

BEAM V. STEWART
845 A.2d 1040 (Del. 2004)

In this appeal we review and affirm the judgment of the Court of Chancery in dismissing [...] a claim in a derivative suit because the plaintiff failed to make presuit demand on the corporation's board of directors and failed to demonstrate demand futility. [...] The single issue before us is that of demand futility, no appeal having been taken on the other issues.

[...]

Facts

The plaintiff, Monica A. Beam, owns shares of Martha Stewart Living Omnimedia, Inc. (MSO). Beam filed a derivative action in the Court of Chancery against Martha Stewart, the five other members of MSO's board of directors, and former board member L. John Doerr. In four counts, Beam's amended complaint (the "complaint") challenged three types of activity by Stewart and the MSO board. [All four counts were dismissed by the Court of Chancery. Only the dismissal of one count is appealed.]

In the single claim at issue on appeal (Count 1), Beam alleged that Stewart breached her fiduciary duties of loyalty and care by illegally selling ImClone stock in December of 2001 and by mishandling the media attention that followed, thereby jeopardizing the financial future of MSO. The Court of Chancery dismissed Count 1 [...] because Beam failed to plead particularized facts demonstrating presuit demand futility.

When Beam filed the complaint in the Court of Chancery, the MSO board of directors consisted of six members: Stewart, Sharon L. Patrick, Arthur C. Martinez, Darla D. Moore, Naomi O. Seligman, and Jeffrey W. Ubben. The Chancellor concluded that the complaint alleged sufficient facts to support the conclusion that two of the directors, Stewart and Patrick, were not disinterested or independent for purposes of considering a presuit demand.

The Court of Chancery found that Stewart's potential civil and criminal liability for the acts underlying Beam's claim rendered Stewart an interested party and therefore unable to consider demand.³ The Court also found that Patrick's position as an officer and inside director,⁴ together with the substantial compensation she receives from the company, raised a reasonable doubt as to her ability objectively to consider demand. The defendants do not challenge the Court's conclusions with respect to Patrick and Stewart.

We now address the plaintiff's allegations concerning the independence of the other board members. We must determine if the following allegations of the complaint, and the reasonable inferences that may flow from them, create a reasonable doubt of the independence of either Martinez, Moore or Seligman:⁶ [The court quotes from the Plaintiffs' complaint allegations regarding Martinez, Moore and Seligman]

³ Stewart was, at all relevant times, MSO's chairman and chief executive. She controls over 94% of the shareholder vote. She also personifies MSO's brands and was its primary creative force.

⁴ Patrick is the president and chief operating officer of MSO.

⁶ The Court of Chancery did not address Ubben's ability to consider demand in its [analysis]. The parties also do not press the issue here, perhaps because Beam's demand futility allegations with respect to Ubben related more to a claim that was dismissed [...]. Because the parties do not argue and the court below did not address the issue of Ubben's independence, we do not address it. Thus, we assume for purposes of this appeal that the presumption of Ubben's independence is un rebutted. [...]

Decision of the Court of Chancery

The Chancellor found that Beam had not alleged sufficient facts to support the conclusion that demand was futile because he determined that the complaint failed to raise a reasonable doubt that these outside directors are independent of Stewart. Because Patrick and Stewart herself are not independent for demand purposes, all the plaintiff need show is that one of the remaining directors is not independent, there being only six board members.⁸ [...]

It is appropriate here to quote the Chancellor's analysis of the allegations regarding these three directors:

The factual allegations regarding Stewart's friendship with Martinez are inadequate to raise a reasonable doubt of his independence. While employed by Sears, Martinez developed business ties to MSO due to Sears' marketing of a substantial quantity of MSO products. Martinez was recruited to serve on MSO's board of directors by Beers, who is described as Stewart's longtime personal friend and confidante and who was at that time an MSO director. Shortly after Martinez joined MSO's board, Patrick was quoted in a magazine article saying, "Arthur [Martinez] is an old friend to both me and Martha [Stewart]." Weighing against these factors, the amended complaint discloses that Martinez has been an executive and director for major corporations since at least 1990. At present he serves as a director for four prominent corporations, including MSO, and is the chairman of the Federal Reserve Bank of Chicago. One might say that Martinez's reputation for acting as a careful fiduciary is essential to his career--a matter in which he would surely have a material interest. *Furthermore, the amended complaint does not give a single example of any action by Martinez that might be construed as evidence of even a slight inclination to disregard his duties as a fiduciary for any reason. In this context, I cannot reasonably infer, on the basis of several years of business interactions and a single affirmation of friendship by a third party, that the friendship between Stewart and Martinez raises a reasonable doubt of Martinez's ability to evaluate demand independently of Stewart's personal interests.*

The allegations regarding the friendship between Moore and Stewart are somewhat more detailed, yet still fall short of raising a reasonable doubt about Moore's ability properly to consider demand on Count I. In 1995, Stewart's lawyer, Allen Grubman, hosted a wedding reception for his daughter. Among those in attendance at the reception were Moore, Stewart, and Waksal. In addition, *Fortune* magazine published an article in 1996 that focused on the close personal friendships among Moore, Stewart, and Beers. In September 2001, when Beers resigned from MSO's board of directors, Moore was selected to replace her. *Although the amended complaint lists fewer positions of fiduciary responsibility for Moore than were listed for Martinez, it is clear that Moore's professional reputation similarly would be harmed if she failed to fulfill her fiduciary obligations. To my mind, this is quite a close call. Perhaps the balance could have been tipped by additional, more detailed allegations about the closeness or nature of the friendship, details of the business and social interactions between the two, or allegations raising additional considerations that might inappropriately affect Moore's ability to impartially consider pursuit of a lawsuit against Stewart. On the facts pled, however, I cannot say that I have a reasonable doubt of Moore's ability to properly consider demand. No particular felicity is alleged to exist between Stewart and Seligman. The amended complaint reports in ominous tones, however, that Seligman, who is a director both for MSO and for JWS, contacted JWS' chief executive officer about an unflattering biography of Stewart slated for publication. From this, the Court is asked to infer that Seligman acted in a way that preferred the protection of Stewart over her fiduciary duties to one or both of these companies. Without details about the nature of the contact, other than Seligman's wish to "express concern," it is impossible reasonably to make this inference. Stewart's public image, as plaintiff persistently*

⁸ If three directors of a six person board are not independent and three directors are independent, there is not a majority of independent directors and demand would be futile. [...]

asserts, is critical to the fortunes of MSO and its shareholders. As a fiduciary of MSO, Seligman may have felt obligated to express concern and seek additional information about the publication before its release. As a fiduciary of JWS, she could well have anticipated some risk of liability if any of the unflattering characterizations of Stewart proved to be insufficiently researched or made carelessly. There is no allegation that Seligman made any inappropriate attempt to prevent the publication of the biography. Nor does the amended complaint indicate whether the biography was ultimately published and, if so, whether Seligman's inquiry is believed to have resulted in any changes to the content of the book. As alleged, this matter does not serve to raise a reasonable doubt of Seligman's independence or ability to consider demand on Count I.

In sum, plaintiff offers various theories to suggest reasons that the outside directors might be inappropriately swayed by Stewart's wishes or interests, but fails to plead sufficient facts that could permit the Court reasonably to infer that one or more of the theories could be accurate.

Demand Futility and Director Independence

[...]

Under the first prong of *Aronson*,¹⁴ a stockholder may not pursue a derivative suit to assert a claim of the corporation unless: (a) she has first demanded that the directors pursue the corporate claim and they have wrongfully refused to do so; or (b) such demand is excused because the directors are deemed incapable of making an impartial decision regarding the pursuit of the litigation. The issue in this case is the quantum of doubt about a director's independence that is "reasonable" in order to excuse a presuit demand. The parties argue opposite sides of that issue.

The key principle upon which this area of our jurisprudence is based is that the directors are entitled to a *presumption* that they were faithful to their fiduciary duties. In the context of presuit demand, the burden is upon the plaintiff in a derivative action to overcome that presumption. The Court must determine whether a plaintiff has alleged particularized facts creating a reasonable doubt of a director's independence to rebut the presumption at the pleading stage. If the Court determines that the pleaded facts create a reasonable doubt that a majority of the board could have acted independently in responding to the demand, the presumption is rebutted for pleading purposes and demand will be excused as futile.

A director will be considered unable to act objectively with respect to a presuit demand if he or she is interested in the outcome of the litigation or is otherwise not independent.²⁰ A director's interest may be shown by demonstrating a potential personal benefit or detriment to the director as a result of the decision. "In such circumstances, a director cannot be expected to exercise his or her independent business judgment without being influenced by the ... personal consequences resulting from the decision." The primary basis upon which a director's independence must be measured is whether the director's decision is based on the corporate merits of the subject before the board, rather than extraneous considerations or influences. This broad statement of the law requires an analysis of whether the director is disinterested in the underlying transaction and, even if disinterested, whether the director is otherwise independent. More precisely in the context of the present case, the independence inquiry requires us to determine whether there is a reasonable

¹⁴ See *Aronson v. Lewis* (setting forth two steps of a demand futility analysis: whether (1) "the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment").

²⁰ See *Grimes v. Donald* ("The basis for claiming excusal would normally be that: (1) a majority of the board has a material financial or familial interest; (2) a majority of the board is incapable of acting independently for some other reason such as domination or control; or (3) the underlying transaction is not the product of a valid exercise of business judgment."); see also *In re EBAY, Inc. Shareholders Litig.* (demand was excused where futility analysis turned not on personal relationship but on allegations that compensation to non-interested directors in the form of not-yet-vested stock options created a reasonable doubt of their independence for presuit pleading purposes; although allegations were made of "personal ties," the analysis addressed only the financial ties and whether that raised the pleading inference that the non-interested directors were beholden to the interested directors).

doubt that any one of these three directors is capable of objectively making a business decision to assert or not assert a corporate claim against Stewart.

Independence Is a Contextual Inquiry

Independence is a fact-specific determination made in the context of a particular case. The court must make that determination by answering the inquiries: independent from whom and independent for what purpose? To excuse presuit demand in this case, the plaintiff has the burden to plead particularized facts that create a reasonable doubt sufficient to rebut the presumption that either Moore, Seligman or Martinez was independent of defendant Stewart.

In order to show lack of independence, the complaint of a stockholder-plaintiff must create a reasonable doubt that a director is not so " beholden " to an interested director (in this case Stewart) that his or her " discretion would be sterilized. " Our jurisprudence explicating the demand requirement is designed to create a balanced environment which will: (1) on the one hand, deter costly, baseless suits by creating a screening mechanism to eliminate claims where there is only a suspicion expressed solely in conclusory terms; and (2) on the other hand, permit suit by a stockholder who is able to articulate particularized facts showing that there is a reasonable doubt either that (a) a majority of the board is independent for purposes of responding to the demand, or (b) the underlying transaction is protected by the business judgment rule.

The " reasonable doubt " standard " is sufficiently flexible and workable to provide the stockholder with ' the keys to the courthouse ' in an appropriate case where the claim is not based on mere suspicions or stated solely in conclusory terms. "

Personal Friendship

A variety of motivations, including friendship, may influence the demand futility inquiry. But, to render a director unable to consider demand, a relationship must be of a bias-producing nature. Allegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence. [...]

The facts alleged by Beam regarding the relationships between Stewart and these other members of MSO's board of directors largely boil down to a " structural bias " argument, which presupposes that the professional and social relationships that naturally develop among members of a board impede independent decisionmaking. [...]

In the present case, the plaintiff attempted to plead affinity beyond mere friendship between Stewart and the other directors, but her attempt is not sufficient to demonstrate demand futility. Even if the alleged friendships may have preceded the directors' membership on MSO's board and did not necessarily arise out of that membership, these relationships are of the same nature as those giving rise to the structural bias argument.

Allegations that Stewart and the other directors moved in the same social circles, attended the same weddings, developed business relationships before joining the board, and described each other as " friends, " even when coupled with Stewart's 94% voting power, are insufficient, without more, to rebut the presumption of independence. They do not provide a sufficient basis from which reasonably to infer that Martinez, Moore and Seligman may have been beholden to Stewart. Whether they arise before board membership or later as a result of collegial relationships among the board of directors, such affinities – standing alone – will not render presuit demand futile.

The Court of Chancery in the first instance, and this Court on appeal, must review the complaint on a case-by-case basis to determine whether it states with particularity facts indicating that a

relationship – whether it preceded or followed board membership – is so close that the director's independence may *reasonably* be doubted. This doubt might arise either because of financial ties, familial affinity, a particularly close or intimate personal or business affinity or because of evidence that in the past the relationship caused the director to act non-independently vis à vis an interested director. No such allegations are made here. Mere allegations that they move in the same business and social circles, or a characterization that they are close friends, is not enough to negate independence for demand excusal purposes.

That is not to say that personal friendship is always irrelevant to the independence calculus. But, for presuit demand purposes, friendship must be accompanied by substantially more in the nature of serious allegations that would lead to a reasonable doubt as to a director's independence. That a much stronger relationship is necessary to overcome the presumption of independence at the demand futility stage becomes especially compelling when one considers the risks that directors would take by protecting their social acquaintances in the face of allegations that those friends engaged in misconduct. To create a reasonable doubt about an outside director's independence, a plaintiff must plead facts that would support the inference that because of the nature of a relationship or additional circumstances other than the interested director's stock ownership or voting power, the non-interested director would be more willing to risk his or her reputation than risk the relationship with the interested director.

Specific Allegations Concerning Seligman and Moore³³

1. Seligman

Beam's allegations concerning Seligman's lack of independence raise an additional issue not present in the Moore and Martinez relationships. Those allegations are not necessarily based on a purported friendship between Seligman and Stewart. Rather, they are based on a specific past act by Seligman that, Beam claims, indicates Seligman's lack of independence from Stewart. Beam alleges that Seligman called John Wiley & Sons (Wiley) at Stewart's request in order to prevent an unfavorable publication reference to Stewart. The Chancellor concluded, properly in our view, that this allegation does not provide particularized facts from which one may reasonably infer improper influence.

The bare fact that Seligman contacted Wiley, on whose board Seligman also served, to dissuade Wiley from publishing unfavorable references to Stewart, even if done at Stewart's request, is insufficient to create a reasonable doubt that Seligman is capable of considering presuit demand free of Stewart's influence. Although the court should draw all *reasonable* inferences in Beam's favor, neither improper influence by Stewart over Seligman nor that Seligman was beholden to Stewart is a reasonable inference from these allegations.

Indeed, the reasonable inference is that Seligman's purported intervention on Stewart's behalf was of benefit to MSO and *its* reputation, which is allegedly tied to *Stewart's* reputation, as the Chancellor noted. A motivation by Seligman to benefit the company every bit as much as Stewart herself is the only reasonable inference supported by the complaint, when all of its allegations are read in context.

³³ In her reply brief in this Court the plaintiff appears to have abandoned any serious contention that she has properly alleged a reasonable doubt that Martinez is independent, focusing instead on her contention that the Chancellor erred in dismissing her complaint as to Moore and Seligman. [...] Accordingly, we do not analyze separately the allegations concerning Martinez. Moreover, since it is clear that the plaintiff has not pleaded facts raising a reasonable doubt as to Seligman and Moore, a fortiori, the plaintiff's weaker allegations concerning Martinez must fail.

2. Moore

The Court of Chancery concluded that the plaintiff's allegations with respect to Moore's social relationship with Stewart presented "quite a close call" and suggested ways that the "balance could have been tipped." Although we agree that there are ways that the balance could be tipped so that mere allegations of social relationships would become allegations casting reasonable doubt on independence, we do not agree that the facts as alleged present a "close call" with respect to Moore's independence. These allegations center on: (a) Moore's attendance at a wedding reception for the daughter of Stewart's lawyer where Stewart and Waksal were also present; (b) a *Fortune* magazine article focusing on the close personal relationships among Moore, Stewart and Beers; and (c) the fact that Moore replaced Beers on the MSO board. In our view, these bare social relationships clearly do not create a reasonable doubt of independence.

3. Stewart's 94% Stock Ownership

Beam attempts to bolster her allegations regarding the relationships between Stewart and Seligman and Moore by emphasizing Stewart's overwhelming voting control of MSO. That attempt also fails to create a reasonable doubt of independence. A stockholder's control of a corporation does not excuse presuit demand on the board without particularized allegations of relationships between the directors and the controlling stockholder demonstrating that the directors are beholden to the stockholder. As noted earlier, the relationships alleged by Beam do not lead to the inference that the directors were beholden to Stewart and, thus, unable independently to consider demand. Coupling those relationships with Stewart's overwhelming voting control of MSO does not close that gap.

A Word About the Oracle Case

In his opinion, the Chancellor referred several times to the Delaware Court of Chancery decision in *In re Oracle Corp. Derivative Litigation*. Indeed, the plaintiff relies on the *Oracle* case in this appeal. *Oracle* involved the issue of the independence of the Special Litigation Committee (SLC) appointed by the Oracle board to determine whether or not the corporation should cause the dismissal of a corporate claim by stockholder-plaintiffs against directors. The Court of Chancery undertook a searching inquiry of the relationships between the members of the SLC and Stanford University in the context of the financial support of Stanford by the corporation and its management. The Vice Chancellor concluded, after considering the SLC Report and the discovery record, that those relationships were too close for purposes of the SLC analysis of independence.

An SLC is a unique creature that was introduced into Delaware law by *Zapata v. Maldonado* in 1981. The SLC procedure is a method sometimes employed where presuit demand has already been excused and the SLC is vested with the full power of the board to conduct an extensive investigation into the merits of the corporate claim with a view toward determining whether – in the SLC's business judgment – the corporate claim should be pursued. Unlike the demand-excusals context, where the board is presumed to be independent, the SLC has the burden of establishing its own independence by a yardstick that must be "like Caesar's wife" - "above reproach." Moreover, unlike the presuit demand context, the SLC analysis contemplates not only a shift in the burden of persuasion but also the availability of discovery into various issues, including independence.

We need not decide whether the substantive standard of independence in an SLC case differs from that in a presuit demand case. As a practical matter, the procedural distinction relating to the diametrically-opposed burdens and the availability of discovery into independence may be outcome-determinative on the issue of independence. Moreover, because the members of an SLC are vested with enormous power to seek dismissal of a derivative suit brought against their

director-colleagues in a setting where presuit demand is already excused, the Court of Chancery must exercise careful oversight of the bona fides of the SLC and its process. Aside from the procedural distinctions, the Stanford connections in *Oracle* are factually distinct from the relationships present here.⁴⁵

Section 220

Beam's failure to plead sufficient facts to support her claim of demand futility may be due in part to her failure to exhaust all reasonably available means of gathering facts. As the Chancellor noted, had Beam first brought a Section 220 action seeking inspection of MSO's books and records, she might have uncovered facts that would have created a reasonable doubt. For example, irregularities or "cronyism" in MSO's process of nominating board members might possibly strengthen her claim concerning Stewart's control over MSO's directors. A books and records inspection might have revealed whether the board used a nominating committee to select directors and maintained a separation between the director-selection process and management. A books and records inspection might also have revealed whether Stewart unduly controlled the nominating process or whether the process incorporated procedural safeguards to ensure directors' independence. Beam might also have reviewed the minutes of the board's meetings to determine how the directors handled Stewart's proposals or conduct in various contexts. Whether or not the result of this exploration might create a reasonable doubt would be sheer speculation at this stage. But the point is that it was within the plaintiff's power to explore these matters and she elected not to make the effort.

In general, derivative plaintiffs are not entitled to discovery in order to demonstrate demand futility. The general unavailability of discovery to assist plaintiffs with pleading demand futility does not leave plaintiffs without means of gathering information to support their allegations of demand futility, however. Both this Court and the Court of Chancery have continually advised plaintiffs who seek to plead facts establishing demand futility that the plaintiffs might successfully have used a Section 220 books and records inspection to uncover such facts.

Because Beam did not even attempt to use the fact-gathering tools available to her by seeking to review MSO's books and records in support of her demand futility claim, we cannot know if such an effort would have been fruitless, as Beam claimed on appeal. Beam's failure to seek a books and records inspection that may have uncovered the facts necessary to support a reasonable doubt of independence has resulted in substantial cost to the parties and the judiciary.⁵²

Conclusion

Because Beam did not plead facts sufficient to support a reasonable inference that at least one MSO director in addition to Stewart and Patrick was incapable of considering demand, Beam was required to make demand on the board before pursuing a derivative suit. Hence, presuit demand was not excused. [...]

⁴⁵ The analysis applied to determine the independence of a special committee in a merger case also has its own special procedural characteristics. In such cases, courts evaluate not only whether the relationships among members of the committee and interested parties placed them in a position objectively to consider a proposed transaction, but also whether the committee members in fact functioned independently. [...]

⁵² [...]A plaintiff's use of, or failure to use, a books and records inspection does not change the standard to be applied to review of the complaint. Regardless of whether the plaintiff secured any facts alleged in her complaint through a Section 220 inspection, the court must draw all reasonable inferences in the plaintiff's favor and determine whether those facts create a reasonable doubt of the directors' independence. [...]