.”).

67. Cf., e.g., *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) (“A board of directors enjoys a presumption of sound business judgment, and its

The difficulty of proving waste is a reflection of the pervasiveness of the business judgment rule and its tenet that, absent allegations of fraud or conflict of interest, Delaware courts will not second-guess the substantive decisions of boards.⁶⁸ Waste is the exception to this rule and forces the court to analyze the substantive decision of the defendants.⁶⁹ The waste exception, therefore, functions as a means to “police[] the outer boundaries” of the discretion granted to a board of directors under Delaware corporate law.⁷⁰ It is not entirely clear where waste falls within the Delaware fiduciary duty doctrinal framework.

C. SHAREHOLDER DERIVATIVE LITIGATION

Shareholders who wish to bring suit against directors of a corporation for breaches of fiduciary duties will typically pursue a derivative action.⁷¹ Shareholder derivative litigation is equivalent to the shareholder-plaintiff compelling the corporation to sue the director-defendants for harm done to the corporation.⁷² As the corporation is technically the plaintiff, any recovery gained through derivative litigation goes to the corporation, rather than to the shareholder-plaintiffs.⁷³ The shareholder-plaintiffs benefit through both their share in the corporation and, more importantly, the grant of attorneys’ fees

decisions will not be disturbed if they can be attributed to any rational business purpose.”).

68. *Steiner*, 1995 WL 441999, at *5; see also Jaclyn J. Janssen, *In re Walt Disney Company Derivative Litigation: Why Stockholders Should Not Put Too Much Faith in the Duty of Good Faith to Enhance Director Accountability*, 2004 WIS. L. REV. 1573, 1597 (“[C]ourts are reluctant to undertake a substantive review of director decisions.”).

69. See *Gagliardi*, 683 A.2d at 1051–52.

70. *Sample v. Morgan*, 914 A.2d 647, 669 (Del. Ch. 2007).

71. See *Bird v. Lida, Inc.*, 681 A.2d 399, 403 (Del. Ch. 1996). To pursue derivative litigation, the plaintiffs must be shareholders in the corporation. See DEL. CODE ANN. tit. 8, § 327 (2001). Some claims, including corporate waste, may only be brought in derivative actions. *Kramer v. W. Pac. Indus., Inc.*, 546 A.2d 348, 353 (Del. 1988) (holding that any claim of waste “is entirely derivative in nature”). Shareholders may also bring direct suits against directors for many claims, but this approach is frequently undesirable due to standing requirements, see *Moran v. Household Int’l, Inc.*, 490 A.2d 1059, 1070 (Del. Ch. 1985) (citing *Condec Corp. v. Lunkenheimer Co.*, 230 A.2d 769, 777 (Del. Ch. 1967)), and the small relative benefit for each shareholder in bringing a direct suit, see *Bird*, 681 A.2d at 402–03.

72. *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1036 (Del. 2004).

73. *Sternberg v. O’Neil*, 550 A.2d 1105, 1124 (Del. 1988).

if the litigation is successful.⁷⁴ The downside of these attorneys' fees is that some plaintiffs and lawyers will bring frivolous lawsuits against directors to gain the fees.⁷⁵

To ensure that only worthwhile derivative suits reach trial and to protect the deference granted to directors of Delaware corporations to manage their company, the Delaware courts utilize the demand requirement.⁷⁶ Under the demand requirement, shareholders of a corporation who wish for the corporation to bring suit against its directors have two options.⁷⁷ First, they may ask the board of directors to sue the director-defendants.⁷⁸ This is problematic, in that the board is not likely to sue its own members.⁷⁹ Additionally, the courts will defer to the board's business judgment in refusing the plaintiff's demand.⁸⁰

The second option for shareholders is to forego demand and claim demand futility.⁸¹ If shareholder-plaintiffs do not bring

74. See *Bird*, 681 A.2d at 403.

75. See William M. Lafferty & W. Leighton Lord III, *Towards a Relaxed Summary Judgment Standard for the Delaware Court of Chancery: A New Weapon Against "Strike" Suits*, 15 DEL. J. CORP. L. 921, 925 (1990); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 65 (1991) (arguing that attorneys are the primary beneficiaries of derivative suits); Mark D. West, *Why Shareholders Sue: The Evidence from Japan*, 30 J. LEGAL STUD. 351, 351 (2001) ("Shareholders seldom profit—suits are filed because their attorneys stand to reap substantial fees."). But see Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747, 1749–50 (2004) (arguing that most derivative suits are not strike suits).

76. See *Aronson v. Lewis*, 473 A.2d 805, 811–12 (Del. 1984), *overruled on other grounds*, *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); cf. *Jones v. Taylor*, 348 A.2d 188, 191 (Del. Ch. 1975) (describing the shareholder-standing requirement, enumerated in title 8, section 327 of the Delaware Code, as an additional method to eliminate strike suits).

77. See *Kaplan v. Peat, Marwick, Mitchell & Co.*, 540 A.2d 726, 730 (Del. 1988).

78. See DEL. CT. CH. R. 23.1(a) ("[Complaints in derivative actions must] allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority.").

79. See George W. Dent, Jr., *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW. U. L. REV. 96, 139 (1980).

80. See *Zapata Corp. v. Maldonado*, 430 A.2d 779, 784 n.10 (Del. 1981) ("[W]hen stockholders, after making demand and having their suit rejected, attack the board's decision as improper, the board's decision falls under the 'business judgment' rule and will be respected if the requirements of the rule are met.").

81. See DEL. CT. CH. R. 23.1(a) (stating that complaints in derivative actions, after listing any efforts made to compel directors to take action, must

demand, the director-defendants can, and usually will, bring a motion to dismiss for failure to make demand pursuant to Delaware Court of Chancery Rule 23.1.⁸² To avoid dismissal of the derivative suit, the shareholder-plaintiffs must satisfy the test used in *Aronson v. Lewis*, which requires that they allege “with particularity”⁸³ facts that raise a reasonable doubt that either a majority of “the directors are disinterested and independent,” or “the challenged transaction was otherwise the product of a valid exercise of business judgment.”⁸⁴ The court draws all reasonable inferences in favor of the plaintiff, but it accepts as true only well-pled factual allegations that do not include conclusory statements.⁸⁵ The ability of the shareholders to prove one of these *Aronson* prongs is limited, as they do not have the luxury of full discovery.⁸⁶

If the shareholder-plaintiffs fail to prove one of the *Aronson* prongs, the court will rule that demand was not futile and the shareholders must make demand on the board before they can bring a derivative action against the directors.⁸⁷ If, however, the shareholder-plaintiffs survive the motion to dismiss for failure to make demand, the director-defendants are more likely to settle to avoid further litigation⁸⁸ and the risk that the shareholder-plaintiffs will gain additional support for their

give the plaintiff’s reasons for “failure to obtain the action” or “not making the effort”).

82. See Thomas P. Kinney, *Stockholder Derivative Suits: Demand and Futility Where the Board Fails to Stop Wrongdoers*, 78 MARQ. L. REV. 172, 177 (1994). See generally *Solomon v. Pathe Commc’ns Corp.*, 672 A.2d 35, 39 (Del. 1996) (“Delaware courts have recognized that the standard to be used to evaluate a Chancery Rule 12(b)(6) motion is less stringent than the standard applied when evaluating whether a pre-suit demand has been excused in a stockholder derivative suit filed pursuant to Chancery Rule 23.1.”).

83. DEL. CT. CH. R. 23.1.

84. *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984), *overruled on other grounds*, *Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000).

85. See *Brehm*, 746 A.2d at 254.

86. See, e.g., *Levine v. Smith*, 591 A.2d 194, 208–10 (Del. 1991). At the demand stage, shareholder-plaintiffs are limited to section 220 discovery, which permits them to check the books and records of the corporation. *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1056 (Del. 2004).

87. See *Aronson*, 473 A.2d at 814 (construing DEL. CT. CH. R. 23.1).

88. See *Gagliardi v. TriFoods Int’l, Inc.*, 683 A.2d 1049, 1054 (Del. Ch. 1996). *But see Zapata Corp. v. Maldonado*, 430 A.2d 779, 788–89 (Del. 1981) (describing the role of special litigation committees, which may be used to dismiss derivative actions before or after demand is excused).

claims once they have access to full discovery.⁸⁹ As such, demand futility is often the main battleground in shareholder derivative litigation.⁹⁰

In their attempt to hold director-defendants personally liable through derivative suits, shareholder-plaintiffs need to pursue claims that allege a violation of fiduciary duties that Delaware courts will not dismiss pursuant to section 102(b)(7) clauses. If waste falls under the duty of loyalty, it will serve as a viable means to avoid dismissal due to the protection of exculpation clauses.

II. THE CURRENT STATUS OF THE WASTE DOCTRINE

The Delaware courts did not officially rule on whether waste falls under the duty of care (exculpable) or the duty of loyalty (nonexculpable). If, as recent cases indicate, waste falls under the duty of loyalty through the duty of good faith, the question becomes how difficult it is for shareholder-plaintiffs' waste claims to survive the director-defendants' 23.1 motion to dismiss for failure to make demand. Surprisingly, in spite of supposedly stringent pleading requirements, some Delaware courts permitted waste claims to survive past 23.1 motions with little factual support.⁹¹ Thus, waste serves as a viable vehicle for shareholder-plaintiffs to survive a motion to dismiss for failure to make demand and reach discovery, as well as a better settlement position. This Part describes the Delaware courts' procedural treatment of waste and the level of factual support courts required for waste claims to survive the demand stage of derivative litigation.

A. THE PROCEDURAL PLACEMENT OF WASTE IN THE DELAWARE FIDUCIARY DUTY FRAMEWORK

While the Delaware courts clearly stated that waste and good faith are connected, the Delaware Supreme Court failed to explicitly address the doctrinal placement of waste. This avoidance leaves open the question of whether directors protected by

89. *Cf. Beam*, 845 A.2d at 1056 (noting the limitations on discovery during the demand futility stage of litigation).

90. *See, e.g., Gagliardi*, 683 A.2d at 1054–55 (discussing the factors that cause few derivative suits to reach trial).

91. *See, e.g., Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 901–02 (Del. Ch. 1999) (discussing the policy of permitting waste claims to survive the demand stage with little support).

section 102(b)(7) exculpation clauses are liable for waste claims.

Until 2001, the Delaware Court of Chancery provided conflicting opinions regarding the role of waste in the Delaware fiduciary duty framework.⁹² For example, in *Emerald Partners v. Berlin*, the court of chancery strongly indicated that waste was a part of good faith.⁹³ The plaintiff's complaint alleged that the director-defendants committed waste by approving a transfer of assets to another director for little or no compensation to the corporation.⁹⁴ The court ruled that, if the director-defendants committed waste, section 102(b)(7) "would not protect them from personal liability because they would have acted in bad faith."⁹⁵ Thus, *Emerald Partners* indicates that waste falls under the duty of good faith.

Despite the ruling in *Emerald Partners*, the court of chancery continued to disagree about the doctrinal placement of waste. In *Green v. Phillips*, the plaintiffs alleged that the director-defendants committed waste by approving a salary for a former director in exchange for an agreement not to compete or divulge the company's confidential secrets.⁹⁶ The court of chancery dismissed the waste claim, holding that a showing of waste did not implicate the duty of good faith and the directors were protected from a waste claim by their corporation's section 102(b)(7) clause.⁹⁷ The court distinguished the court of chancery's decision in *Emerald Partners* by stating that "the waste claim alleged there did bring the directors' loyalty and good faith into question."⁹⁸ Thus, the *Green* decision indicates that some, but not all, claims of waste will implicate bad faith.

In *White v. Panic*, the Supreme Court of Delaware addressed the topic of waste, but failed to provide clarity on

92. Cf. John L. Reed & Matt Neiderman, "Good Faith" and the Ability of Directors to Assert § 102(b)(7) of the Delaware General Corporation Law as a Defense to Claims Alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty, 29 DEL. J. CORP. L. 111, 112 & n.3, 117-18 (2004) (comparing the treatment of Delaware courts in permitting section 102(b)(7) exculpation clauses to protect directors from claims of waste).

93. *Emerald Partners v. Berlin*, Civ. A. No. 9700, 1993 WL 545409, at *8 (Del. Ch. Dec. 23, 1993).

94. *See id.* at *1-2.

95. *Id.* at *8.

96. *Green v. Phillips*, Civil Action No. 14436, 1996 WL 342093, at *2 (Del. Ch. June 19, 1996).

97. *See id.* at *6-7.

98. *Id.* at *7.

waste's procedural placement.⁹⁹ In comparing waste and good faith, the *White* court stated that both standards are "similar" in that each requires a "reasonableness" determination—whether no reasonable person would make the decision.¹⁰⁰ This opinion indicates that, rather than waste showing bad faith, good faith and waste may be roughly synonymous.¹⁰¹ Additionally, the court avoided the issue of whether a corporation's section 102(b)(7) clause would bar liability for waste, thereby continuing the ambiguity regarding the placement of waste within Delaware's fiduciary duty framework.¹⁰²

The court of chancery nonetheless interpreted the *White* decision as indicating that waste is a part of the duty of good faith. In *In re Walt Disney Co. Derivative Litigation (Disney IV)*, the court of chancery stated that *White* provided an implicit recognition that waste falls under the duty of good faith.¹⁰³ On appeal, the Delaware Supreme Court addressed the waste issue, but curiously failed to address the court of chancery's reference to the doctrinal placement of waste.¹⁰⁴ Subsequently, the court of chancery continued to interpret *White* as implicitly providing that waste falls under the duty of good faith.¹⁰⁵ Indeed, in the court of chancery's recent *Citigroup* decision, Chancellor Chandler cited the *Disney IV* opinion as justification to avoid dismissal of the plaintiff's waste claim, despite the presence of a section 102(b)(7) exculpation clause.¹⁰⁶ Nonetheless, the *Citigroup* court used skeptical language, indicating that the issue regarding the procedural placement of waste is still not definitively settled.¹⁰⁷

99. *White v. Panic*, 783 A.2d 543, 554 n.36 (Del. 2001).

100. *See id.*

101. In *Brehm v. Eisner*, the Delaware Supreme Court maintained that the methods to prove waste and good faith are similar. *See* 746 A.2d 244, 264 (Del. 2000) ("Irrationality may be the functional equivalent of the waste test or it may tend to show that the decision is not made in good faith . . .").

102. *See White*, 783 A.2d at 555 n.43 ("Because the Court of Chancery did not discuss the effect of this provision in this case and because our conclusion obviates the need to reach this issue, we do not address it here.")

103. *In re Walt Disney Co. Derivative Litig. (Disney IV)*, 907 A.2d 693, 749 (Del. Ch. 2005), *aff'd*, 906 A.2d 27, 75 (Del. 2006) ("The Delaware Supreme Court has implicitly held that committing waste is an act of bad faith. It is not necessarily true, however, that every act of bad faith by a director constitutes waste." (citing *White*, 783 A.2d at 553–55)).

104. *See Disney V*, 906 A.2d 27, 73–75 (Del. 2006).

105. *See In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 139 n.113 (Del. Ch. 2009).

106. *See id.* (citing *Disney IV*, 907 A.2d at 749).

107. *See id.* ("I am also *not convinced* that defendants would be exculpated

The court of chancery decisions in *Disney IV* and *Citigroup* indicate that waste is a part of the duty of good faith, which means that directors are not protected from waste claims by their corporations' section 102(b)(7) exculpation clauses. Despite the significance of the placement of waste under good faith, the Delaware Supreme Court has yet to explicitly address the court of chancery's interpretation of its decision in *White*. The continued avoidance by the Delaware Supreme Court of the doctrinal position of waste is unfortunate, given the implications of the *Disney IV* and *Citigroup* decisions for the protections of directors under section 102(b)(7) exculpation clauses.

B. THE ABILITY OF PLAINTIFFS ALLEGING WASTE TO SUCCEED IN DEMONSTRATING DEMAND FUTILITY

If waste falls under the duty of good faith and is, therefore, not an exculpable claim, the question becomes how difficult it is for plaintiffs alleging waste to survive motions to dismiss for failure to make demand. Despite the steep factual requirements of the *Aronson* test and the difficulty in succeeding with a waste claim at trial, the Delaware courts are often lenient in the facts required for a waste claim to survive the demand stage of derivative litigation.¹⁰⁸

A plaintiff who seeks to avoid making demand on the board must demonstrate demand futility under the *Aronson* test.¹⁰⁹ The first prong of the *Aronson* test mandates that the plaintiff must create a "reasonable doubt" that a majority of the board is not "disinterested and independent."¹¹⁰ A plaintiff who brings a waste claim will attempt to satisfy the second prong and create a "reasonable doubt" that "the challenged transaction was otherwise the product of a valid exercise of business judgment."¹¹¹ Both prongs require that the plaintiff make particularized factual allegations to demonstrate demand futility.¹¹²

The Delaware courts are strict in the level of factual allegations required to survive a motion to dismiss for failure to

under *Citigroup's* certificate for committing waste." (emphasis added)).

108. See, e.g., *Weiss v. Swanson*, 948 A.2d 433, 450 (Del. Ch. 2008).

109. *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984), *overruled on other grounds*, *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

110. *Id.*

111. *Id.*

112. *Id.*

make demand under the first prong of the *Aronson* test.¹¹³ Delaware courts found that many potential indications that directors have a stake in a transaction are insufficient to demonstrate that they are not “disinterested and independent.”¹¹⁴

Despite the high level of factual support required for a plaintiff to survive under the first prong of the *Aronson* test, the Delaware courts demonstrated inconsistency in the facts necessary for a claim of waste to bypass demand under the second *Aronson* prong.¹¹⁵ Many Delaware courts are hesitant to dismiss claims of waste, as they are fact-specific allegations.¹¹⁶ This approach permits plaintiffs who claim waste to survive to discovery, even if the claim is “barely supported by the record.”¹¹⁷

Examples illustrate the ease with which some waste claims survive demand. In *Emerald Partners*, the shareholder-plaintiffs supported their allegation of waste by noting that auditor reports showing a transfer of corporate assets did not note any return compensation for the corporation.¹¹⁸ Despite the contention of the defendants that this omission did not mean there was no return compensation, the court of chancery drew

113. See, e.g., *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1057 (Del. 2004).

114. Under the first prong of the *Aronson* test, “it is not enough to charge that a director was nominated by or elected at the behest of those controlling the outcome of a corporate election.” 473 A.2d at 816. Additionally, it is insufficient to only allege domination or control. *Id.* Instead, the plaintiff must “allege particularized facts manifesting ‘a direction of corporate conduct in such a way as to comport with the wishes or interests of the corporation (or persons) doing the controlling.’” *Id.* (quoting *Kaplan v. Centex Corp.*, 284 A.2d 119, 123 (Del. Ch. 1971)).

115. Cf. *Reed & Neiderman*, *supra* note 92, at 117 (“Delaware cases involving the effect of a § 102(b)(7) charter provision on allegations of waste have held that some, but not all, claims for monetary damages based on a theory of waste may be subject to dismissal in light of an exculpatory provision.”).

116. See, e.g., *Michelson v. Duncan*, 407 A.2d 211, 223 (Del. 1979) (“Claims of gift or waste of corporate assets are seldom subject to disposition by summary judgment . . .”); *Gottlieb v. McKee*, 107 A.2d 240, 243 (Del. Ch. 1954) (stating that the determination of a gift of corporate assets is “largely a question of fact”). *But see Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 902 (Del. Ch. 1999) (criticizing the policy of permitting waste claims past the summary judgment stage of litigation); *Lewis v. Vogelstein*, 699 A.2d 327, 338–39 (Del. Ch. 1997) (stating that some claims of waste may be dismissed before discovery).

117. *Schreiber v. Carney*, 447 A.2d 17, 27 (Del. Ch. 1982); see also *Harbor Fin. Partners*, 751 A.2d at 902 (“[Waste] claims with no genuine likelihood of success can make it to discovery and perhaps to trial.”).

118. *Emerald Partners v. Berlin*, Civ. A. No. 97000, 1993 WL 545409, at *6 (Del. Ch. Dec. 23, 1993).

the inference in favor of the plaintiffs and denied the director-defendants' motion to dismiss for failure to make demand.¹¹⁹ Thus, the court did not require the shareholder-plaintiffs to allege particularized facts demonstrating a lack of compensation, but, instead, was willing to construe the omission in the auditor reports in favor of the plaintiffs.¹²⁰

In *Weiss v. Swanson*, the plaintiff alleged that the director-defendants committed waste by granting themselves stock options without a valid corporate purpose, but the plaintiff failed to provide evidence indicating the lack of purpose.¹²¹ Even though the court recognized the steep hurdle plaintiffs must meet to succeed on waste claims at trial, Vice Chancellor Lamb was remarkably lenient with the level of deference granted to the plaintiff's waste claim.¹²² Indeed, the vice chancellor permitted the waste claim to survive the motion to dismiss for failure to make demand because he could not "conclude that there is no reasonably conceivable set of facts under which [plaintiff] could prove a claim of waste."¹²³ Thus, the court did not require particularized facts demonstrating that there was no corporate purpose behind the stock options.

Additionally, the recent decision of the Delaware Court of Chancery in *Citigroup* illustrates the leniency afforded to plaintiffs who assert demand futility under the second prong of the *Aronson* test. In *Citigroup*, the plaintiffs alleged that the board committed waste in the level of compensation granted to the departing CEO, Prince.¹²⁴ The court of chancery denied the director-defendants' motion to dismiss for failure to make demand despite the plaintiffs' failure to provide particularized factual allegations with regard to the amount that Prince was given, or the value of compensation afforded to the corporation.¹²⁵ The court's decision to allow the waste claim to proceed to discovery without these facts illustrates the ease with which some claims of waste may survive rule 23.1 motions to dismiss.

119. *Id.* at *6-7.

120. *See id.* at *6.

121. *Weiss v. Swanson*, 948 A.2d 433, 450 (Del. Ch. 2008).

122. *See id.*

123. *Id.*

124. *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 138 (Del. Ch. 2009).

125. *Id.* ("I am left with very little information regarding (1) how much additional compensation Prince actually received as a result of the letter agreement and (2) the real value, if any, of the various promises given by Prince.")

These examples show that Delaware courts do not always require particularized factual allegations to permit a claim of waste to survive demand under the second *Aronson* prong. This low factual requirement is poorly chosen, considering that waste is theoretically the most deferential standard for director-defendants.¹²⁶

Not all waste claims survive the defendants' motion to dismiss for failure to make demand.¹²⁷ Claims of waste failed due to procedural mistakes,¹²⁸ or a poorly crafted complaint.¹²⁹ Additionally, some Delaware decisions employed a heightened requirement of particularized factual allegations that was similar to those required under the first prong of the *Aronson* test.¹³⁰ Finally, Delaware courts also dismissed claims of waste on the vague grounds that the complaint made conclusory allegations.¹³¹ Nonetheless, the dismissal of waste claims by some courts merely indicates that the Delaware courts differ in the level of factual allegations required for a waste claim to survive a rule 23.1 motion.¹³²

The ease with which some Delaware courts permit claims of waste to proceed past the demand stage of derivative litigation is shown in the success rates of waste claims. A 2001 study of 124 derivative claims challenging executive compensation packages in both public and closely held corporations shows that, including all stages of litigation,¹³³ waste claims succeed in Delaware at a similar rate to duty of loyalty and care

126. See *Steiner v. Meyerson*, Civ. A. No. 13139, 1995 WL 441999, at *1 (Del. Ch. July 19, 1995) (“[Waste is] an extreme test, very rarely satisfied by a shareholder plaintiff.”).

127. See, e.g., *In re Citigroup*, 964 A.2d at 137 (dismissing a claim of waste that included allegations that the board repurchased stock at market value, which the court construed, in and of itself, to indicate a rational decision).

128. See, e.g., *Gagliardi v. TriFoods Int'l, Inc.*, 683 A.2d 1049, 1054 (Del. Ch. 1996) (dismissing the waste claim because the plaintiffs previously made demand on the board).

129. See *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000).

130. See, e.g., *White v. Panic*, 783 A.2d 543, 555 (Del. 2001).

131. See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 817 (Del. 1984), *overruled on other grounds*, *Brehm*, 746 A.2d 244.

132. Cf. *Reed & Neiderman*, *supra* note 92, at 117.

133. See Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569, 583 (2001) (“[W]e define success as defeating a motion to dismiss for failure to make demand, a motion to dismiss for failure to state a claim, or a motion for summary judgment, or prevailing at trial or on appeal.”).

claims.¹³⁴ This success rate is astonishingly high, considering that it includes the postdemand stage portions of litigation where it is extremely difficult for plaintiffs to succeed with waste claims.¹³⁵

This analysis indicates two findings. First, the waste standard in Delaware corporate law is arguably a part of the duty of good faith, which is not exculpable under a corporation's section 102(b)(7) clause. Second, some Delaware courts do not require particularized factual allegations for a waste claim to survive a rule 23.1 motion to dismiss for failure to make demand. Together, these two factors permit plaintiffs who bring waste claims to both avoid exculpation clauses and survive the demand stage of derivative litigation without alleging particularized factual allegations, thereby creating a means to effectively avoid the demand requirement.

III. RECOMMENDED ADJUSTMENTS TO DELAWARE'S APPROACH TO WASTE

This Note recommends that the Delaware courts explicitly place waste under the duty of good faith. The Delaware courts should also uniformly apply the particularized factual allegation requirement to ensure that only the most worthwhile waste claims survive a rule 23.1 motion to dismiss for failure to make demand.

A. WASTE BELONGS UNDER THE DUTY OF GOOD FAITH

Delaware courts should remove the current fog of ambiguity around the waste standard and explicitly state that waste is a part of the duty of good faith.¹³⁶ While there are substantial public policy arguments against permitting courts to review the

134. The Thomas and Martin study of cases between 1912 and 2000, *id.* at 573, found that waste claims succeeded in twenty-nine percent of the Delaware cases, *id.* at 583, compared to twenty-seven percent for duty of care claims, *id.* at 582, and thirty percent for duty of loyalty claims, *id.* at 585. Additionally, the study found that plaintiffs raised waste claims in more cases (ninety-seven out of 124) than duty of care (twenty out of 124) or loyalty (eighty-two out of 124) claims. *Id.* at 583.

135. *Cf. Gagliardi v. TriFoods Int'l, Inc.*, 683 A.2d 1049, 1051–52 (Del. Ch. 1996) (describing the difficulty plaintiffs face when bringing a waste claim at trial).

136. Some commentators argue that waste should fall under the duty of care, rather than the duty of loyalty. *E.g.*, DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* 84–90 (5th ed. 1998). *See generally Brehm*, 746 A.2d at 262–63 (finding that plaintiff's "substantive due care" claim was actually a waste claim).

substantive decisions of directors, these concerns are misguided, as waste only applies to indefensible director decisions.

An explicit ruling that places waste under good faith would provide a new mechanism for shareholders to hold directors accountable for their irrational business decisions. The economic crisis that began in 2007 and the ensuing dramatic detrimental impact upon shareholders¹³⁷ demonstrate the need to make adjustments to the ways that directors manage corporations.¹³⁸ By placing waste under the duty of good faith, waste would become a viable vehicle for shareholders to bring derivative suits against directors, even if they are protected by section 102(b)(7) exculpation clauses.¹³⁹ This could have several important ramifications.

First, shareholders would be able to hold directors who make irrational business decisions personally accountable for the harm they cause to the corporation through those decisions.¹⁴⁰ Waste is a stringent standard, so it would only be a viable claim for completely unreasonable decisions.¹⁴¹ Nonetheless, recent decisions of boards and their impact upon the shareholders of corporations,¹⁴² as well as both the national and world economies,¹⁴³ indicate that a claim that addresses ir-

137. Cf. Dash & Creswell, *supra* note 1, at (describing the decline in Citigroup's share price during the economic crisis).

138. There is an ongoing debate regarding whether the directors of Delaware corporations that sustained substantial losses in the financial crisis also suffered significant personal financial harm, perhaps indicating that additional regulatory mechanisms are inappropriate. Compare Lucian A. Bebchuk et al., *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000–2008*, 27 YALE J. ON REG. 257, 257 (2010) (finding that executives at Bear Stearns and Lehman Brothers avoided substantial personal financial losses during the crisis), with Rüdiger Fahlenbrach & René M. Stulz, *Bank CEO Incentives and the Credit Crisis* 1–2 (Charles A. Dice Ctr. for Research in Fin. Econ., Working Paper No. 2009-13, 2010), available at <http://www.ssrn.com/abstract=1439859> (finding that CEOs at corporations that experienced significant losses during the crisis also suffered substantial personal financial harm).

139. See DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 2010) (stating that the provision does not apply to “acts or omissions not in good faith”).

140. Cf. Lawrence A. Cunningham, *Commonalities and Prescriptions in the Vertical Dimension of Global Corporate Governance*, 84 CORNELL L. REV. 1133, 1183 (1999) (arguing that the deference to decisions of directors under the business judgment rule creates a “lack of accountability”).

141. See, e.g., *Saxe v. Brady*, 184 A.2d 602, 610 (Del. Ch. 1962).

142. See Dash & Creswell, *supra* note 1.

143. Cf. *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 112–13 (Del. Ch. 2009) (describing some aspects of the economic downturn).

rational decisions may be a necessary and viable mechanism of accountability.

Second, the placement of waste under the duty of good faith would provide a means to empower the shareholders of Delaware corporations. If corporations' exculpation clauses protect directors from claims of waste, shareholders will lose a means to constrain the irrational decisions of board members.¹⁴⁴ By placing waste under good faith, the Delaware courts will permit shareholders to protect both their individual interests and the interests of the corporation against directors who choose to make irrational decisions with significant detrimental impacts.¹⁴⁵

Third, an explicit statement by the Delaware courts that waste falls under the duty of good faith may change the culture of Delaware's corporations.¹⁴⁶ Directors who commit waste would not be able to hide behind exculpation clauses.¹⁴⁷ The threat of personal liability may force directors to avoid irrational and indefensible decisions, while still permitting boards discretion for the vast majority of their decisions.¹⁴⁸ Such an adjustment to board culture and decisions is warranted, as evidenced by the recent economic crisis.¹⁴⁹

144. Cf. D.A. Jeremy Telman, *The Business Judgment Rule, Disclosure, and Executive Compensation*, 81 TUL. L. REV. 829, 886 (2007) (arguing that, outside the situation where discovery would harm the corporation, the business judgment rule and the deference granted to the decisions of boards by the Delaware courts "impedes the adjudication of shareholder rights and interests" and "prevents shareholder actions from constraining boards").

145. Cf. Joel Seligman, *Rethinking Private Securities Litigation*, 73 U. CIN. L. REV. 95, 135 (2004) (arguing for a stronger waste standard to curb excessive compensation packages).

146. See Andrew S. Gold, *The New Concept of Loyalty in Corporate Law*, 43 U.C. DAVIS L. REV. 457, 518–22 (2009) (discussing the role of Delaware judicial decisions on directors internalizing new notions of the duty of loyalty).

147. See, e.g., *In re LNR Prop. Corp. S'holders Litig.*, 896 A.2d 169, 178–79 (Del. Ch. 2005).

148. Cf. Gold, *supra* note 48, at 444 ("Proponents of enhanced judicial scrutiny in good faith cases point to the incentive effects of a more stringent standard of review."). Commentators also suggest that directors merely complying with recent notions of loyalty may increase trust "among corporate directors, their shareholders, and other interested parties." Gold, *supra* note 146, at 509.

149. Cf. Dash & Creswell, *supra* note 1 (discussing decisions and a lack of oversight that led Citigroup into financial difficulties). *But see* Desimone v. Barrows, 924 A.2d 908, 931–32 (Del. Ch. 2007) ("[The] justified concern that concepts of fiduciary duty not be used in an unprincipled and wholly-elastic way to reach any and all behavior that, upon first blush, strikes judges as inappropriate.").

Fourth, the placement of waste under the duty of good faith will serve to simplify Delaware's system of fiduciary duties. The Delaware Supreme Court demonstrated an interest in simplifying the fiduciary duty framework in *Stone v. Ritter* by making good faith a part of the duty of loyalty.¹⁵⁰ Removing waste from its current procedural limbo and placing it under good faith will further this simplification by creating only two overarching fiduciary duties in Delaware corporate law: the duties of loyalty and care.¹⁵¹

Finally, placing waste under good faith will provide continuity to Delaware's treatment of the waste doctrine.¹⁵² While the *Disney IV* and *Citigroup* decisions provide some measure of ambiguity regarding the placement of waste, they also serve as precedent that waste may fall under good faith.¹⁵³ Thus, waste as a part of good faith would permit both courts and litigants to predict the Delaware courts' treatment of waste claims.¹⁵⁴

A claim of waste permits Delaware courts to review the substantive decisions of boards of directors, so placing it under the duty of loyalty and making it a nonexculpable claim raises serious public policy issues. First, Delaware statutory law grants the authority to manage a corporation to its board of directors.¹⁵⁵ Permitting courts to review the substantive decisions of boards by making waste a nonexculpable claim arguably in-

150. See Velasco, *supra* note 37, at 1234.

151. See *id.* ("[M]any scholars and jurists have been seeking to return the law of fiduciary duties to greater simplicity. One manifestation of this movement is rebifurcation."). But see Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 585–88 (2008) (discussing the difficulty of expanding the duty of loyalty to situations that do not involve improper personal benefit).

152. Some authors caution, however, that the Delaware courts' frequent announcements of new fiduciary law detract from the continuity of Delaware corporate law. See, e.g., William J. Carney & George B. Shepherd, *The Mystery of Delaware Law's Continuing Success*, 2009 U. ILL. L. REV. 1, 16–17.

153. See, e.g., *Disney IV*, 907 A.2d 693, 749 (Del. Ch. 2005) ("The Delaware Supreme Court has implicitly held that committing waste is an act of bad faith."). Some commentators note, however, that the Delaware Supreme Court occasionally does not seem concerned with notions of *stare decisis*. See, e.g., Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1078 (2000).

154. Cf. Romano, *supra* note 75, at 85 (noting the importance of clarifying legal rules).

155. See DEL. CODE ANN. tit. 8, § 141(a) (2001); *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) ("Under Delaware law, the business judgment rule is the offspring of the fundamental principle . . . that the business and affairs of a Delaware corporation are managed by or under its board of directors."), *overruled on other grounds*, *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009).

terferes with this statutory mandate.¹⁵⁶ Additionally, making waste a viable claim against directors might cause director candidates to refuse positions on boards to avoid the potential for liability, thereby preventing corporations from gaining the most talented candidates as directors.¹⁵⁷

These concerns are not well-founded, as waste is a standard reserved for irrational director decisions.¹⁵⁸ As such, waste is a self-limiting doctrine that will only permit the courts to find directors liable for the most egregious of business decisions.¹⁵⁹ The placement of waste under the duty of good faith will permit boards to freely manage their corporations, so long as they avoid irrational and extreme decisions.¹⁶⁰ Similarly, qualified candidates will not be detracted from serving on the boards of Delaware corporations, as the potential for personal liability is minimized by the stringent nature of the waste standard.¹⁶¹

Second, some might argue that judges lack the business expertise to review the substantive decisions of boards,¹⁶² which would be permitted by making waste a viable claim

156. Cf. Gold, *supra* note 48, at 445 (“Limiting the availability of derivative suits protects the board’s ability to manage the corporation.”). Some commentators and courts suggest that the waste standard should be eliminated entirely. *E.g.*, William T. Allen et al., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1317–18 (2001); see also *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996) (“[W]hether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through ‘stupid’ to ‘egregious’ or ‘irrational’, provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a *good faith* effort to advance corporate interests.”).

157. Cf. Gold, *supra* note 48, at 445 (noting that the risk of deterring competent directors from serving on boards is one justification for the protections of the business judgment rule).

158. See *Disney V*, 906 A.2d 27, 74 (2006) (quoting *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000)) (describing the plaintiff’s burden in demonstrating waste).

159. See *Lewis v. Austen*, No. C.A. 12937, 1999 WL 378125, at *6 (Del. Ch. 1999).

160. See *Disney V*, 906 A.2d at 74 (quoting *Brehm*, 746 A.2d at 263).

161. Cf. *Gagliardi v. TriFoods Int’l, Inc.*, 683 A.2d 1049, 1051–52 (Del. Ch. 1996) (describing waste as “theoretical”).

162. Eric A. Posner, *A Theory of Contract Law Under Conditions of Radical Judicial Error*, 94 NW. U. L. REV. 749, 758 (2000). The initial articulation of this argument is found in *Dodge v. Ford Motor Co.*, where the court declined to impose its business judgment over that of the board. 170 N.W. 668, 684 (Mich. 1919).

through its incorporation into the duty of good faith.¹⁶³ Courts also have the luxury of viewing all the ramifications of a business decision, while directors are limited to the information available at the time of the decision.¹⁶⁴ This may cause courts to have hindsight bias and view the substantive decisions of boards in a negatively skewed light due to the results of those decisions, regardless of whether those results were foreseeable.¹⁶⁵ Judges also are not accountable for their decisions, so there are no repercussions if they render an inappropriate decision.¹⁶⁶ Finally, these critics may support their argument that judges are ill suited to review the substantive decisions of directors by noting the Delaware courts' inconsistent treatment of waste claims at the demand stage of derivative litigation.¹⁶⁷

These arguments fail to acknowledge that Delaware judges typically hold a high level of business expertise and experience.¹⁶⁸ Delaware judges also have substantial incentives to maintain their personal reputations and will be cautious in the exercise of their review of the substantive decisions of directors.¹⁶⁹ These traits ensure that judges will take caution to appropriately decide cases, giving the proper level of deference to

163. See DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 2010) (stating that the protections of a board's section 102(b)(7) clause do not extend to decisions made in bad faith).

164. See *Joy v. North*, 692 F.2d 880, 885–86 (2d Cir. 1982) (“The entrepreneur’s function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge.”). Courts also may not have as much information about the corporation as the directors. Bainbridge, *supra* note 27, at 119.

165. Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1523 (1998); see also FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 100 (1991) (“Judges also are accustomed to deciding cases on full records and may be too quick to blame managers who act—as often they should—in haste or on incomplete information.”); Bainbridge, *supra* note 27, at 114 (“Given the vagaries of business . . . even carefully made choices . . . may turn out badly.”).

166. See EASTERBROOK & FISCHER, *supra* note 165, at 100 (“Judges are neither chosen for business acumen nor fired or subject to reductions in salary if they err in assessing business situations.”).

167. Cf. *Gagliardi v. TriFoods Int’l, Inc.*, 683 A.2d 1049, 1052–53 (Del. Ch. 1996) (noting that there is no logical terminus once courts begin to review the substantive decisions of directors).

168. See Bainbridge, *supra* note 27, at 120 (“In contrast to judges in other states[,] . . . Delaware chancellors frequently have considerable prior corporate experience as practitioners.”); Bernard S. Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 589–90 (1990).

169. See Bainbridge, *supra* note 27, at 121.

directors for their information shortfalls at the time of decisions.¹⁷⁰ Any inconsistency in the handling of waste claims by the Delaware courts is, therefore, not attributable to the qualifications or incentives of the judges, but the contradictory doctrines of making waste the theoretically most difficult standard to prove, and yet easily permitting waste claims to survive the demand stage of derivative litigation.¹⁷¹

Third, some may argue that Delaware courts should not review the substantive decisions of boards through the waste standard, as there are already market mechanisms that protect shareholders and constrain directors.¹⁷² Today, institutional investors function as active shareholders, removing collective action issues present with a large number of small shareholders¹⁷³ and providing a mechanism of control over directors.¹⁷⁴ Additionally, directors have incentives to make appropriate decisions to maintain and improve their personal reputations.¹⁷⁵ Finally, dissatisfied shareholders can simply vote out any offending board members.¹⁷⁶ Thus, judicial review of the substan-

170. See *Joy v. North*, 692 F.2d 880, 886 (2d Cir. 1982) (“[C]ourts recognize that after-the-fact litigation is a most imperfect device to evaluate corporate business decisions.”).

171. Compare *Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 902 (Del. Ch. 1999) (stating that waste claims frequently survive the demand stage of derivative litigation with little factual support), with *Gagliardi*, 683 A.2d at 1051–52 (describing waste as “theoretical”).

172. See Jonathan R. Macey, *Private Trusts for the Provision of Private Goods*, 37 EMORY L.J. 295, 303–06 (1988); cf. Mark J. Roe, *German Codetermination and German Securities Markets*, 1998 COLUM. BUS. L. REV. 167, 181 (noting that directors of American corporations are monitored by market mechanisms).

173. William B. Chandler III, *On the Instructiveness of Insiders, Independents, and Institutional Investors*, 67 U. CIN. L. REV. 1083, 1089–90 (1999).

174. See Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895, 926 (1992) (“Institutions are more likely than other shareholders to vote at all, more likely to vote against manager proposals, and more likely to vote for proposals by other shareholders.”). But see John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1292–93 (1991) (noting that many institutional investors do not challenge the positions of directors).

175. See Bainbridge, *supra* note 27, at 122; David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1832–35 (2001) (discussing the effects of shaming sanctions on corporate managers).

176. See, e.g., William T. Allen et al., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and Its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449, 451–52 (2002).

tive decisions of boards is arguably an unnecessary and “redundant” check on a board of directors.¹⁷⁷

Despite these concerns, market mechanisms do not always apply an adequate check to the discretion of directors.¹⁷⁸ Even during good economic times, directors may make irrationally risky decisions.¹⁷⁹ The potential for directors to make poor decisions is only exacerbated when corporations face a financial crisis.¹⁸⁰ Under such circumstances, directors have incentives to make risky decisions, perhaps even irrationally risky choices, as directors have far less to lose if their decisions create financially devastating results for their corporation and its shareholders.¹⁸¹ The recent financial crisis is an example of how market mechanisms failed to adequately check the unbridled discretion of directors when their corporations faced difficult situations.¹⁸² Thus, judicial review of the substantive decisions of boards through the stringent waste standard is not redundant, but rather provides a necessary check upon the decisions of directors.¹⁸³

Similar to the market mechanism concern, critics of placing waste under the duty of good faith would argue that permitting courts to review the substantive decisions of boards through the waste standard would stifle directors’ ability to make beneficial risky decisions.¹⁸⁴ According to these critics,

177. See Ronald J. Gibson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 839 (1981).

178. Cf. Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1808 (2001) (finding that external market sanctions do not always serve as a viable means to regulate director actions).

179. Cf. William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 1001 (2003) (discussing the lack of an adequate qualitative judicial response to the rise of executive compensation packages).

180. A. Mechele Dickerson, *A Behavioral Approach to Analyzing Corporate Failures*, 38 WAKE FOREST L. REV. 1, 23 (2003).

181. See *id.*

182. Cf. *In re Citigroup Inc. S’holder Derivative Litig.*, 964 A.2d 106, 113 (Del. Ch. 2009) (noting the subprime mortgage crisis).

183. Cf. Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1906 (1992) (arguing that shareholders who wish to curb director compensation packages should “consider enlisting the aid of the courts”). But see Blair & Stout, *supra* note 178, at 1808 (finding that judicial sanctions are not always a successful method to curb director conduct).

184. Cf. *Gagliardi v. TriFoods Int’l, Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996) (describing risks associated with judicial “second-guessing” of directors’ substantive business decisions).

risky decisions are desirable, as they hold the potential to yield greater returns to the corporation and promote innovation.¹⁸⁵ Additionally, shareholders of corporations have little incentive to stifle risky decisions by directors, as they stand to benefit greatly by such decisions,¹⁸⁶ while under little risk of substantial losses or liability.¹⁸⁷ Thus, the concern is that judicial oversight of the substantive decisions of directors will cause boards to avoid beneficial risky decisions out of fear of personal liability.¹⁸⁸

The beneficial risk concern is misguided in the context of waste claims. Directors will not avoid beneficial risk due to the threat imposed by waste, as the potential for personal liability is mitigated by the difficulty for plaintiffs to establish a claim of waste.¹⁸⁹ The vast majority of directorial decisions are not irrational, as seen by the infrequency of successful waste claims.¹⁹⁰ As such, there is little basis to argue that judicial review of director decisions through the waste standard will hinder directors' propensity towards the assumption of beneficial risk.¹⁹¹

Delaware courts should place waste under the duty of good faith, as this will provide a nonexculpable means for shareholders to hold directors personally liable for making irrational decisions, and potentially shift corporate culture away from indefensible decisionmaking. The concerns typically associated with

185. See PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 cmt. d (1994).

186. See WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE 258–60 (8th ed. 2002).

187. See Bainbridge, *supra* note 27, at 111. See generally RONALD J. GILSON & BERNARD S. BLACK, (SOME OF) THE ESSENTIALS OF FINANCE AND INVESTMENT 95–97 (1993) (stating that shareholders can limit their personal risk by diversifying their portfolio).

188. See *Gagliardi*, 683 A.2d at 1052 (“[D]irectors will tend to deviate from this rational acceptance of corporate risk if in authorizing the corporation to undertake a risky investment, the directors must assume some degree of personal risk relating to *ex post facto* claims of derivative liability for any resulting corporate loss.”); Allen et al., *supra* note 176, at 450 (“By intruding on the protected space that the business judgment rule accords such decisions, courts create disincentives for businesses to engage in the risk-taking that is fundamental to a capitalist economy.”).

189. See *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997) (stating that the current waste standard permits directors to assume “optimal rational acceptance of risk”).

190. See, e.g., *Steiner v. Meyerson*, Civ. A. No. 13139, 1995 WL 441999, at *5 (Del. Ch. July 19, 1995) (describing a successful claim of waste as the “rarest of all” claims).

191. See *id.* at *1 (stating that one reason for making the waste test difficult for plaintiffs to satisfy is to preserve the risk-taking incentive for directors).

judicial review of substantive decisions of boards are inappropriate when dealing with waste, as this is a stringent standard that will only police the most egregious director decisions. The benefits of placing waste under good faith are severely limited, however, if courts permit waste claims to easily survive rule 23.1 motions to dismiss for failure to make demand.

B. DELAWARE COURTS SHOULD UNIFORMLY EMPLOY A HEIGHTENED FACTUAL REQUIREMENT FOR WASTE CLAIMS AT THE DEMAND STAGE OF DERIVATIVE LITIGATION

While there are numerous benefits to permitting judicial oversight of the substantive decisions of boards through the waste standard, these are less persuasive if Delaware courts allow waste claims to easily survive the demand stage of litigation. To preserve the managerial authority of boards and prevent needless litigation costs, the Delaware courts should uniformly apply the particularized factual allegation requirement to waste claims when determining demand futility.

The current lack of uniformity in requiring plaintiffs to plead particularized factual allegations for waste permits some claims of waste to easily survive past the demand stage of litigation and reach expensive discovery.¹⁹² Requiring a low level of factual specificity for waste claims under rule 23.1 motions has the potential for numerous negative consequences. First, Delaware corporations and shareholders will suffer. Discovery has the potential to “disrupt normal corporate functions” and potentially “force corporations to reveal their prospective business plans.”¹⁹³ Additionally, derivative suits that reach discovery impose potential financial and reputation costs upon directors and their corporations.¹⁹⁴ These costs are a significant reason as to why directors are much more likely to settle derivative suits if they succeed in pleading demand futility.¹⁹⁵ One of the primary functions of the demand requirement is to eliminate dubious derivative suits, thereby permitting only worthwhile claims to impose these burdens upon directors and corporations.¹⁹⁶

192. See, e.g., *Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 902 (Del. Ch. 1999).

193. Gold, *supra* note 48, at 467.

194. See Telman, *supra* note 144, at 839.

195. Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 531–32 (1991).

196. See *Gagliardi v. TriFoods Int'l, Inc.*, 683 A.2d 1049, 1054 (Del. Ch.

The current treatment of waste by the Delaware courts does not protect directors and corporations from these strike suits. Permitting waste claims to survive demand with minimal factual allegations essentially removes the important demand obstacle and imposes warrantless financial and reputation costs upon directors and corporations.¹⁹⁷ While viable claims of waste are rare and do not provide an obstacle to corporations finding the most qualified directors, these candidates may avoid serving on boards if they frequently have to settle claims of waste to avoid discovery.¹⁹⁸ To preserve the demand requirement and protect directors and corporations from strike suits, the Delaware courts should uniformly apply a particularized factual allegation requirement to waste claims brought by plaintiffs who seek to avoid making demand on the board under the second *Aronson* prong.

Second, permitting waste to easily survive demand allows Delaware courts to limit the statutorily granted managerial authority conferred to directors under Delaware corporate law.¹⁹⁹ If a plaintiff need only plead waste to survive demand, Delaware courts will be able to review all substantive decisions of boards. While this substantive review is defensible if plaintiffs provide particularized factual allegations in their claims of waste, it becomes an impermissible restriction on the directors' right to manage their corporation when plaintiffs may survive to discovery with dubious claims.²⁰⁰ Thus, to limit the substantive review of director decisions to extreme cases, the Delaware courts should uniformly apply a heightened factual pleading requirement to waste claims.

Finally, the current Delaware treatment of waste claims at the demand stage threatens to limit directors' assumption of

1996); Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 952 (1993) (arguing in favor of the demand stage due to its particularized factual allegation requirement).

197. Permitting claims of waste to easily reach discovery also poses unnecessary costs upon the Delaware judiciary. Cf. Douglas M. Branson, *The Rule that Isn't a Rule – the Business Judgment Rule*, 36 VAL. U. L. REV. 631, 637–38 (2002) (describing one justification for the business judgment rule as the “conservation of the judicial resource”).

198. Cf. Gold, *supra* note 48, at 445 (noting that one justification for the business judgment rule is the fear that directors will not serve on boards if there is a high risk of personal liability).

199. See DEL. CODE ANN. tit. 8, § 141(a) (2001).

200. Cf. Gold, *supra* note 48, at 445 (“Limiting the availability of derivative suits protects the board’s ability to manage the corporation.”).

risk. As viable waste claims are rare, directors only have to fear liability for waste from irrational decisions.²⁰¹ This balance is lost if waste claims can easily survive the demand stage. To avoid settling large numbers of waste claims, directors may start to avoid the assumption of risk, which would serve to harm both corporations and shareholders.²⁰² To protect director assumption of beneficial risk, Delaware courts should require particularized factual allegations for waste claims, thereby only permitting well-pled claims of waste to survive to discovery.

The benefits accrued from Delaware courts reviewing the substantive decisions of boards through waste claims are limited if courts permit claims of waste to survive rule 23.1 motions to dismiss for failure to make demand with only minimal factual pleadings. Courts should uniformly require particularized factual allegations for all claims of waste at the demand stage of derivative litigation.

CONCLUSION

Waste is a stringent standard that is meant to hold directors personally liable for irrational business decisions. Despite some indication from Delaware courts that waste is a part of the duty of good faith and is, therefore, nonexculpable by a corporation's section 102(b)(7) clause, the courts failed to explicitly state the procedural placement of waste within Delaware's fiduciary duty framework. In addition to this ambiguity, some Delaware courts permit waste to survive the important demand stage of derivative litigation with minimal factual allegations.

Delaware courts should explicitly hold that waste falls under the duty of good faith, and thus permit shareholders to hold directors accountable for irrational business decisions and potentially create a corporate culture different from the one that produced the recent economic crisis. However, the benefits of permitting courts to review the substantive decisions of directors through the waste standard are lost if some courts permit claims of waste to easily survive rule 23.1 motions to dismiss for failure to make demand. Thus, Delaware courts should uniformly require that plaintiffs plead particularized factual allegations for claims of waste to succeed in demonstrating demand futility.

201. See *Disney V*, 906 A.2d 27, 74 (2006) (quoting *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000)).

202. See *Gagliardi v. TriFoods Int'l, Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996).