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Transaction ID 11243677

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

DHRUV KHANNA, PATRICK SAMS, and SYBIL MEISEL, derivatively and on behalf of all those similarly situated,	:	
Plaintiffs,	:	
v.	:	**C.A. No. 20545-NC**
CHARLES McMINN, DANIEL LYNCH, FRANK MARSHALL, RICHARD SHAPERO, ROBERT HAWK, ROBERT E. KNOWLING, JR., DEBRA DUNN, HELLENE RUNTAGH, LARRY IRVING, CHARLES HOFFMAN, L. DALE CRANDALL, RICHARD A. JALKUT, and CROSSPOINT VENTURE PARTNERS, L.P.,	:	
Defendants,	:	
and	:	
COVAD COMMUNICATIONS GROUP, INC., a Delaware corporation,	:	
Nominal Defendant.	:	

MEMORANDUM OPINION AND ORDER

Date Submitted: November 7, 2005
Date Decided: May 9, 2006

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NOBLE, Vice Chancellor

Plaintiff Dhruv Khanna ("Khanna") is a cofounder and shareholder of Nominal Defendant Covad Communications Group, Inc. ("Covad") and served as its General Counsel and Executive Vice President from its formation in 1996 until June 2002 when he was removed from these positions amidst charges of sexual impropriety. On September 15, 2003, he brought this action, both derivatively and as a class action, to challenge acts and omissions of Covad's board while he was Covad's General Counsel and to contest certain omissions and misrepresentations which he alleges impaired the accuracy of Covad's proxy statements issued in advance of shareholders' meetings.[1] On August 3, 2004, Sybil Meisel and Patrick Sams, also Covad shareholders, joined him as representative plaintiffs with the filing of the Amended Derivative and Class Action Complaint (the "Amended Complaint").

The Individual Defendants are current and former directors of Covad. Also named as a defendant is Crosspoint Venture Partners, L.P. ("Crosspoint"), a venture capital firm closely connected to some of Covad's directors, a former investor in Covad, and the principal beneficiary of some of the actions which the Plaintiffs challenge. The Plaintiffs seek to impose

[1] Khanna, on August 11, 2003, also filed an action, under 8 *Del.C.* § 220, to compel Covad to grant him access to certain of its books and records. *See Khanna v. Covad Commc'n Group, Inc.*, 2004 WL 187274 (Del. Ch. Jan. 23, 2004). For convenience, exhibits produced at the § 220 trial are identified as "JTX", and the transcript of that trial is referred to as "Trial Tr."

liability on Crosspoint under principles of fiduciary duty for certain conduct when it was a large shareholder of Covad and under notions of aiding and abetting and *respondeat superior*.

The Defendants, as one would expect, have moved to dismiss the Amended Complaint under Court of Chancery Rule 23.1 because pre-suit demand upon the board was not excused and under Court of Chancery Rule 12(b)(6) for failure to state a claim upon which relief can be granted. Not so typically, the Defendants have also moved to dismiss because, they contend, (1) Khanna did, in fact, make demand upon Covad's board through a letter transmitted shortly after he was terminated and (2) Khanna is not qualified to act as a representative plaintiff in this action because of his former role as General Counsel of Covad and because of the mixed motives prompting the filing of this action—not only as a shareholder, but as a disgruntled former employee. In addition, the Defendants seek dismissal of Meisel and Sams as representative plaintiffs because they are alleged to have been "tainted" by their association with Khanna. Finally, the parties quarrel over the confidential treatment to be given to certain of Khanna's allegations. This dispute requires resolution of opposing motions relating to maintaining the Amended Complaint under seal.

I. FACTS[2]

Covad, a service provider of broadband internet and network access using digital subscriber line (DSL) technology, is a Delaware corporation headquartered in San Jose, California. It filed for bankruptcy in August 2001 and departed from that jurisdiction in December 2001.

A. *The Plaintiffs' Challenges—A Brief Overview*

In the Amended Complaint, the Plaintiffs seek redress for six matters (other than disclosure claims) allegedly resulting from breaches of fiduciary duties by various Covad Directors: (1) allowing the vesting of Defendant Charles McMinn's ("McMinn") founders' shares in Covad even though he had not satisfied the requirements for vesting; (2) permitting McMinn and Defendant Rich Shapero ("Shapero"), with Crosspoint, to develop Certive, Inc. ("Certive"), a competitor of Covad; (3) Covad's subsequent investment in Certive; (4) Covad's acquisition of BlueStar Communications Group, Inc. ("BlueStar"), an act that rescued a failing investment of Crosspoint and was the principal cause of Covad's entry into bankruptcy; (5) the BlueStar earn-out settlement; and (6) Covad's investment in DishnetDSL ("Dishnet"), an entity with which McMinn was involved, and the payments Covad made to

[2] The "facts" are drawn primarily from the "well-pleaded" allegations of the Amended Complaint. Some "facts" are taken from documents (or portions thereof) incorporated into the Amended Complaint. Finally, for the debates over disqualification and confidential treatment of portions of the record, the Court looks to a broader range of sources.

end that relationship. Crosspoint is alleged to be liable for the adverse consequences of some of those fiduciary failures either directly, as a controlling shareholder, or as an aider and abettor and under the doctrine of *respondeat superior*.

Additionally, Khanna, in correspondence with Covad's Board, shortly after his termination, made numerous allegations of wrongdoing against members of Covad's Board. The Plaintiffs contest the sufficiency of Covad's proxy statements in 2002, 2003, and 2004 principally because, it is alleged, the charges Khanna made against Covad's Board were not fully disclosed to the shareholders who could have used the information in determining how to vote for directors standing for reelection to the Board.

B. *Covad's Board of Directors*

When this action was filed, Covad's Board consisted of eight directors.

1. Charles McMinn

McMinn is a founder of Covad and Chairman of its Board of Directors. He has been on the Board—with the exception of an approximately one-year absence from November 1999 to late-October 2000—since October 1996. He was the company's Chief Executive Officer and President from October 1996 to July 1998.

McMinn is also a founder of Certive, which was incorporated in July 1999, and was Certive's Chief Executive Officer from November 1999 to October 2000. McMinn served as a director of BlueStar until Covad acquired it. He is also a member of Dishnet's board.

2. Robert Hawk

Hawk has been a member of Covad's Board since April 1998. Hawk is a "Special Limited Partner" of Crosspoint.[3] It is alleged that "through Crosspoint and directly, Hawk has owned a substantial equity interest in BlueStar."[4] Through Crosspoint, Hawk owned 12% of Diamond Lane (which paid $52 million to Covad for services rendered in 1998 and 1999) and a "significant" stake in Efficient Technologies, both of which are Covad vendors. Additionally, Hawk is alleged to have "joined the [Covad] board as a result of his friendship, connections and/or business affiliations with Defendants Shapero and/or McMinn."[5]

3. Charles Hoffman

Since June 2001, Hoffman has been a director, President, and Chief Executive Officer of Covad. It is alleged that he was recruited by McMinn

[3] Amended Compl. at ¶ 12.
[4] *Id.*
[5] *Id.*

and "immediately forged a close relationship with defendant McMinn,"[6] whom he regards as his boss. Hoffman receives various benefits from Covad, including a $500,000 salary, a $375,000 annual bonus, a $100,000 signing bonus, term life insurance, and stock options.[7]

4. Larry Irving

Irving has served as a member of Covad's Board since April 2000. In the Amended Complaint, the Plaintiffs identify various instances in which Irving joined other Covad directors in making, what the Plaintiffs consider, egregious decisions.[8]

5. Richard A. Jalkut

Jalkut was appointed to the Covad Board on July 18, 2002. He is the President and Chief Executive Officer of TelePacific, Inc., a Covad reseller.

6. Daniel Lynch

Lynch has been a member of the Covad Board since April 1997. Lynch is a member of the Board of Advisors of Certive,[9] appointed soon

[6] *Id.* at ¶ 17.
[7] *Id.* at ¶ 138.
[8] These decisions include allowing Shapero to sit on the boards of Covad competitors, allowing Hawk to maintain his investment in BlueStar, granting Hoffman an overly generous compensation package, allowing McMinn to serve on the Covad and Dishnet boards while the two companies were in litigation, and retaliating against Khanna when he objected to the Board's improper conduct. *Id.* at ¶ 139.
[9] The Amended Complaint fails to develop sufficiently, for particularized pleading purposes, the nature of Certive's Board of Advisors. It may be that appointment to this

after Covad's investment in Certive. He is also a long-time friend of McMinn. The two own homes in the same neighborhood and neighboring wineries in St. Helena, Napa.[10]

7. L. Dale Crandall

Crandall was appointed to the Covad Board on June 20, 2002. He also sits on the board of BEA Systems ("BEA"), a company that supplies Covad with software and related support.[11] Covad paid in excess of $2.2 million to BEA in 2004.

8. Hellene Runtagh

Runtagh has been a member of the Covad Board of Directors since November 1999. "She became a director with the consent and approval of the McMinn-Shapero director appointees. Defendant Runtagh derived the benefits of being and remaining on the Board of Directors of, and receiving compensation from, Covad by supporting and favoring the self-dealing of other directors in the BlueStar and Dishnet Transactions."[12]

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position carried significant remunerative benefits, but the Plaintiffs' conclusory pleadings in this respect fail to set forth the detail necessary to satisfy Court of Chancery Rule 23.1.

[10] Amended Compl. at ¶ 9.

[11] Calder Decl., Ex. E, at 4. These facts are drawn from Covad's 2004 Proxy Statement. Although one may doubt whether this aspect of Covad's 2004 Proxy Statement was incorporated into the Amended Complaint, this information is not outcome-determinative.

[12] Amended Compl. at ¶ 15.

C. *Former Covad Board Members*

A brief review of the following former Covad directors is important to understanding, as the Plaintiffs tell the story, the "incestuous" nature of Covad's Board, as well as the transactions challenged by the Plaintiffs.

1. Frank Marshall

Marshall served on Covad's Board from October 1997 to December 2002 and was Covad's interim chief executive officer from November 2000 until June 2001. He also serves on Certive's Board of Advisors. He has been a partner in Sequoia Capital ("Sequoia"), a venture capital firm, which invested with Crosspoint. He is a director of NetScreen Technologies, a Covad vendor that received $33,000 from Covad in 2001. Defendant Marshall is alleged to be a longtime friend of McMinn.

2. Rich Shapero

Shapero served on the Covad Board—as Crosspoint's designee—from July 1997 to May 2002 and on the Covad compensation committee.

Shapero is the Managing Partner, as well as a General Partner, of Crosspoint. Crosspoint had stakes in various entities associated with Covad, such as Certive, BlueStar, Diamond Lane, and Efficient Technologies, another Covad vendor. Shapero was also a member of the boards of BlueStar and NewEdge Networks ("NewEdge").

3. Robert E. Knowling, Jr.

Knowling was Covad's Chief Executive Officer and a member of Covad's Board from July 1998 until November 1, 2000. He also served as Chairman of the Board from September 1999 until his departure from Covad in November 2000. Knowling is a former colleague of Hawk, with whom he worked at "US West Communications, Inc. and/or its affiliates."[13] Covad's stock price began its "steep descent in the [s]pring of 2000"[14] on Knowling's watch.

4. Debra Dunn

Dunn served on the Covad Board from April 2000 to October 2000. She is a senior executive at Hewlett-Packard. Dunn was recruited to join the Covad Board through Knowling, who served on Hewlett-Packard's Board of Directors.

D. *Crosspoint and Other Relationships*

Crosspoint is a "venture capital firm that invests in early stage companies in two strategic areas: (a) Virtual Service Providers and E-Business Services; and (b) Broadband Infrastructure."[15] Crosspoint had invested in Covad, Certive, BlueStar, and NewEdge and also "owned a

[13] Amended Compl. at ¶ 13.
[14] *Id.*
[15] *Id.* at ¶ 18.

significant stake in Diamond Lane and Efficient Technologies, both of which were Covad vendors."[16] In addition, Crosspoint "co-invested in one or more companies alongside" Sequoia, with which Marshall is affiliated.[17] As noted, Shapero serves as Crosspoint's General and Managing Partner, and Hawk is a Special Limited Partner. Crosspoint "cashed out" its investment in Covad in "1999-2000."[18]

E. *The Plaintiffs' Challenges*

1. The Certive Claims[19]

The Plaintiffs allege that the events surrounding Covad's investment in Certive reflect a pattern of self-dealing by McMinn and Crosspoint and that various supine Covad directors were rewarded with lucrative positions in exchange for their support.

Covad went public in January 1999. McMinn was no longer chief executive officer, but needed to remain a full-time employee of Covad until November 2000 for his founders' shares to vest fully. While employed at

[16] *Id.* NewEdge is a "provider of dedicated internet access for businesses and communications carriers . . . ." *Id*. at ¶ 11. Diamond Lane is "a Covad vendor who Covad paid $52 million for services rendered in 1998 and 1999." *Id*.
[17] *Id.* at ¶ 18.
[18] *Id.*
[19] Although referred to, for convenience, as the "Certive Claims," there are three separate aspects: (1) the vesting of McMinn's "founders' shares" (Count I); (2) the usurpation by McMinn of Covad's business opportunity with respect to the activities of Certive (Count II); and (3) the decision of Covad's Board to invest in Certive (Count III).

Covad, McMinn began looking for other investment opportunities. He wrote to Knowling, then-chief executive officer of Covad: "The taking of board seats [with Crosspoint affiliates] and coming up with ideas that Crosspoint and I could invest in is what [C]rosspoint wanted me to do and what I thought we had agreed to with me helping them."[20] He justified his involvement with other companies by contending that "these would be deals that Covad would benefit from [and] that Covad may or may not want to invest in/partner with."[21] Knowling, although concerned about the example that McMinn's behavior would set for other Covad employees, eventually acquiesced: "You are the founder and exceptions can be made to make anything work."[22] Thus, McMinn received his "founders' shares" despite the fact that he did not remain with Covad on a full-time basis until November 2000. This special treatment was not reported to Covad's shareholders.

One of the opportunities that McMinn was pursuing involved Certive, a privately-held provider of computerized data integration services. Certive's website, as of mid-2002, explained that Certive was "developing a full-service e-business network to provide live support and systems to

[20] *Id.* at ¶ 43.
[21] *Id.* at ¶ 44.
[22] *Id.* at ¶ 46.

entrepreneurs over a broadband connection . . . ."[23] McMinn was a founder of Certive, which was incorporated in July 1999 when McMinn was a full-time employee of Covad. Crosspoint and McMinn held substantial stakes in Certive. McMinn received 1,333,333 founders' shares of Certive and invested $1 million for an additional 666,667 Series A Preferred Shares. Crosspoint received 3 million Series A Preferred shares for an investment of $4.5 million.

Certive is alleged to have been in Covad's "line of business."[24] Covad was not offered the opportunity to invest in Certive's Series A Preferred round of financing.

On September 22, 1999, the Covad Board blessed McMinn's involvement and investment in Certive *ex post*. This blessing came two months after McMinn had founded Certive and one month after McMinn and Crosspoint had invested in Certive's Series A Preferred shares. Covad's Board decided that "the company would not be interested in pursuing an investment in [Certive] on the terms and conditions offered to McMinn and Crosspoint."[25] At this meeting, the Covad Board also adopted a "corporate opportunity policy" which forbade, without prior approval, a fiduciary of

[23] *Id.* at ¶ 47.
[24] *Id.* at ¶153.
[25] *Id.* at ¶ 55.

Covad to sit on the board of, or invest in, a company in competition with Covad.

Nineteen days later, however, Covad invested in Certive's Series B-1 Preferred round of financing. Covad paid $5 million for 1,111,111 Series B-1 Preferred shares (approximately $4.50 per share). Additionally, Covad signed a Shareholders' Rights Agreement that bound Covad to vote its shares in favor of Crosspoint and McMinn's designees on the Certive Board. Hawk, Lynch, Marshall, and Knowling participated in the Covad Board's deliberations and vote.

After Covad's investment in Certive, Lynch and Marshall were invited to serve on Certive's Board of Advisers. "[Advisory board] positions are highly sought after and potentially lucrative as advisory board members in Silicon Valley companies are given stock options which during the 1990s became a source of great wealth for many people."[26]

2. The BlueStar Transactions

For convenience, Covad's involvement with BlueStar may be viewed as two separate, although closely related, transactions: (1) the BlueStar acquisition, and (2) the BlueStar earn-out settlement.

[26] *Id.* at ¶ 56.

a. *BlueStar Acquisition*

On June 16, 2000, Covad announced that it had entered into a merger agreement with BlueStar. BlueStar sold DSL services directly to retail customers. From mid-1999 on, Crosspoint owned more than 40% of BlueStar's outstanding shares. McMinn and Hawk "owned a substantial number of preferred shares."[27] Shapero and McMinn sat on the BlueStar board.

"By mid-2000, BlueStar had incurred significant debt and liabilities and was losing millions of dollars every month. Its efforts to raise money through an initial public offering of stock were unsuccessful and it (and its major investor, Crosspoint) needed a bail-out."[28] Shapero lobbied Knowling for Covad to acquire BlueStar, and Covad eventually succumbed. A fairness opinion prepared by BlueStar's financial advisor for the transaction reported, "The management of [BlueStar] . . . informed us that [BlueStar], as of June 14, 2000, expected to exhaust its liquidity in the near term and did not have a financing source for funding its anticipated operating and capital needs over the following 12 months."[29] In addition to BlueStar's fiscal problems, senior Covad management opposed the transaction: "BlueStar's

[27] *Id.* at ¶ 58.
[28] *Id.* at ¶ 61.
[29] *Id.* at ¶ 63.

entire business was built on a feet-on-the-street direct sales model already tried and rejected by Covad."[30] The merger is alleged to have been "fraught with self-dealing because of the interlocking and conflicting relationships between the Covad and BlueStar boards."[31]

On September 22, 2000, Covad completed the BlueStar acquisition by issuing approximately 6.1 million shares of Covad common stock to BlueStar shareholders under an exchange ratio that enabled BlueStar preferred and common shareholders to receive an average price of $14.23 per share of Bluestar. Additionally, BlueStar's stock options and warrants were converted into approximately 255,000 Covad shares at a fair value of $6.55 per share. The total consideration Covad paid was valued at, at least, $200 million.[32] Knowling, Marshall, Lynch, Dunn, and Runtagh approved the BlueStar acquisition.

The acquisition immediately appeared to be a failure as, the day after the merger was announced, Covad's shares dropped 27%. On June 25, 2001, within a year after the merger, Covad announced it was shutting down the BlueStar network and laying off more than 400 employees.

[30] *Id.* at ¶ 69.
[31] *Id.* at ¶ 71.
[32] *Id.* at ¶ 73.

b. *BlueStar Earn-Out Settlement*

In addition to the consideration paid at the time of the merger, BlueStar shareholders were entitled to receive up to 5,000,000 additional Covad common shares at the end of 2001 if BlueStar achieved certain revenue and EBITDA goals. "Despite BlueStar's utterly dismal performance and failure to even approach, let alone reach, its EBITDA targets, in April 2001 Covad reached an agreement with BlueStar representatives, negotiated by Lynch, whereby BlueStar stockholders were given 3,250,000 of the 5,000,000 shares, in exchange for a release of all claims against [Covad] . . . ."[33] Lynch negotiated this settlement without final BlueStar accounting results and even though the former BlueStar shareholders were not entitled to any payments until the end of 2001. At the same time that Lynch's negotiations were taking place, Marshall "was sending emails to the Covad Board calling the BlueStar acquisition 'a very costly mistake, probably the worst mistake I have ever seen a company make.'"[34] No corporate record was kept of the negotiations. The BlueStar earn-out settlement cost Covad $100 million, to the substantial benefit of Crosspoint, Shapero, McMinn, and Hawk (who collectively received almost

[33] *Id.* at ¶ 74.
[34] *Id.*

half of the 3,250,000 shares from the earn-out settlement).[35] Covad reported that McMinn, Hawk, and Shapero did not participate in the meetings concerning the review and approval of the BlueStar earn-out settlement.[36] Marshall, Lynch, Runtagh, and Irving participated in the BlueStar earn-out settlement deliberations and vote.

3. The Dishnet Transaction

McMinn sat on the Board of Directors of Dishnet and held options to purchase shares of that company. Dishnet is a privately held telecommunications company that provides DSL and dial-up access in India.

On February 15, 2001, Covad—through a wholly owned subsidiary—purchased 2,000,000 shares of Dishnet for $22,980,000. In addition to the subscription agreement, Dishnet entered into an agreement with Covad to license Covad's proprietary operational support system for use in India. The business relationship soon deteriorated.

In October 2001, Dishnet filed a proof of claim in Bankruptcy Court against Covad asserting damages in excess of $24 million. Covad attempted to exercise its $23 million put option in Dishnet. As a result of these actions,

[35] *Id.* at ¶ 78.

[36] *See* Amended Compl. at ¶ 80 ("In fact, [Covad] has publicly stated that McMinn, Hawk and Shapero did not participate in the meetings concerning the 'review and approval' of the [BlueStar earn-out settlement]."); *see also* Stone Aff., Ex. E at 121 (Covad's 10-K for fiscal year ending December 2000).

McMinn was simultaneously sitting on the boards of two companies engaged in a substantial legal dispute.

Covad and Dishnet resolved their dispute. Among the terms of the settlement were (1) the sale of Covad's investment in Dishnet for $3 million, (2) resolution of Dishnet's claims against Covad, and (3) the relinquishment of Covad's put option in Dishnet.

F. *Proxy Disclosures and Khanna's Letter to Covad's Board*

The Plaintiffs allege that Khanna protested against the transactions discussed above on the grounds that they were compromised by self-dealing and otherwise lacked substantive business purpose. Covad's Board then "vowed to remove Khanna so he would not be an obstacle to their self-dealing."[37] Khanna was accused of sexual harassment, removed as General Counsel, and placed on administrative leave in June 2002.

On June 10, 2002, Covad issued its 2002 Proxy Statement. The annual meeting of Covad shareholders was scheduled for July 25, 2002. On June 19, 2002, after he was relieved of his duties, Khanna (through his attorney) sent a letter to Covad's Board "outlining among other things, the breaches of fiduciary duty alleged against the Board in [the Amended Complaint], including the Board's conduct in the Certive, BlueStar, and

[37] Amended Compl. at ¶ 110.

Dishnet transactions."[38] Khanna contends that this was not a demand on the Board; "[r]ather, it was a last-ditch attempt on his part to get the slim minority of directors who did not have direct interests in these transactions to do something to seek a remedy for the corporation."[39]

Although Khanna's charges were broadly directed at alleged fiduciary breaches by the Covad Board—breaches which, if as alleged, would have affected all public shareholders adversely—the response sought by Khanna was unique to him and provided no direct benefit to the other shareholders. Khanna attempted to extract the following terms:

> 1. Mr. Khanna shall be allowed to join the Covad Board of Directors, as Vice Chairman, with a not less than 15-year contract, . . . he shall be responsible for overall conflict of interest compliance.
>
> 2. Mr. Khanna shall be given a role as Executive Vice President for Corporate Strategy reporting directly to the CEO, which shall include the following areas: Public Advocacy Strategy, including legal and related PR strategy, press release review, and second (second to the CEO) public spokesperson (without any impairment to the CFO's role as head of Investor Relations); Legal Strategy, including Litigation Initiation and Settlement Strategy; New and Existing Product Implementation Strategy; ILEC Restructuring Strategy; and related strategies.

[38] *Id.* at ¶ 122.

[39] *Id.* at ¶ 123. The letter, which may be considered as incorporated into the Amended Complaint, was part of the record in the § 220 action as JTX 123. *See, e.g.*, Amended Compl. at ¶ 3.

3. He will retain the responsibility of being Covad's chief representative at trade associations . . . .

4. He will remain on all pre-existing e-mail mailing lists and will join any applicable new ones.

5. He will be compensated at all times not less than a comparable officer that serves as both an officer and as a director. He shall not be terminated or investigated for any reason other than fraud or illegal conduct during the 15-year period.

6. Covad will make a statement to the legal department, corporate officers and members of the Board clearing Mr. Khanna of any and all violations of law and stating that he has been subjected to two separate investigations and has been cleared of any ethical or integrity violations as well. . . .

7. Mr. Khanna will have five individuals reporting to him on a solid line basis . . . , and his administrative support person . . . , plus a minimum of four individuals reporting to him on a dotted line basis . . . .[40]

On July 9, 2002, shortly after his letter to Covad's Board, Khanna sent a draft fiduciary duty complaint. His implicit threat: if the Board did not accede to his selfish wishes, a derivative and class action complaint would be brought, purportedly for the benefit of all shareholders.

Covad's Board formed a committee, consisting of directors Runtagh and Crandall, to investigate Khanna's allegations; the committee was not initially given any power to act independently of the Covad Board.

[40] JTX 123.

Additionally, Crandall was given the authority to act alone on behalf of the committee if his opinion differed from that of Runtagh. Although Khanna was not aware of it, at some point Jalkut became a member of the committee. On September 20, 2002, the Board gave the committee authority to determine whether or not to bring a suit based on Khanna's allegations of wrongdoing.

In October 2002, the committee concluded that the company should not pursue litigation based on the Certive matters.[41] The Amended Complaint charges that only disclosures Covad's Board made of Khanna's allegations and the subsequent investigations into those allegations were in its March 2003 10-K, its May 2003 10-Q, and its 2004 Proxy Statement.[42] Both of Covad's 2003 disclosures were essentially the same; its March 2003 10-K recited:

> In June 2002, Dhruv Khanna was relieved of his duties as our General Counsel and Secretary. Shortly thereafter, Mr. Khanna alleged that, over a period of years, certain current and

[41] *Id.* at ¶ 129. It is unclear from the Amended Complaint when the committee decided not to pursue claims based on the other transactions of which Khanna complained. It does allege that the committee "informed Khanna that [it] believed his allegations were without merit" on December 26, 2002. *Id*. at ¶ 133.

[42] *Id.* at ¶¶ 204, 213. Paragraph 213 of the Amended Complaint contradicts Paragraph 204 by alleging that the disclosures were in the 2003 Proxy Statement. Additionally, Paragraph 133 of the Amended Complaint alleges that the "only public disclosure" of Khanna's allegations and the investigation occurred in Covad's March 2003 10-K; however, the Amended Complaint explains in other paragraphs that disclosures were made at least in the May 2003 10-Q and the 2004 Proxy Statement. *See id*. at ¶¶ 204, 213.

former directors and officers had breached their fiduciary duties to the Company by engaging in or approving actions that constituted waste and self-dealing, that certain current and former directors and officers had provided false representations to our auditors and that he had been relieved of his duties in retaliation for his being a purported whistleblower and because of racial or national origin discrimination. He has threatened to file a shareholder derivative action against those current and former directors and officers, as well as a wrongful termination lawsuit. Mr. Khanna was placed on paid leave while his allegations were being investigated.

Our Board of Directors appointed a special investigative committee, which initially consisted of Mr. Crandall and Ms. Runtagh, to investigate the allegations made by Mr. Khanna. Mr. Jalkut was appointed to this committee shortly after he joined our Board of Directors. This committee retained an independent law firm to assist in its investigation. Based on this investigation, the committee concluded that Mr. Khanna's allegations were without merit and that it would not be in the best interest of the Company to commence litigation based on these allegations. The committee considered, among other things, that many of Mr. Khanna's allegations were not accurate, that certain allegations challenged business decisions lawfully made by management or the Board, that the transactions challenged by Mr. Khanna in which any director had an interest were approved by a majority of disinterested directors in accordance with Delaware law, that the challenged director and officer representations to the auditors were true and accurate, and that Mr. Khanna was not relieved of his duties as a result of retaliation for alleged whistleblowing or racial or national origin discrimination. Mr. Khanna has disputed the committee's work and the outcome of the investigation.

After the committee's findings had been presented and analyzed, the Company concluded in January 2003 that it would not be appropriate to continue Mr. Khanna on paid leave status, and determined that there was no suitable role for him at the Company. Accordingly, he was terminated as an employee of the Company. While the Company believes the contentions

> of Mr. Khanna referred to above are without merit, and will be vigorously defended if brought, it is unable to predict the outcome of any potential lawsuit.[43]

No other public disclosure was made of Khanna's termination and the charges he made in his letter to the Board.

II. CONTENTIONS

A. *Derivative Fiduciary Duty Claims*

Count I of the Amended Complaint alleges breaches of fiduciary duty against McMinn, Shapero, Marshall, Lynch, Hawk, and Knowling for allowing McMinn's founders' shares to vest. The Defendants respond that the Plaintiffs' claim is time-barred and that this decision is protected by the business judgment rule.

Count II of the Amended Complaint charges McMinn, Shapero, and Crosspoint with breaching their fiduciary duties by usurping a Covad corporate opportunity in founding, and investing in Series A Preferred shares of, Certive. The Defendants argue that this claim is time-barred, that it was properly rejected by a majority of disinterested and independent directors, and that the Plaintiffs have not properly alleged that pre-suit demand upon the Board would have been futile. Additionally, Crosspoint argues that this

[43] *Id.* at ¶ 133.

claim should be dismissed because the Plaintiffs do not sufficiently allege that Crosspoint owed fiduciary duties to Covad's shareholders.

Count III of the Amended Complaint alleges breaches of fiduciary duty by McMinn, Shapero, Hawk, Lynch, Marshall, and Knowling during Covad's acquisition of a substantial equity interest in Certive. The Plaintiffs assert that some of these directors were interested in the transaction and that the investment was detrimental to Covad's shareholders. The Plaintiffs contend that the investment constituted corporate waste. The Defendants respond that the Plaintiffs' claims surrounding the Certive investment are time-barred, that there was no breach of a duty of loyalty because the transaction was approved by a majority of disinterested and independent directors, that the Plaintiffs' claim for breach of fiduciary duty for failure to seek restitution for the Certive investment fails as a matter of law, and that pre-suit demand is not excused.

Count IV of the Amended Complaint asserts a claim against McMinn, Shapero, Hawk, Lynch, Marshall, Dunn, Knowling, Runtagh, and Irving for breaches of fiduciary duty with respect to the two BlueStar transactions (the acquisition and the earn-out settlement). The Defendants assert that this claim is time-barred and that the Plaintiffs have not shown that a majority of

the directors who approved these transactions were interested or lacked independence.

Count V of the Amended Complaint alleges breaches of fiduciary duty by McMinn, Shapero, Hawk, Lynch, Marshall, Hoffman, Runtagh, and Irving for the Dishnet transaction. The Defendants contend that the Dishnet settlement was approved a majority of disinterested and independent directors.

In addition, the Defendants assert that the Plaintiffs have failed to plead a proper claim for waste. Moreover, the Director Defendants have attempted to invoke the exculpatory provision adopted in Covad's Amended and Restated Certificate of Incorporation under 8 *Del.C.* § 102(b)(7), which would shield them from personal liability for money damages based on any breach of the duty of care.

Count VI of the Amended Complaint asserts a derivative claim against Crosspoint for aiding and abetting Covad's directors in breaching their fiduciary duties in the Certive and BlueStar transactions. Crosspoint argues that the Plaintiffs do not sufficiently plead an underlying breach of fiduciary duty (so there can be no secondary liability) and that the Plaintiffs failed to plead that Crosspoint knowingly participated in any breach of duty.

Count VII of the Amended Complaint seeks to set forth a claim against Crosspoint under the doctrine of *respondeat superior*. The Plaintiffs allege that Shapero and Hawk—acting as Crosspoint's agents—caused harm to Covad by orchestrating the Certive and BlueStar transactions. Crosspoint responds the Plaintiffs have failed to plead an underlying breach of fiduciary duty for the Certive and BlueStar transactions and that the Plaintiffs' *respondeat superior* claim fails as a matter of law.

B. *Demand on the Board and Demand Futility*

The Defendants also contend that Khanna's letter to the Board was a demand on Covad's Board and the Plaintiffs have not set forth facts that show that the demand was wrongfully rejected. Furthermore, the Defendants contend that, even if Khanna did not make a demand on Covad's Board, the Plaintiffs have not set forth facts demonstrating that demand would have been futile and, thus, all derivative claims must be dismissed. The Plaintiffs respond that Khanna's letter to the Board was not a demand and that they have indeed pleaded facts showing that demand on Covad's Board would have been futile and, therefore, that demand should be excused.

C. *Direct Claims for Breach of Fiduciary Duty with regard to Covad's 2002, 2003, and 2004 Proxy Statements*[44]

Count VIII of the Amended Complaint is a direct claim against McMinn, Shapero, Hawk, Lynch, Marshall, Irving, Hoffman, and Runtagh for breaches of fiduciary duty resulting from material omissions in Covad's 2002 Proxy Statement. In 2002, McMinn, Hawk, and Hoffman were reelected to the Covad Board. The Plaintiffs allege that 2002 Proxy Statement did not disclose certain information—*e.g.*, Khanna's June 19, 2002 letter to the Board, the Standstill Agreement,[45] the real reasons for Khanna's termination, that the BlueStar earn-out criteria had not been met, and that McMinn was working for Certive in 1999—and that these omissions were material to shareholders. The Defendants argue that the Plaintiffs' claim is barred by laches and that Covad satisfied its disclosure obligations.

Counts IX and X concern Covad's 2003 and 2004 Proxy Statements. In 2003, Lynch, Irving, and Jalkut were reelected to the Covad Board; and in 2004, Crandall and Runtagh were reelected. The Plaintiffs allege that

[44] The Plaintiffs do not allege that the board elections were contested.

[45] Covad and Khanna entered into the "Standstill Agreement" which allowed for "confidential settlement discussions" during the period of July 10, 2002 through July 23, 2002. *Id.* at ¶ 116. This period was subsequently extended through July 26, 2002. Under the Standstill Agreement, the parties agreed that "[d]uring the Negotiating Period, neither party shall take any actions to advance, or that will have the effect of advancing, its litigation position, and they shall diligently and vigorously focus their attention on resolving the disputes among them." *Id.*

certain information was either inadequately disclosed or entirely omitted—Khanna's June 19, 2002 letter, the real reasons for Khanna's termination from Covad, that the BlueStar earn-out criterion had not been met, and which transactions and directors Khanna was challenging—and that these omissions were material to shareholders. Again, the Defendants argue that the Plaintiffs' claims are barred by laches and that Covad satisfied its disclosure requirements.

D. *Motion to Disqualify Plaintiffs*

Covad contends that Khanna must be disqualified as a representative plaintiff because (1) Khanna's ethical duties, as Covad's former General Counsel, prevent him from pursuing this litigation; (2) he is barred from pursuing litigation against his former client on matters with which he had a "substantial relationship"; (3) he participated, or at least acquiesced, in the challenged transactions; and (4) he has a personal agenda against the Defendants separate from Covad shareholders. Khanna denies all of these allegations. Additionally, Covad contends that Sams and Meisel must be disqualified because they have been "tainted" by exposure to Khanna's privileged information and because they are not the "driving force" behind this litigation.

E. *Motions to Strike Portions of the Amended Complaint—Motions to Seal/Unseal the Record*

Covad contends that Paragraphs 52, 54, 55, and 57 of the Amended Complaint should be stricken because they disclose privileged information in violation of Khanna's attorney-client duties. Khanna argues that these paragraphs should not be stricken because the information is public information gained from the § 220 proceeding and, with regard to paragraph 52, because Covad waived any privilege it may have had by introducing its facts as evidence at the § 220 trial.

Comparable arguments regarding privilege are made in the competing motions to seal and unseal the record.[46] In addition to the challenges presented above, Covad argues that Paragraphs 43, 44, and 74 of the Amended Complaint should remain sealed because they contain confidential and sensitive information.

III. DEMAND FUTILITY

The Plaintiffs seek to assert multiple derivative claims on behalf of Covad. The Court must first inquire as to whether demand was made on Covad's Board. If it was not, the Court must then determine whether demand is excused.

[46] Plaintiffs have moved to unseal the record, in addition to Covad's motion for continued sealing of portions of the record.

A. *Legal Standard for Demand Futility*

"A shareholder's right to bring a derivative action does not arise until he has made a demand on the board of directors to institute such an action directly, such demand has been wrongfully refused, or until the shareholder has demonstrated, with particularity, the reasons why pre-suit demand would be futile."[47] This requirement, found in Court of Chancery Rule 23.1,[48] arises from the fundamental principle that the board of directors manages the business and affairs of a corporation, including decisions of whether to bring suit on behalf of the corporation.[49] In order to bring a derivative claim, a plaintiff "must overcome the powerful presumptions of the business judgment rule . . . ."[50] Indeed, "[t]he key principle upon which

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[47] *Ash v. McCall*, 2000 WL 1370341, at *6 (Del. Ch. Sept. 15, 2000).

[48] CT. CH. R. 23.1 ("The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort.").

[49] *See* 8 *Del.C.* § 141; *see also White v. Panic*, 793 A.2d 356, 363 (Del. Ch. 2000), *aff'd*, 783 A.2d 543 (Del. 2001).

[50] *Rales v. Blasband*, 634 A.2d 927, 933 (Del. 1993). This Court has previously explained that

> [t]he purpose for the demand requirement and concomitant heightened pleading standard is to "effectively distinguish between strike suits motivated by the hope of creating settlement leverage through the prospect of expensive and time-consuming litigation discovery and suits reflecting a reasonable apprehension of actionable director malfeasance that the sitting board cannot be expected to objectively pursue on the corporation's behalf."

White, 793 A.2d at 364 (quoting DONALD J. WOLFE, JR. & MICHAEL A. PITTENGER, CORPORATE AND COMMERCIAL PRACTICE IN THE DELAWARE COURT OF CHANCERY § 9-2(b)(3)(i), at 554 (1998)); *see also Beam v. Stewart*, 845 A.2d 1040, 1050 (Del. 2004).

this area of our jurisprudence is based is that the directors are entitled to a *presumption* that they were faithful to their fiduciary duties."[51] "By its very nature the derivative suit impinges on the managerial freedom of directors."[52] As a consequence, Court of Chancery Rule 23.1 imposes on a plaintiff a pleading burden that is "more onerous" than the burden a plaintiff must satisfy when confronted with a motion to dismiss under Court of Chancery Rule 12(b)(6).[53]

As this Court has previously explained, depending on the circumstances, inquiry into whether demand is excused proceeds under either *Aronson v. Lewis*[54] or *Rales v. Blasband*.[55]

> Under the two-pronged *Aronson* test, demand will be excused if the derivative complaint pleads particularized facts creating a reasonable doubt that "(1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." As the Supreme Court stated in *Rales* . . ., however, there are three circumstances in which the *Aronson* standard will not be applied: "(1) where a business decision was made by the board of a company, but a majority of the directors making the

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[51] *Beam*, 845 A.2d at 1050 (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds*, *Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000)).
[52] *Aronson*, 473 A.2d at 811. "The hurdle of proving demand futility also serves an important policy function of promoting internal resolution, as opposed to litigation, of corporate disputes and grants the corporation a degree of control over any litigation brought for its benefit." *Rattner v. Bidzos*, 2003 WL 22284323, at *7 (Del. Ch. Sep. 30, 2003) (citations omitted).
[53] *Levine v. Smith*, 591 A.2d 194, 207 (Del. 1991), *overruled on other grounds*, *Brehm*, 746 A.2d at 254.
[54] 473 A.2d 805 (Del. 1984).
[55] 634 A.2d 927 (Del. 1993).

> decision have been replaced; (2) where the subject of the derivative suit is not a business decision of the board; and (3) where . . . the decision being challenged was made by the board of a different corporation." In those situations, demand is excused only where "particularized factual allegations . . . create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."[56]

In other words, if the pleadings present particularized "facts sufficient to create a reasonable doubt that . . . a majority of the directors are disinterested and independent," [57] then demand will be excused under either the test in *Rales* or the first prong of *Aronson*.

> Disinterested "means that directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally." "Independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences."[58]

If, however, the Court's "review of the complaint reveals that it does not allege with particularity facts from which the court could reasonably conclude" that at least half "of the directors in office when the complaint

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[56] *In re Bally's Grand Deriv. Litig.*, 1997 WL 305803, at *3 (Del. Ch. June 4, 1997) (footnotes omitted). See also the Court's discussion at Part III(C)(2), *infra*, addressing analysis of "substantial threat[s] of personal liability" for directors applicable under *Rales* in certain circumstances.

[57] *White*, 793 A.2d at 364. The burden of demonstrating demand futility lies with the Plaintiffs. *See Aronson*, 473 A.2d at 812.

[58] *In re J.P. Morgan Chase & Co.*, 2005 WL 1076069, at *8 (Del. Ch. Apr. 29, 2005) (quoting *Aronson*, 473 A.2d at 812, 816), *aff'd*, 2006 WL 585606 (Del. Mar. 8, 2006); *see also Beam*, 845 A.2d at 1049; *Rales*, 634 A.2d at 936.

was filed were disabled from impartially considering a demand," then the plaintiff's derivative claim will be dismissed—unless the second prong of *Aronson* applies and is satisfied.[59]

"At the motion to dismiss stage of the litigation, '[p]laintiffs are entitled to all reasonable factual inferences that logically flow from the particularized facts alleged, but conclusory allegations are not considered as expressly pleaded facts or factual inferences.'"[60] The Court "need not blindly accept as true all allegations, nor must [it] draw all inferences from them in plaintiffs' favor unless they are reasonable inferences."[61] Pleading with particularity is essential for a plaintiff to satisfy the requirements of demand excusal. Indeed, such "pleadings must comply with stringent requirements of factual particularity that differ substantially from the permissive notice pleadings governed solely by Chancery Rule 8(a)."[62] The Court must, however, "accept as true all well-pled allegations of fact in the

[59] *Highland Legacy Ltd. v. Singer*, 2006 WL 741939, at *1 (Del. Ch. Mar. 17, 2006); *see also Beneville v. York*, 769 A.2d 80, 86 (Del. Ch. 2000) (describing analysis where half of board compromised).

[60] *White v. Panic*, 783 A.2d 543, 549 (Del. 2001) (citations omitted); *see also Kahn v. Roberts*, 1994 WL 70118, at *5 (Del. Ch. Feb. 28, 1994) ("Conclusory allegations of domination and control, without particularized facts showing that an individual person or entity interested in the transaction controlled the board's vote on the transaction, are insufficient to excuse pre-suit demand.").

[61] *White*, 783 A.2d at 549 (citation omitted).

[62] *Brehm*, 746 A.2d at 254 ("What the pleader must set forth are particularized factual statements that are essential to the claim. Such facts are sometimes referred to as 'ultimate facts,' 'principal facts' or 'elemental facts.'" (citations omitted)).

complaint, and all reasonable inferences from non-conclusory allegations contained in the complaint must be drawn in favor of the plaintiff."[63]

B. *Khanna's Letter Was Not a Demand to Covad's Board*

Before proceeding to demand futility analysis, the Court must first ascertain whether Khanna's letter of June 19, 2002, constituted a demand on the Covad Board. By making demand on a board of directors, a plaintiff concedes the disinterestedness and independence of that board.[64] It is then left to the board to determine whether to pursue litigation. A plaintiff's only recourse, in that circumstance, would be to demonstrate that demand was wrongfully rejected, but, as with any board decision, rejection of shareholder demand is afforded the presumptions of the business judgment rule.[65]

In determining whether Khanna's June 19, 2002, letter to the Board was a demand, the Court cannot look for "magic words" establishing that a communication is a demand for purposes of Court of Chancery Rule 23.1.[66]

> To constitute a demand, a communication must specifically state: (i) the identity of the alleged wrongdoers, (ii) the wrongdoing they allegedly perpetrated and the resultant injury to the corporation, and (iii) the legal action the shareholder

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[63] *Rattner*, 2003 WL 22284323, at *7 (citing *Grobow v. Perot*, 539 A.2d 180, 187 (Del. 1988), *overruled on other grounds*, *Brehm*, 746 A.2d at 254).
[64] *See, e.g.*, *Scattered Corp. v. Chicago Stock Exchange, Inc.*, 701 A.2d 70, 73 (Del. 1997) (quoting *Levine*, 591 A.2d at 197-98).
[65] *Id.*
[66] *See Yaw v. Talley*, 1994 WL 89019, at *7 (Del. Ch. Mar. 2 1994) ("There is no all-inclusive legal formula defining what types of communications will constitute a demand. That determination is essentially fact-driven.").

> wants the board to take on the corporation's behalf. Those elements are consistent with and derive from the policies underlying the demand requirement.[67]

The burden of demonstrating that a communication was a demand lies with the party alleging that the communication should be viewed as such.[68]

In this instance, the Defendants contend that the June 19, 2002, letter from Khanna's attorney[69] constituted a demand. The letter clearly meets the first two requirements of a demand: it identified the alleged wrongdoers and the harm they caused Covad. The issue, then, is whether the letter identified "the legal action the shareholder wants the board to take on the corporation's behalf."[70] Covad argues that the letter can be "fairly construed [to give] rise to the inference that Khanna was demanding the Board take legal action on the corporation's behalf"[71] and cites, in particular, to various requests (or, in the Defendants' view, demands) made by Khanna in the letter, such as his reinstatement as General Counsel and his appointment to Covad's Board.[72]

Though it is not a question free from doubt, the Court rejects Defendants' argument for the following reasons. First, the Defendants bear

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[67] *Id.*
[68] *See id.* ("Policy considerations require that the burden lie with the party asserting that a demand was made, and that ambiguous communications be construed against a finding of a demand.").
[69] JTX 123.
[70] *Yaw*, 1994 WL 89019, at *7 (emphasis added).
[71] Reply Mem. in Supp. of Covad Commc'ns Group, Inc.'s Mot. to Dismiss Am. Deriv. & Class Action Compl. ("Covad Reply Br. to Dismiss") at 3.
[72] JTX 123, at 11-12.

the burden of establishing that demand was, in fact, made, and any ambiguity must be construed against a finding of demand. Second, the remedial actions sought by Khanna related to his removal as Covad's General Counsel and his future employment status at Covad. The relief would have been for his personal benefit; it would have accomplished little (or nothing) for the shareholders. The transactions challenged in this litigation are related, at most, tangentially to his termination dispute. In other words, the remedies Khanna sought in the letter addressed directly his claimed wrongful suspension and likely termination, and the letter cannot fairly be read as an attempt to seek a remedy for the challenged transactions for the good of Covad or its shareholders.[73]

Covad points out language in the letter—for example, the threat to "light a legal fuse"[74]—that could be read as an expansive threat to seek a remedy for every wrong alleged in the letter and that the remedies Khanna sought, while inadequate to "make whole" the shareholders at large, nonetheless were the remedies Khanna chose. A far more plausible reading of the letter, however, is that the remedies Khanna sought were, as the

[73] This question is complicated by transmission of a draft complaint. *See* Amended Compl. at ¶ 123; JTX 124. Although the transmission of a draft complaint, along with other communications, has been previously held not to constitute demand, *see Yaw*, 1994 WL 89019, at *6 - *8, the aggregate here draws near the threshold of demand status.
[74] JTX 123 at 12.

letter's opening sentence provides, "relat[ed] to his removal from the position of General Counsel of Covad."[75] Ambiguity of this sort must be resolved in favor of Khanna (*i.e.*, the party not seeking to show that the letter was a demand). Therefore, the Court concludes that Khanna's June 19, 2002, letter did not constitute demand upon the Covad Board.[76]

C. *Plaintiffs' Failure to Allege with Particularity that the Covad Board was Interested or Lacked Independence*

The Court now turns to the question of whether at least half of the Covad Board was either interested or lacked independence when this action was filed.[77] The Court's demand-futility analysis here is somewhat complicated by the relatively long time-span during which the challenged transactions took place and by turnover in the membership of Covad's Board. A majority of Covad's Board changed after the events surrounding Counts II and III and, probably, Count I. Additionally, the Plaintiffs bring

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[75] *Id.* at 1.

[76] Covad also argues that the letter constituted demand because "[t]he Board did exactly what it was required to do upon receiving a pre-lawsuit demand" and notes that "Khanna was an active and willing participant in the investigation." Covad Reply Br. to Dismiss, at 4. Although this may be true, the Board's interpretation of what the letter represented does not control the Court's determination of whether it was a demand.

[77] *See, e.g.*, *Brehm*, 746 A.2d at 257; *see also Highland Legacy Ltd.*, 2006 WL 741939, at *4; *In re Nat'l Auto Credit, Inc. S'holders Litig.*, 2003 WL 139768, at *8 (Del. Ch. Jan. 10, 2003); *Cal. Pub. Employees' Ret. Sys. v. Coulter*, 2002 WL 31888343, at *10 (Del. Ch. Dec. 18, 2002); *In re Bally's Grand*, 1997 WL 305803, at *3. *Cf.* DONALD J. WOLFE, JR. & MICHAEL A. PITTENGER, CORPORATE AND COMMERCIAL PRACTICE IN THE DELAWARE COURT OF CHANCERY, § 9-2[b], at 9-75 to –76, 9-78 (2005), (considering which "Board"—at the time of suit or the time of the transaction—must be evaluated under *Aronson*).

Count I (the vesting of McMinn's founders' shares) on the theory that it was result of board inaction—*i.e.*, that no business decision was made. The parties agree, therefore, that demand-futility with respect to the Certive Claims must be analyzed under *Rales*.[78] A majority of the Covad board has *not* changed, however, since the events surrounding Counts IV and V (*i.e.*, the "BlueStar Claims" and the "Dishnet Claims," respectively); therefore, the Court employs the two-prong standard of *Aronson* with respect to these claims.

"Demand futility [will] be determined solely from the well-pled allegations of the Complaint."[79] This analysis is fact-intensive and proceeds director-by-director and transaction-by-transaction.[80] The Covad Board, at the time of filing of this action, consisted of eight directors: Irving, Jalkut, Lynch, Crandall, Runtagh, Hawk, Hoffman, and McMinn.[81] If the Court concludes that the Plaintiffs failed in their efforts to allege that at least four

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[78] *See Rales*, 634 A.2d at 934. With respect to Count I, the Amended Complaint fails to allege the date of the vesting of the disputed Covad shares. *Rales*, in one form or another, will control. *See, e.g.*, Pls.' Ans. Br. in Opp'n to Covad Commc'ns Group, Inc.'s Mot. to Dismiss Am. Deriv. & Class Action Compl. ("Pls.' Ans. Br. to Covad's Mot. to Dismiss") at 30**;** Covad Reply Br. to Dismiss at 9; Pls.' Ans. Br. in Opp'n to Dir. Defs. Mot. to Dismiss Am. Deriv. & Class Action Compl. ("Pls.' Ans. Br. to Dirs.' Mot. to Dismiss") at 31. *But cf. In re Bally's Grand*, 1997 WL 305803, at *3 - *4 (declining to examine demand futility because complaint failed to identify directors on board at filing).

[79] *In re Cooper Co., Inc.*, 2000 WL 1664167, at *5 (Del. Ch. Oct. 31, 2000).

[80] *See, e.g.*, *Beam*, 845 A.2d at 1051 (explaining that review occurs on a "case-by-case basis").

[81] As explained below, consideration of Jalkut does not prejudice the Plaintiffs. *See* Part III (C)(5), *infra*.

of the directors were not disinterested and independent for demand purposes, then the Court's analysis with respect to *Rales* and the first-prong of *Aronson* is at an end.

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As a preliminary matter, the Court notes that the Amended Complaint repeatedly sets forth certain generalized, conclusory allegations. In the interest of efficiency, the Court examines these now. Demand-futility jurisprudence often recites that certain allegations cannot "without more," or "standing alone," satisfy the particularized pleading requirements of Court of Chancery Rule 23.1. These conclusory allegations add no, or only *de minimis*, substance to the Court's demand-futility inquiry; they are to be distinguished from substantive allegations that are, by themselves, insufficient but, when viewed *in toto*, may push the analysis over the threshold of "reasonable doubt" and thereby excuse demand.

First, the Plaintiffs repeatedly allege that the Covad Board is McMinn (and/or Shapero) "dominated," or some variant thereof.[82] Indeed, the Plaintiffs' theory as to why demand is excused appears, at times, to hinge largely on this characterization. The Plaintiffs have not, however, alleged that McMinn is a controlling shareholder, and, even if he were, "[t]here must

[82] *See, e.g.*, Amended Compl. at ¶¶ 32, 40, 138.

be coupled with the allegation of control such facts as would demonstrate that through personal or other relationships the directors are beholden to the controlling person."[83] Whether McMinn (or any other director) "dominates" the Covad Board is a question that must be resolved director-by-director, based on particularized allegations of fact. "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?"[84] Conclusory, across-the-board allegations of a lack of independence will not prevail; allegations of this type are akin to the "shorthand shibboleth" which this Court has long-rejected.[85]

Second, the Amended Complaint repeatedly alleges that McMinn (or another director) "recruited" certain individuals to be Covad directors, that those individuals took their seats at McMinn's (or others') "behest," and that those individuals became directors with the other directors' "consent and approval."[86] Again, conclusory allegations of this nature do not advance the Court's inquiry; they will not "sterilize" a director's judgment with respect

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[83] *Aronson*, 473 A.2d at 815; *see also Beam*, 845 A.2d at 1050.
[84] *Beam*, 845 A.2d at 1049-50; *see also Highland Legacy, Ltd.*, 2006 WL 741939, at *5 ("There must be some alleged nexus between the domination and the resulting personal benefit to the controlling party." (citing *Aronson*, 473 A.2d at 816)).
[85] *See, e.g., Cal. Pub. Employees' Ret. Sys.*, 2002 WL 31888343, at *7; *see also* WOLFE & PITTENGER, *supra* note 77, § 9-2[b], at 9-57, 9-69 to -72.
[86] *See, e.g.*, Amended Compl. at ¶¶ 15-17.

to demand.[87] "The proper focus is the care, skill and diligence used by the directors in making the challenged decision rather than upon the way in which the directors obtained their seats in the boardroom."[88] "Directors must be nominated and elected to the board in one fashion or another,"[89] and to hold otherwise would unnecessarily subject the independence of many corporate directors to doubt. Conclusory allegations of this type do not cast suspicion on the independence of directors without additional facts demonstrating reason to view the nomination process askance. As a consequence, such allegations, "without more," are of little assistance in view of the requirement for particularity—and the "piling-on" of more and similar conclusory allegations will not sum to a reasonable doubt.

Third, the Amended Complaint sets forth the repeated incantation that the directors' lack of independence is demonstrated by their "pattern" of votes and "acquiescence" in permitting McMinn and others to benefit from self-dealing transactions.[90] The complaint fails either to explain, in most instances, how the directors' alleged acquiescence benefited them (other

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[87] *See Aronson*, 473 A.2d at 816. *See also White*, 793 A.2d at 366; *Benerofe v. Cha*, 1996 WL 535405, at *7 (Del. Ch. Sept. 12, 1996); *cf. In re W. Nat'l Corp. S'holders Litig.*, 2000 WL 710192, at *15 (Del. Ch. May 22, 2000) (applying summary judgment standard).
[88] *Emerald Partners v. Berlin*, 1993 WL 545409, at *4 (Del. Ch. Dec. 23, 1993).
[89] *In re W. Nat'l Corp.*, 2000 WL 710192, at *15.
[90] *See* Amended Compl. at ¶¶ 14-16, 139.

than possibly as addressed in the next paragraph)[91] or to set forth particularized facts showing a pattern of votes (in addition to the few challenged transactions) from which the Court could draw a reasonable inference.[92]

Fourth, the Amended Complaint alleges, repeatedly, that the directors "derived the benefit of being and remaining on the Board of Directors of, and receiving compensation from, Covad . . . ."[93] The Plaintiffs then conclusorily allege that the price of these "benefits" was the directors' support for the "self-dealing" occurring at Covad.[94] As with the allegations described above, the mere fact that a director receives compensation for her service as a board member adds little or nothing to demand-futility analysis, "without more"[95]—*i.e.*, unless the pleadings demonstrate, for example, that the status or compensation was somehow "material" to the director or otherwise outside the norm.

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[91] *Cf. In re eBay, Inc. S'holders Litig.*, 2004 WL 253521, at *4 - *5 (Del. Ch. 2004).

[92] *See, e.g.*, *Cal. Pub. Employees' Ret. Sys.*, 2002 WL 31888343, at *7, *9; *Beam v. Stewart*, 833 A.2d 961, 981 (Del. Ch. 2003), *aff'd*, 845 A.2d 1040 (Del. 2004). *Cf. Brehm*, 746 A.2d at 257 n.34.

Although there may be instances in which a director's voting history would be sufficient to negate a director's presumed independence, routine consensus cannot suffice to demonstrate disloyalty on the part of a director. To conclude otherwise would simply encourage staged disagreements and nonunanimous decisions for the sake of nonunanimous decisions in the boardroom.

[93] *See* Amended Compl. at ¶¶ 14-17.

[94] *See id.*

[95] *See, e.g.*, *Grobow*, 539 A.2d at 188; *cf. Highland Legacy Ltd.*, 2006 WL 741939, at *5; *White*, 793 A.2d at 366 (addressing allegations involving normal fees and compensation).

Finally, the Amended Complaint sets forth numerous allegations of various social and business ties among members of the Covad Board.[96] With the exception of Lynch, however, as discussed in some detail below, the Plaintiffs' allegations amount to no more than the equivalent of a simple assertion that demand should be excused due to "structural bias." As explained in *Beam v. Stewart*,[97] "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."[98] The Court's analysis in *Beam* was primarily directed at social relationships, but it also may inform the evaluation of allegations of business relationships, as well: "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 pre-suit demand futile."[99] Although not all allegations of past or present social or business relationships may be lumped in the category of allegations that provide no

[96] *See* Amended Compl. at ¶¶ 13-14.
[97] 845 A.2d 1040 (Del. 2004).
[98] *Id.* at 1051.
[99] *Id.*; *see also Jacobs v. Yang*, 2004 WL 1728521, at *5 - *6, *7 (Del. Ch. Aug. 2, 2004), *aff'd*, 867 A.2d 902 (Del. 2005) (TABLE) (citing *Orman v. Cullman*, 794 A.2d 5, 27 n.33 (Del. Ch. 2002) ("The naked assertion of previous business relationships is not enough to overcome the presumption of a director's independence.")); *Cal. Pub. Employees' Ret. Sys.*, 2002 WL 31888343, at *9.

grist for the mill of demand-futility inquiry, the heightened strength of relationship required to find that a director's "discretion would be sterilized" renders allegations concerning most ordinary relationships of limited value, at most.[100]

Having examined the repeated, conclusory allegations that comprise too much of the Amended Complaint, the Court now begins a director-by-director (and, as necessary, transaction-by-transaction) inquiry into the specific, substantive allegations of the Amended Complaint relevant to demand excusal.[101]

1. Crandall

The Amended Complaint, on its face, fails to create a reasonable doubt as to the disinterestedness or independence of Crandall. Crandall was only appointed to the Covad Board on June 20, 2002, after the challenged transactions took place.[102] While this does not, alone, make demonstration of potential interest or lack of independence impossible, it does make the

[100] *See, e.g.*, *Beam*, 845 A.2d at 1050-52; *see also* Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503, 534-35 (1989).

[101] It should be noted that, in several instances during the course of analysis, the Court identifies facts that the Plaintiffs did not plead in their attempt to obtain demand excusal. This is not intended to set forth a requirement that each of the absent facts be pleaded in order that demand be excused; on the contrary, the Court's intent is only to point out facts that, if alleged, could significantly increase the likelihood of a finding of interestedness or lack of independence.

[102] Amended Compl. at ¶ 19. Nowhere in the Amended Complaint is Crandall alleged to have been interested in any of the transactions in question.

Plaintiffs' burden more difficult. Indeed, the Amended Complaint may be read to concede Crandall's disinterestedness and independence. The complaint does not list Crandall as among the seven members of the Covad Board who are alleged either to be interested or lack independence.[103]

The Plaintiffs, in their answering brief, however, assert for the first time that Crandall's independence is compromised by his ties to BEA Systems, a Covad vendor.[104] The Plaintiffs explain that Crandall is a member of the board of directors of BEA Systems, a supplier of software and related support that received in excess of $2.2 million in revenue from Covad in 2004. The Plaintiffs make no mention of BEA Systems in the Amended Complaint;[105] nevertheless, they now ask the Court to consider this information on the grounds that it is contained in Covad's 2004 Proxy, which is referenced in their brief with respect to the Plaintiffs' proxy disclosure claims.[106] Although the Court is skeptical that this constitutes a proper means of asserting by way of a *well-pleaded complaint* particularized facts within the meaning of Court of Chancery Rule 23.1,[107] the parties may

[103] *See* Amended Compl. at ¶¶ 137, 140; *see also* CT. CH. R. 23.1 (requiring that complaint "allege with particularity . . . the reasons . . . for not making [demand]").
[104] Pls.' Ans. Br. to Covad's Mot. to Dismiss at 34.
[105] *See* Amended Compl. at ¶ 19.
[106] *See* Calder Decl., Ex. E (Covad's 2004 Proxy Statement).
[107] A plaintiff for whom demand will be excused should be capable of demonstrating demand futility by recourse solely to the particularized facts alleged in the complaint. *Cf. Kaplan v. Peat, Marwick, Mitchell & Co.*, 540 A.2d 726, 727-28 (Del. 1988) ("When

refer to the substance of certain documents if those documents are "integral to plaintiffs' claims and incorporated in the complaint."[108] Here, the proxy statement was "integral" to the disclosure claims, not to assertions regarding Crandall's independence. To evaluate fully the Plaintiffs' claims, the Court will consider Crandall's ties to BEA Systems in analyzing his independence, as well.

Ultimately, the inquiry into independence turns in this instance on whether Covad's business relationship with BEA Systems was material to BEA or to Crandall himself as a director of BEA.[109] The 2004 Proxy merely reports that Crandall is a member of the BEA Systems board of directors and the amounts Covad paid for the firm's products and services. These facts, standing alone, are insufficient to cast reasonable doubt on Crandall's independence for demand purposes.[110] The Court cannot discern whether the revenue from Covad is material to either BEA Systems or to Crandall because of his relationship with BEA Systems.[111] Neither the terms of BEA

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deciding a motion to dismiss for failure to make a demand under Chancery Rule 23.1 the record before the court must be restricted to the allegations of the complaint.").

[108] *Saito v. McCall*, 2004 WL 3029876, at *1 n.9 (Del. Ch. Dec. 20, 2004). *Cf. In re Gen. Motors (Hughes) S'holder Litig.*, 2006 WL 722198, at *3 (Del. Mar. 20, 2006) (describing extent to which a court may consider matters outside complaint on motion to dismiss under Rule 12(b)(6)).

[109] *See, e.g.*, *Jacobs*, 2004 WL 1728521, at *6.

[110] *See id*; *see also Cal. Pub. Employees' Ret. Sys.*, 2002 WL 31888343, at *9.

[111] *See Jacobs*, 2004 WL 1728521, at *6.

Systems' relationship with Covad (*e.g.*, whether the companies have entered into a long-term contract), nor particularized facts supporting the Plaintiffs' conclusory statement in their brief that BEA Systems' business with Covad could be "taken away"[112] by McMinn and others, are provided.[113] Moreover, no allegation has been made that Crandall's responsibilities to BEA Systems include managing the firm's relationship with Covad; nor could the Court conclude that Crandall has a financial interest in BEA, other than possibly an unspecified director's salary, which might influence his decisions.[114] Put simply, even considering Crandall's ties to BEA Systems, the Plaintiffs have not alleged particularized facts sufficient to demonstrate that Crandall independent discretion would be compromised.[115]

2. Runtagh

Similarly, the Plaintiffs fail to create a reasonable doubt as to Runtagh's disinterestedness and independence. The Plaintiffs' principal claim is that Runtagh lacks independence because "[s]he became a director with the consent and approval of the McMinn-Shapero director

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[112] Pls.' Ans. Br. to Covad's Mot. to Dismiss at 34.

[113] These statements are too conclusory to demonstrate that particular interested Covad directors "have the authority or ability to cause [Covad] to terminate its relationships with the companies." *Jacobs*, 2004 WL 1728521, at *6.

[114] *See id.*

[115] *See id.* ("[T]he existence of contractual relationships with companies that directors are affiliated with potentially makes the board's decision more difficult, 'but it does not sterilize the board's ability to decide.'" (citation omitted)).

appointees"[116] and "derived the benefits of being and remaining on the Board of Directors of, and receiving compensation from, Covad by supporting and favoring the self-dealing of other directors in the BlueStar and Dishnet transactions."[117] As explained above, these bare allegations are insufficient to negate Runtagh's presumed independence.

Interestingly, the Plaintiffs also allege that Runtagh has a "disabling interest" that was "acknowledged" by the Covad Board in its resolution creating the special committee to investigate the claims made by Khanna in his June 19, 2002 letter to the Covad Board.[118] The Plaintiffs quote the resolution, which provides: "Mr. Crandall shall have the authority to act alone in the event that, in his sole judgment, an alleged material conflict of interest arises with respect to Ms. Runtagh."[119] This short statement, however, cannot be construed as an admission by the Board, cannot satisfy

[116] Amended Compl. at ¶ 15.
[117] *Id.* Similarly, the Court rejects the Plaintiffs' conclusory allegation that Runtagh "acquiesced knowingly in . . . McMinn's breach of duty." *Id.* at ¶¶ 93, 139. *See Cal. Pub. Employees' Ret. Sys.*, 2002 WL 31888343, at *9 ("Our cases have determined that personal friendships, without more; outside business relationships, without more; *and approving of or acquiescing in the challenged transactions, without more,* are each insufficient to raise a reasonable doubt of a director's ability to exercise independent business judgment.") (emphasis added)).
[118] Amended Compl. at ¶¶ 125, 137. The Plaintiffs allege that "Defendant Runtagh . . . has a disabling interest, which was acknowledged by defendants in their resolutions constituting the Committee." *Id.* at ¶ 137.
[119] *Id.* at ¶ 125.

demand-futility's pleading with particularity requirement, and does not permit a *reasonable* inference of interestedness or lack of independence.[120]

Because Count I of the Amended Complaint (the vesting of McMinn's founders' shares) may be analyzed under *Rales* for having resulted from board inaction, one additional issue must be considered with respect to Runtagh's capacity to consider demand: whether she faces a "substantial likelihood" of personal liability resulting from the vesting of McMinn's shares.[121] As the Court in *David B. Shaev Profit Sharing Account v. Armstrong*,[122] explained: "Most notably in *In re Caremark Int'l Inc. Derivative Litigation*, and then in other cases . . . this court has taken cognisance of allegations that the directors failed to act when they otherwise

[120] *See White*, 783 A.2d at 549 (The Court "need not blindly accept as true all allegations, nor must [it] draw all inferences from them in plaintiffs' favor unless they are reasonable inferences." (citation omitted)).

[121] As discussed below, the Court considers whether a director considering demand faces a "substantial threat" of personal liability arising from the alleged wrongful acts—with a finding of a "substantial threat" resulting in reasonable doubt as to the capacity of that director to consider demand. *See, e.g.*, *David B. Shaev Profit Sharing Account v. Armstrong*, 2006 WL 391931, at *4 (Del. Ch. Feb. 13, 2006); *Guttman*, 823 A.2d at 501. This analysis would perhaps apply equally, for example, in analyzing the disinterestedness of current directors who participated in the alleged wrongful conduct, *see Rales*, 634 A.2d at 936, even though a majority of board has "flipped." The confusion, here, lies in the fact that the Court cannot determine from the Amended Complaint whether Runtagh was a member of the Covad Board at the time the vesting challenged in Count I occurred—and, therefore, is unable to determine with confidence whether the *Rales* analysis proceeds under the first or second *Aronson* exception. *See Rales*, 634 A.2d at 934. As a consequence, the Court's analysis addresses both scenarios. The Court need not address these considerations for Board members other than Runtagh, however, because, with respect to Counts II and III, it is clear that a majority of the current Board members both did not participate in the underlying acts and have been determined otherwise to be disinterested and independent.

[122] *Shaev*, 2006 WL 391931 (Del. Ch. Feb. 13, 2006).

should have done so."[123] When analyzing demand futility under *Rales* where no board action was taken,[124] the Court looks not only to whether directors are disinterested and independent for demand purposes, but also to whether directors "face a substantial likelihood of personal liability, because doubt has been created as to whether their actions were products of a legitimate business judgment."[125] A "mere threat of personal liability," however, is insufficient in this context.[126]

The Plaintiffs allege that a breach of duty occurred because, "under his Restricted Stock Purchase Agreement, McMinn needed to remain a full-time employee of Covad until November 2000 to fully vest in his founders' shares of [Covad]. If he did not maintain full-employment with the Company until all of his shares were vested, Covad had the right under the Restricted Stock Purchase Agreement to repurchase his unvested shares for mere pennies."[127] McMinn, however, determined that he wished to pursue other opportunities (namely, the formation of Certive), and informed Knowling by email, on May 3, 1999, that he would be pursuing investment

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[123] *Id.* at *4 (citing *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996)).
[124] *Compare supra* note 121.
[125] *Id.* (citing *Guttman*, 823 A.2d at 501).
[126] *See Rales*, 634 A.2d at 936 ("[T]he mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterestedness of directors . . . ." (quoting *Aronson*, 473 A.2d at 815)).
[127] Amended Compl. at ¶ 42.

opportunities with Crosspoint.[128] The Amended Complaint further provides that, although McMinn "offered to leave Covad's employ altogether, but only if he could 'accelerate the vesting of the remaining 31% of [his] unvested Covad stock,'" an "exception" was made for his benefit.[129] "[U]nbeknownst to Covad's public shareholders, [McMinn] continued vesting his founders' shares, drew a full-time salary from Covad, and served as its Chairman of the Board . . . ."[130] The complaint additionally alleges that Shapero, as General and Managing Partner of Crosspoint, was aware of McMinn's activities, and that it was "highly likely" that Hawk, as a Special Limited Partner of Crosspoint, knew, as well.[131] McMinn resigned as a Covad director on November 1, 1999, and did not rejoin the board until late October 2000.

The Amended Complaint does not allege when McMinn's shares fully vested. It is this difficulty that potentially necessitates analysis of Runtagh's liability with respect to this claim. It perhaps can be said that two potential alternative conclusions may be reasonably inferred from the Plaintiffs' allegations: (1) that McMinn's shares were deemed vested when he resigned on November 1, 1999, or (2) that the exception for McMinn permitted his

[128] *Id.* at ¶ 43.
[129] *Id.* at ¶ 45.
[130] *Id.*
[131] *Id.* at ¶ 48.

shares to vest fully as of November 2000. The Amended Complaint provides only that Runtagh joined the Covad board in "November 1999."[132] If it is the former, then it is unreasonable to conclude that Runtagh faced a "substantial likelihood" of personal liability for a vesting of shares that occurred, at most, only on her first day as director. In the event it is the latter, however, it is theoretically possible that Runtagh could face personal liability for the vesting such that she would be unable to consider demand with respect to this claim. In that case, analysis of Runtagh's potential liability under *Caremark* would be necessary.

Notwithstanding the above, the Court concludes that this potential aspect the Plaintiffs' vesting claim, however, is without merit for several reasons. The dilemma presented by the multiple alternative scenarios points to the foremost reason why the Court need not develop this analysis: the absence of alleged facts permitting the Court to determine whether vesting occurred throughout the relevant period fails to satisfy the particularity requirements of Court of Chancery Rule 23.1.[133]

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[132] *Id.* at ¶ 15. A third inference that may be drawn is that the vesting ended with the meeting of the Covad board on September 22, 1999, at which the board "blessed" McMinn's founding of Certive, but also adopted a corporate opportunity policy "expressly requir[ing] the prior approval of the Board before a fiduciary of Covad could take a corporate opportunity for himself." *Id.* at ¶ 54.

[133] Indeed, the imprecise allegation that Runtagh joined that Covad board in "November 1999" only compounds the Court's difficulties. Also, the question of whether the Plaintiffs' claims are time-barred has been vigorously debated; that defense would further

3. Irving

In setting forth their reasons for why Irving lacks independence, the Plaintiffs make conclusory allegations regarding Irving's voting history, that he became a director "with the consent and approval of the McMinn-Shapero nominees," and that he receives compensation as a Covad director.[134] Again, bare allegations of this nature are insufficient, separately or cumulatively, to negate Irving's independence.

First, the Plaintiffs allege that Irving "put[] the interests of the McMinn cronies ahead of Covad's . . . ." This conclusory allegation, however, is essentially a repetition of the Plaintiffs' "acquiescence" arguments, which the Court has already rejected for being insufficient to assist in meeting the particularized pleading requirements.[135] Second, the Plaintiffs' refrain that a particular director was appointed to the Covad Board "with the consent and approval of the McMinn-Shapero nominees" fails, without more. Finally, the Plaintiffs have failed to allege particularized facts demonstrating that the fees Irving receives as a director would

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diminish the prospect of liability for Runtagh (who also is not named by the Plaintiffs as a defendant liable with respect to Count I). *See Rales*, 634 A.2d at 936 (stating that a "mere threat of personal liability" is insufficient). Finally, the Plaintiffs have not argued that Runtagh is exposed to personal liability as the result of the vesting of McMinn's shares.

[134] Amended Compl. at ¶¶ 16, 139.

[135] *See also Cal. Pub. Employees' Ret. Sys.*, 2002 WL 31888343, at *9.

somehow interfere with the exercise of his judgment; indeed, they have failed to enumerate even what these fees are. As a consequence, Irving's disinterestedness and independence are not subject to reasonable doubt on the basis of the facts plead.

4. Lynch

The Plaintiffs have failed to satisfy their burden to present sufficient particularized facts to create a reasonable doubt as to the presumed disinterestedness and independence of Lynch. The Amended Complaint alleges that Lynch is a "long-time friend of McMinn."[136] Indeed, the Plaintiffs' allegations provide that their friendship is "so close" that they own both homes in the same neighborhood and "neighboring wineries." Certainly, according to these allegations, Lynch and McMinn are not strangers—indeed, they maybe fairly close—but allegations of this nature do not allow a reasonable inference that the exercise of a director's discretion and judgment is impaired. As alluded to above, "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

[136] Amended Compl. at ¶ 9.

about a director's independence."[137] This is true regardless of whether such ties arose as a consequence of the directors' board membership or whether they were pre-existing.[138] "Mere allegations that [the directors in question] 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."[139] In the context of pre-suit demand, "friendship must be accompanied by substantially more in the nature of *serious* allegations" supporting a reasonable doubt as to independence.[140] In other words, considering "the risks that directors would take by protecting their social acquaintances in the face of allegations that those friends engaged in misconduct,"[141] the Plaintiffs have failed to create a reasonable doubt that Lynch "would be more willing to risk his . . . reputation than risk the relationship with the interested director."[142]

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[137] *Beam*, 845 A.2d at 1051; *see also Odyssey Partners, L.P. v. Fleming Cos., Inc.*, 735 A.2d 386, 409 (Del. Ch. 1999) ("That [directors] were neighbors or former neighbors is of no moment.").
[138] *See Beam*, 845 A.2d at 1051.
[139] *Id.* at 1051-52.
[140] *Id.* at 1052 (emphasis added); *see also id.* at 1050-51 (describing other instances in which reasonable doubt might arise).
[141] *Id.* at 1052.
[142] *Id.*

Similarly, "the naked assertion of a previous business relationship is not enough to overcome the presumption of a director's independence."[143] In their Amended Complaint, the Plaintiffs again repeat their well-worn allegation that Lynch "derived the benefits of being and remaining on the Board . . . of, and receiving compensation from, Covad . . .;"[144] the Court has already explained its reasons for giving little weight to such allegations. The Amended Complaint, however, also asserts in this instance that Lynch has "derived" these "benefits" as a consequence of certain unspecified "business dealings" with Covad directors.[145] As discussed above, the sweeping absence of particularity, here, precludes a reasonable inference that Lynch's business dealings or relationships compromised his presumed independence.

Finally, the Plaintiffs allege that Lynch was rewarded for his support with membership on Certive's "Advisory Board,"[146] and that fact demonstrates both his interestedness with respect to the Certive Claims, as well his lack of independence generally.[147] Though the question may be close, the Plaintiffs' argument, however, ultimately fails for lack of support with sufficiently particularized allegations. The Amended Complaint does

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[143] *Orman*, 794 A.2d at 27; *see also Crescent/Mach I Partners, L.P. v. Turner*, 846 A.2d 963, 980-81 (Del. Ch. 2000).
[144] Amended Compl. at ¶ 9.
[145] *Id.*
[146] *Id.* at ¶ 56.
[147] *Id.* at ¶¶ 137, 138, 140.

not inform the Court what membership on the Certive "Advisory Board" actually entails. Although the Court cannot conclude with certainty from the face of the pleadings, it does not appear to refer to Certive's board of directors.[148] Moreover, although the Plaintiffs contend that the position is prestigious and lucrative,[149] the only allegation offered to support this assertion is that Certive's website describes the Advisory Board by stating that "many companies use Advisory Boards as window dressing[,] Certive believes they should be much more . . . ."[150] Perhaps a certain level of prestige (at least from Certive's perspective) can be inferred from this statement, but that alone does not prove its materiality to Lynch.

> [I]n the absence of self-dealing, it is not enough to establish the interest of a director by alleging that he received *any* benefit not equally shared by the stockholders. Such benefit must be alleged to be *material* to that director. Materiality means that the alleged benefit was significant enough "*in the context of the director's economic circumstances*, as to have made it improbable that the director could perform her fiduciary duties

[148] *See id.* at ¶ 56. The Amended Complaint quotes the Certive website as explaining: "[The Certive Advisory] Board meets quarterly and *provides insight that we actively use to run the business*. [Advisory] Board meetings are lively and protracted—one and a half days. And, everyone attends." *Id.* (emphasis added). These allegations appear to refer to a group of experienced, outside advisors who generally advise those actually managing the company's affairs. This demonstrates the Court's difficulty (and the need for compliance with the requirement of particularized pleading): the Court can only hazard a guess, based on the allegations—and, therefore, no inference doubting Lynch's presumed independence and disinterestedness can flow from this allegation.

[149] *Id.* ("These positions are highly sought after and potentially lucrative as advisory board members in Silicon Valley companies are given stock options which during the 1990s became a source of great wealth for many people.").

[150] *Id.*

> to the . . . shareholders without being influenced by her overriding personal interest."[151]

The allegations provided by the Plaintiffs clearly fail to meet the above-articulated standard: they set forth no particularized allegations of compensation actually received by Lynch in return for his Advisory Board service or as to whether such compensation would be material to a director in Lynch's position. Indeed, the Plaintiffs allege only that Certive "grant[ed] stock interests in Certive *and/or* provide[d] *some form* of compensation" to Lynch for his service on the Advisory Board.[152] These allegations fail to satisfy the materiality test described above, much less set forth particularized facts sufficient for the Court to conclude that Lynch was "'beholden to [McMinn or Crosspoint] or so under their influence that [his] discretion would be sterilized."[153]

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[151] *Orman*, 794 A.2d at 23 (footnotes omitted) (emphasis in original).
[152] Amended Compl. at ¶ 56; *see also id.* at ¶¶ 137-38.
[153] *Rales*, 634 A.2d at 936. Additionally, the Plaintiffs do not plead when Lynch received his appointment. The Plaintiffs offer no *particularized* facts demonstrating the necessary linkage between Lynch's appointment to the Certive Advisory Board and his relationship to McMinn. Perhaps the Court should infer this from the facts, but the Plaintiffs have also alleged that "Lynch is a private investor in a number of start-up companies in the Internet area." Amended Compl. at ¶ 33. Indeed, it is the relatively "incestuous" nature of Silicon Valley's business culture that appears to be at the heart of the Plaintiffs' suit; however, on the other hand, "cozy" business relationships of this nature are perhaps an almost inevitable by-product of a highly-sophisticated growth industry reliant almost entirely on innovation and a narrow field of experienced entrepreneurial talent.

5. Jalkut

The Plaintiffs dispute inclusion of Jalkut in the Court's demand futility analysis because they allege that his appointment to the Covad Board occurred in violation of the Standstill Agreement between Covad and Khanna,[154] which provided that the parties would "refrain from taking any action that could advance their respective positions."[155] Essentially, the Plaintiffs argue that Covad advanced its position in litigation by appointing Jalkut because it gave "the McMinn-tainted Board one more vote in their camp."[156] This argument begs the question, however, as the inquiry during demand futility analysis, in this context, is independence. Jalkut can only be viewed as a "vote in the McMinn camp" if he is not independent—and if he is not independent, then McMinn and his confederates gain no benefit from his presence. Thus, for demand futility purposes, it is appropriate to consider Jalkut because the inquiry into whether Covad advanced its litigation position by packing the Board (in violation of the Standstill Agreement) and inquiry into Jalkut's independence are substantially the same.

[154] *See* Amended Compl. at ¶¶ 136, 138.
[155] Pls.' Ans. Br. to Covad's Mot. to Dismiss at 33 n.13.
[156] *Id.*

Moreover, because the Court concludes that Jalkut is disinterested and independent, the Court's decision to include or to exclude Jalkut from its demand futility analysis results in no detriment to the Plaintiffs. Exclusion of Jalkut from the Board members considered lowers the total number of directors on the Board for demand futility purposes to seven—therefore, since the Court has already concluded that four are disinterested and independent, analysis under the first prong of *Aronson* is at an end. On the other hand, if Jalkut is included in the Court's analysis, then the total number of directors is raised to eight, with five disinterested and independent directors required to preclude demand excusal under *Aronson*'s first prong. Jalkut, then, is that fifth director.

Assuming that Jalkut is to be included, the Court turns to analysis of his disinterestedness and independence. The Plaintiffs allege that, in addition to his seat on the Covad Board, Jalkut serves as chief executive officer of TelePacific, a Covad reseller (*i.e.*, a Covad retailer). Specifically, the Plaintiffs allege that "[a]s the CEO of a customer of Covad, Jalkut lacks the independence to fairly and impartially judge the actions of his fellow Board members."[157] As with Crandall, the Plaintiffs point to information

[157] Amended Compl. at ¶¶ 20, 138 ("Jalkut lacks independence from the McMinn-dominated Board because he is the CEO and president of one of Covad's customers, TelePacific.").

available in the 2004 Proxy Statement (but not explicitly mentioned in the Amended Complaint) to support their claim. Indeed, the allegations in the Amended Complaint, standing alone, are exceedingly conclusory.

Assuming that the 2004 Proxy Statement may be considered for these purposes,[158] the Plaintiffs still fail to allege facts sufficient to create a reasonable doubt as to Jalkut's independence. Specifically, the Plaintiffs explain that Covad "recognized in excess of $1.3 million and $1.8 million in revenues from TelePacific [in 2002 and 2001], respectively."[159] The Plaintiffs contend that this "obviously" resulted in "many millions more in revenue" for TelePacific, on the theory that services purchased from Covad by TelePacifc were then sold to TelePacific customers at a mark-up.[160] Without particularized allegations of fact, however, there is nothing "obvious" about this argument. Without knowledge of the mark-up, one wonders if "many millions more" is even plausible. Moreover, although gross revenues are not unimportant, the critical information would be profits, something the Plaintiffs have not provided.

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[158] This may not be a good assumption. *Compare Hughes*, 2006 WL 722198, at *3 (holding that court may consider documents referred to in complaint "in some instances and for carefully limited purposes"). *See also supra* text accompanying note 108.
[159] Pls.' Ans. Br. to Covad's Mot. to Dismiss at 33-34.
[160] *Id.*

Moreover, there are no particularized facts alleged adequately linking the business relationship between TelePacific and Covad with the claimed lack of independence of Jalkut. The Plaintiffs argue that TelePacific, as a customer of Covad, would not want to jeopardize the current pricing structure offered to TelePacific (as an increase in price has the potential to adversely affect TelePacific's profits). Arguments of this nature (*i.e.*, that a customer wants to avoid offending its supplier) must be considered with care. First, the Plaintiffs' contention assumes that the market for TelePacific's product is highly elastic and that, as a consequence, increases in cost will be absorbed by TelePacific, instead of passed on to the firm's customers. Although it may be reasonable to assume that some percentage of cost increases will be absorbed by a retailer, the amount (and therefore its materiality) may vary widely across firms and industries. The Plaintiffs argue that "Jalkut clearly does not want TelePacific to have to pay more for [Covad's] services,"[161] which, though certainly a reasonable observation, is insufficient to lead to the broader inference that Jalkut's judgment has been sterilized as to the best interests of Covad shareholders.[162] Moreover, the Plaintiffs' allegations are insufficiently particularized to displace the notion

[161] Pls.' Ans. Br. to Covad's Mot. to Dismiss at 33-34.
[162] *Cf. Jacobs*, 2004 WL 1728521, at *5 - *6.

that, in this context, if Covad unilaterally raised its prices relative to the market, TelePacific would purchase from another, lower-priced seller.

Additionally, as with Crandall and BEA Systems, the Plaintiffs make no allegations as to the terms of TelePacific's business dealings with Covad; nor do the Plaintiffs allege facts permitting the Court to infer, in this context, that TelePacific's relationship with Covad is material. Although the Plaintiffs have asserted that Covad received certain revenue from TelePacific in 2001 and 2002, this tells the Court little about the materiality of this relationship to TelePacific. As a consequence, without more, the Plaintiffs have failed to create a reasonable doubt as to the presumed disinterestedness and independence of Jalkut.

* * *

In summary, the Court concludes that Khanna's June 19, 2002 letter to the Covad Board was not a demand letter, and, thus, there is no need to inquire into whether demand was wrongfully rejected. Additionally, although the Covad Board had "cozy" business and social relationships, the Plaintiffs have failed to plead particularized allegations that would cast a reasonable doubt on the disinterestedness and independence of at least half

of the Covad Board.[163] Consequently, the Plaintiffs have failed to show that demand was excused under the first prong of *Aronson* or under *Rales*.[164]

IV. BUSINESS JUDGMENT

As discussed above, because the two prongs of the test for demand futility under *Aronson* "are disjunctive," the challenged transactions subject to analysis under *Aronson* must be examined under the test's second-prong, in addition to the first prong's "disinterestedness" and "independence" analysis.[165] As a consequence, the BlueStar Transactions and the Dishnet Settlement each require inquiry into whether reasonable doubt is created that these challenged transactions were "otherwise the product of a valid exercise of business judgment."[166]

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[163] The Court notes that the factual paucity described above may have resulted from difficulties in accessing certain information. Indeed, even after using the "tools at hand" to develop particularized facts (*e.g.*, public filings and § 220), certain information may be restricted due to the fact that it is held by entities with no public disclosure obligations. Although the burdens presented by such obstacles have been recognized, *see Brehm*, 746 A.2d at 268 (Hartnett, J., concurring) ("Plaintiffs must not be held to a too-high standard of pleading because they face an almost impossible burden when they must plead facts with particularity and the facts are not public knowledge."), the pleading standard under which the Court examines allegations for requisite particularity remains unaltered, even for plaintiffs who employed the "tools at hand."

[164] Accordingly, the Certive Claims (Counts I through III) must be dismissed.

[165] *See, e.g.*, *In re J.P. Morgan & Co.*, 2005 WL 1076069, at *8.

[166] *See Aronson*, 473 A.2d at 814. Analysis under the second prong of *Aronson* is not required for the Certive Claims, because a majority of the board has changed since the events giving rise to Counts II and III and because Count I does not challenge a business decision. *See Rales*, 634 A.2d at 934.

A. *Legal Standard*

In order to satisfy the second prong of *Aronson*, the Plaintiffs must plead "particularized facts creating a reasonable doubt that the decisions of the [board] were protected by the business judgment rule."[167] "[A]bsent particularized allegations to the contrary, the directors are presumed to have acted on an informed basis and in the honest belief that their decisions were in furtherance of the best interests of the corporation and its shareholders."[168] It is not an easy task to allege that a decision falls outside the realm of the business judgment rule because "[t]his Court will not second-guess the judgment of a board of directors if it bases its decision on a rational business purpose."[169] Thus, "[t]he burden is on the party challenging the decision to establish facts rebutting the presumption."[170] In conducting its analysis, the Court must examine the "substantive nature of the challenged transactions and the board's approval thereof."[171]

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[167] *Brehm*, 746 A.2d at 258.
[168] *Highland Legacy Ltd.*, 2006 WL 741939, at *7; *see also Levine*, 591 A.2d at 206 ("[P]laintiff . . . must plead particularized facts creating a reasonable doubt as to the 'soundness' of the challenged transaction sufficient to rebut the presumption that the business judgment rule attaches to the transaction."); *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984) ("A court does not assume that the transaction was a wrong to the corporation requiring corrective measures by the board."), *overruled on other grounds*, *Brehm*, 746 A.2d at 254.
[169] *Kahn v. Roberts*, 1995 WL 745056, at *4 (Del. Ch. Dec. 6, 1995), *aff'd*, 679 A.2d 460 (Del. 1996).
[170] *Aronson*, 473 A.2d at 812.
[171] *Id*. at 814.

A plaintiff seeking to demonstrate demand futility under the second prong of *Aronson* "must plead particularized facts sufficient to raise (1) a reason to doubt that the action was taken honestly and in good faith or (2) a reason to doubt that the board was adequately informed in making the decision."[172] The Court's inquiry in this context is "predicated upon concepts of gross negligence."[173] "The plaintiff faces a substantial burden, as the second prong of the *Aronson* test is 'directed to extreme cases in which despite the appearance of independence and disinterest a decision is so extreme or curious as to itself raise a legitimate ground to justify further inquiry and judicial review.'"[174] Although the second prong of *Aronson* may potentially be satisfied by recourse to multiple theories,[175] establishing that a board's decision falls outside the scope of the business judgment rule

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[172] *In re Walt Disney Co. Deriv. Litig.*, 825 A.2d 275, 286 (Del. Ch. 2003); *see also In re J.P. Morgan Chase & Co.*, 2005 WL 1076069, at *11. *Cf. Levine*, 591 A.2d at 206 (although addressing only whether directors were adequately informed, identifying self-interest, entrenchment, waste, and acting in such an uninformed manner as to constitute gross negligence as topics of analysis in this context).

[173] *Aronson*, 473 A.2d at 812; *see also Brehm*, 746 A.2d at 259 ("Pre-suit demand will be excused in a derivative suit only if the Court . . . conclude[s] that the particularized facts in the complaint create a reasonable doubt that the informational component of the directors' decisionmaking process, *measured by concepts of gross negligence*, included consideration of all material information reasonably available." (emphasis in original)).

[174] *Greenwald v. Batterson*, 1999 WL 596276, at *7 (Del. Ch. July 26, 1999) (quoting *Kahn v. Tremont Corp.*, 1994 WL 162613, at *6 (Del. Ch. Apr. 22, 1994)); *see also Highland Legacy Ltd.*, 2006 WL 741939, at *7.

[175] *See, e.g.*, *Levine*, 591 A.2d at 206; *see also* WOLFE & PITTENGER, *supra* note 77, § 9-2[b], at 9-76 n.303 (describing analysis under second prong of *Aronson* generally as looking to substantive due care and to procedural due care).

frequently requires a showing of facts tantamount to corporate waste.[176] As a consequence, a plaintiff will bear a difficult, but not insurmountable, burden in pleading particularized facts demonstrating demand futility under this prong of *Aronson*.[177]

B. *The BlueStar Transactions*

The BlueStar acquisition was approved by the Covad Board on June 15, 2000, and announced on June 16, 2000. The Amended Complaint sets forth that, on September 22, 2000, the transaction was completed with Covad's issuance of approximately 6.1 million shares of Covad common stock to BlueStar stockholders "according to an exchange ratio by which BlueStar stockholders received an average market price of $14.23 in exchange for all outstanding preferred and common stock."[178] The Amended Complaint explains that this resulted in a price to Covad of "at

[176] *See Tremont Corp.*, 1994 WL 162613, at *6 ("The test for this second stage is thus necessarily high, similar to the legal test for waste.").

[177] *See, e.g.*, *Brehm*, 746 A.2d at 263 (describing waste as "'an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration'" (quoting *Glazer v. Zapata Corp.*, 658 A.2d 176, 183 (Del. Ch. 1993)); *Grobow*, 539 A.2d at 189 (holding that waste depends on "whether 'what the corporation has received is so inadequate in value that no person of ordinary, sound business judgment would deem it worth that which the corporation has paid'" (quoting *Saxe v. Brady*, 184 A.2d 602, 610 (Del. Ch. 1962)); *see also Green v. Phillips*, 1996 WL 342093 (Del. Ch. June 19, 1996) ("That extreme test is rarely satisfied, because if a reasonable person could conclude the board's action made business sense, the inquiry ends and the complaint will be dismissed.").

[178] Amended Compl. at ¶ 73. Outstanding BlueStar stock options and warrants were converted into options to purchase approximately 225,000 shares of Covad common stock at a "fair value" of $6.55 per share. *Id.*

least $200 million" for BlueStar.[179] The complaint further states that the day after the merger was announced, Covad's shares dropped 27%, constituting $1 billion of market value.[180]

The Plaintiffs identify numerous grounds on which they contend that the BlueStar acquisition was not a valid exercise of the Covad Board's business judgment. They principally argue that the Board's approval process was procedurally deficient, that the Board failed to inform itself adequately and to act in good faith, and that the transaction constituted corporate waste.

The Amended Complaint alleges that no special committee of disinterested directors was formed to consider the transaction.[181] The mere allegation of a failure to form a committee is insufficient, however, to satisfy *Aronson*'s second prong.[182] This fact, however, is not without value, given

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[179] *Id.*

[180] *Id.* at ¶ 70. It is uncertain whether the drop in share price can be attributed solely to the BlueStar transaction, since the Amended Complaint ambiguously explains that, "at the same time [Covad] announced the merger," the company also announced that "it had reduced both the number of end-user lines it expected to be in service on June 30, 2000 and its 2000 line growth expectations primarily because of the channel conflict with BlueStar." *Id.*

[181] *See* Amended Compl. at ¶ 65.

[182] The parties' briefs contain significant debate over which directors participated in the review and approval of the challenged transactions and the effect of those directors' participation on the Court's analysis. The Covad Board at the time of the BlueStar acquisition was comprised of Dunn, Hawk, Irving, Knowling, Lynch, Marshall, Runtagh, and Shapero. The Amended Complaint, however, does not allege which directors participated in the review and approval of the BlueStar acquisition. Although Paragraph 80 of the complaint provides that, with respect to the BlueStar earn-out

the material interests in the transaction of at least one-quarter (*i.e.*, Shapero and Hawk) of the Covad Board.[183] Moreover, the Plaintiffs allege that the acquisition was initiated by the repeated lobbying of Covad's then-chief executive officer and board member, Knowling. The Amended Complaint provides that "Shapero lobbied Knowling through lengthy emails on the weekend of May 20-21, 2000 to have Covad acquire BlueStar and NewEdge. After Shapero's full-court press, Knowling decided on May 21, 2000—without any due diligence—that Covad should acquire BlueStar."[184]

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settlement, "under normal Covad practice, self-interested directors would have left any Board meeting when matters pertaining to their self-interest are discussed and voted upon," the Court is unable to draw any conclusions from this fact as to approval of the BlueStar acquisition under the standard governing motions to dismiss.

At the time of the BlueStar earn-out settlement, McMinn, Shapero, Hawk, Irving, Lynch, Marshall, and Runtagh were members of the Covad Board. Paragraph 80 does explicitly allege that McMinn, Hawk, and Shapero did not participate in board meetings for "review and approval" of the settlement.

[183] The Amended Complaint provides that "at least as early as mid-1999, Shapero, through Crosspoint, owned approximately 46% of BlueStar's outstanding shares, and both McMinn and Hawk owned a substantial number of preferred shares." *Id.* at ¶ 59. Paragraph 72 of the Amended Complaint provides: "Each of Messrs. McMinn, Hawk and Shapero and/or Crosspoint were significant shareholders of BlueStar." Crosspoint, for which Shapero serves as General and Managing Partner, is alleged to have owned approximately 30 million shares, representing approximately 41.9% of all issued and outstanding BlueStar shares. *See id.* "Hawk, a Special Limited Partner of Crosspoint, was also a significant shareholder of BlueStar stock." *Id.* McMinn is alleged to have been the beneficial owner of approximately 656,942 shares of BlueStar common stock, *see id.*; however, it should be noted that McMinn had resigned from the Covad Board on November 1, 1999, prior to the BlueStar acquisition's approval. McMinn rejoined the Board in late October 2000, and was a member at the time of the BlueStar earn-out settlement.

[184] Amended Compl. at ¶ 62. Shapero sat on the board of NewEdge Networks, a "provider of dedicated internet access for businesses and communications carriers." A reasonable doubt has also been shown as to Knowling's independence at the time of the acquisition. At that time, Knowling was Covad's chief executive officer, as well as a member of its Board, and "received a generous compensation package when hired": $1.5

The Amended Complaint further alleges that the reason for the "hasty process" was that it "served BlueStar's interests (and, therefore, Shapero/Crosspoint's interests) in that BlueStar was in a precarious financial condition and had it continued as a stand-alone company, it would have been unable to mask its serious problems any longer."[185] Indeed, the Amended Complaint alleges that the fairness opinion rendered by Donaldson, Lufkin & Jenrette ("DLJ") to BlueStar with respect to the merger stated that DLJ had been informed by the "management of the Company" that "the Company, as of June 14, 2000, expected to exhaust its liquidity in the near term and did not have a financing source for funding its anticipated operating and capital needs over the following 12 months."[186]

The Amended Complaint sets forth that "[a]lmost uniformly, Covad management objected to the transaction."[187] Indeed, the Amended Complaint alleges that Knowling "was the sole Covad officer to support" the

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million signing bonus, $400,000 salary, other bonuses, and stock options. *Id*. at ¶ 97. Additionally, Covad granted Knowling severance benefits "worth $1.5 million" and forgave a $500,000 loan to him when he resigned in November 2000 (months after the BlueStar acquisition). *Id*. Most significantly, Shapero served as a member of Covad's compensation committee at this time. *Id*. at ¶¶ 11, 72.

[185] *Id.* at ¶ 62.

[186] *Id.* at ¶ 63.

[187] *Id.* at ¶ 64. The complaint particularly cites Khanna, Chuck Haas, Vice President and co-founder of Covad, and Ron Marquardt, Covad's engineering director, as having "expressed their objections to the deal."

BlueStar acquisition.[188] The complaint also describes a due diligence report prepared by Covad's engineering director, "which stated that the acquisition would be virtually useless because of the overlap in the companies' networks."[189] The complaint alleges that the Board "ignored" management's due diligence findings, which were presented to the Board and which "expressed serious concern" that "Covad already had overlapping physical assets to provide DSL coverage in 70% of BlueStar service territory . . . ."[190] The Plaintiffs charge that the Covad directors did not "evaluate" the due diligence reports "prepared by . . . [the director of engineering] and others that pointed out many of the key acute problems of BlueStar . . . ."[191]

Finally, the Plaintiffs argue that Covad's investment banker (Bear Stearns), which provided a fairness opinion for the transaction, "had a conflict of interest with respect to the merger, and the Board was aware of the conflict."[192] The Amended Complaint recites that "Bear Stearns

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[188] *Id.* at ¶ 72.

[189] *Id.* at ¶ 64. The Plaintiffs, in their answering brief, also charge, *inter alia*, that the directors approved the transaction after only a "35 minute telephone conversation" with five board members present. Pls.' Ans. Br. to Dirs.' Mot. to Dismiss at 40. This information, however, is not among the allegations of the Amended Complaint.

[190] Amended Compl. at ¶ 68.

[191] *Id.* at ¶ 65. The Plaintiffs' answering brief also provides that "no independent appraisal of BlueStar was sought much less obtained . . . ." This allegation does not appear in the Amended Complaint. Pls.' Ans. Br. to Dirs.' Mot. to Dismiss at 40.

[192] Amended Compl. at ¶ 66. The Amended Complaint describes the fairness opinion as "perfunctory." *Id.* This perhaps adds context, but little substance, to the Court's inquiry. Moreover, the absence of an independent opinion on which the board relied would not, of itself, demonstrate gross negligence satisfying *Aronson*'s second prong. In this instance,

Corporate Lending, Inc., an affiliate of Bear Stearns, provided BlueStar with a $40 million financing commitment to fund BlueStar's continuing operations until the effective date of the merger."[193] The complaint states that, as a result of this bridge loan, it was in the interest of Bear Stearns "to render a favorable opinion . . . and ensure the closing of the transaction," and that, "even though all the signs at the outset indicated that the transaction would spell financial disaster for Covad," Bear Stearns was conflicted from "urging (and therefore failed to urge) Covad to cancel the deal."[194] As the Amended Complaint explains, "if Covad did not close the transaction, Bear Stearns would be left with the unpaid bridge loan . . . ."[195]

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however, the Amended Complaint alleges, for example, that Covad's management's opinion was "[a]lmost uniformly" hostile to the transaction.

[193] *Id.* The Amended Complaint also provides that Bear Stearns was conflicted because it had an "ongoing interest in earning fees from this and other Covad transactions." *Id.* First, this is insufficiently particularized. Second, the mere fact that an investment bank will receive typical fees for its services does not render its advice conflicted.

[194] *Id.*

[195] *Id. Compare Crescent/Mach I Partners, L.P.*, 846 A.2d at 984-85.

The Court notes that the Amended Complaint does not specify when the bridge loan was extended to BlueStar. The chronology, however, may have substantial impact on the analysis. If the bridge loan was made prior to rendering the fairness opinion, then this fact certainly adds substance to the Court's "reasonable doubt" analysis. On the other hand, if the loan was not negotiated or extended until *after* Bear Stearns rendered its fairness opinion (or until after the Covad Board's vote to approve), then the existence of the bridge loan would be substantially less significant to the Court's analysis. Issues of continuing reliance on Bear Stearns' advice might arise, but these would perhaps be distinct from reliance on the fairness opinion, itself.

The Court is commanded to make all reasonable inferences in favor of the Plaintiffs from particularized allegations. In this instance, the inference clearly intended by the Plaintiffs' from Paragraph 66 of the Amended Complaint is that loaned funds were at risk—not merely fees for making the loan—because the loan was extended before the

On a motion to dismiss, the Court is required to accept as true all well-pleaded allegations and to draw all reasonable inferences from such allegations in favor of the Plaintiffs. The Court acknowledges that the above facts, if true, create a reasonable doubt that the transaction was the product of a valid exercise of business judgment. The Plaintiffs have argued that, in acting to approve the merger, the directors committed violations of their duties of good faith and due care. Demand will be excused, for example, where the Court "conclude[s] that the particularized facts in the complaint create a reasonable doubt that the informational component of the directors'

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opinion was delivered. Similarly, Paragraph 141 states that the Board obtained a "highly-conflicted Bear Sterns [sic] opinion in connection with the First BlueStar Transaction." The Plaintiffs' briefs support the Court's inference and make even more clear the light in which the Plaintiffs intended the allegations to be read. *See, e.g.*, Pls.' Ans. Br. to Covad's Mot. to Dismiss at 36-37 ("The Amended Complaint . . . is replete with facts *known to the Board at the time it approved the transaction* which unequivocally show the gross negligence of Runtagh and Lynch. . . . The only financial opinion before the Board was that of Bear Stearns . . . . That opinion was hopelessly conflicted (and the Covad Board knew it) because a subsidiary of Bear Stearns had a $40 million bridge loan outstanding to BlueStar and would not see a dime of that money returned to it unless Covad acquired BlueStar."); *id*. at 12 ("[The Covad Board] accepted the fairness opinion of Covad's investment banker, Bear Stearns, despite the fact that Bear Stearns *had* a glaring conflict of interest with respect to the merger. Bear Stearns Corporate Lending, Inc. . . . *had given* BlueStar a $40 million financing commitment to fund BlueStar's continuing operations, and would have had no hope of recouping a dime of that money without the merger." (citing Amended Compl. at ¶ 66 (emphasis added))); Pls.' Ans. Br. to Dirs.' Mot. to Dismiss at 10 ("[The Covad board] accepted a favorable 'preliminary' opinion from an investment banker that the Covad Board *knew* had an enormous conflict that prevented it from evaluating the BlueStar acquisition in an objective manner." (citing Amended Compl. at ¶¶ 65, 66) (emphasis in original)). The Court recognizes that this is perhaps an example of particularly artful drafting, as well. Indeed, at the hearing on these motions, the Defendants pointed to documents produced in § 220 action that may resolve this issue; however, the Court may not consider them in the present analysis.

decisionmaking process, *measured by concepts of gross negligence*, included consideration of all material information reasonably available."[196] It is possible that demand may also be excused where the Court may reasonably doubt that directors have complied in good faith with the requirement they fulfill their fiduciary duties.[197] This Court has previously addressed the possibility that

> disinterested, independent directors "knew that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss." If they did indeed act in such a way, they have acted in a manner that cannot be said to be the product of sound business judgment and so cannot be protected by the presumption of the business judgment rule.[198]

In other words, if they behaved in such a manner, then they "'*consciously and intentionally disregarded their responsibilities,*' and . . . therefore, could be in violation of their fiduciary duties to the corporation."[199]

The Plaintiffs have pleaded particularized facts alleging, *inter alia*, that the Covad Board had members with significant, material interests in the

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[196] *Brehm*, 746 A.2d at 259 (emphasis in original).
[197] *Cf. Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003); *IHS*, 2004 WL 1949290, at *9 n.36.
[198] *Official Comm. of Unsecured Creditors of Integrated Health Servs., Inc.* ("*IHS*") *v. Elkins*, 2004 WL 1949290, at *10 (Del. Ch. Aug. 24, 2004) (addressing motion to dismiss under Court of Chancery Rule 12(b)(6)) (quoting *In re Walt Disney Co.*, 825 A.2d at 289).
[199] *IHS*, 2004 WL 1949290, at *9 (quoting *In re Walt Disney Co.*, 825 A.2d at 289) (emphasis in original).

transaction, ignored a management that objected to the acquisition "[a]lmost uniformly," failed to "evaluate" management due diligence findings that expressed "serious concerns" about the transaction, and knew of significant conflicts held by the investment banker rendering the fairness opinion on which the Board relied.[200] As a consequence, the Court concludes that the allegations contained in the Amended Complaint create a reasonable doubt as to whether approval of the BlueStar transaction was the product of a valid exercise of business judgment by the Covad Board.[201]

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[200] The Court acknowledges that, after an opportunity for discovery, it may become clear that the bridge loan was negotiated, and funded, only after Bear Stearns had rendered its opinion. *See, e.g.*, *In re New Valley Corp.*, 2001 WL 50212, at *6 n.17 (Del. Ch. Jan. 11, 2001) (remarking that affidavit might give reason to doubt allegations, but was nevertheless improper to consider on motion to dismiss); *Mizel v. Connelly*, 1999 WL 550369, at *5 n.5 (Del. Ch. July 22, 1999) (same).

[201] The Director Defendants contend that their compliance with the "safe harbor" provisions of 8 *Del.C.* § 144(a) conclusively rebuts the Plaintiffs' contentions; however, compliance with § 144(a) does not guarantee the benefit of the presumption of the business judgment rule that entire fairness review will not apply. *See, e.g.*, *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 891 A.2d 150, 185 (Del. Ch. 2005); *In re Cox Commc'ns S'holders Litig.*, 879 A.2d 604, 614-15 (Del. Ch. 2005); *Cal. Pub. Employees' Ret. Sys.*, 2002 WL 31888343, at *13. As the Court in *Benihana* explained:

> Satisfying the requirements of § 144 only means that the [challenged transaction] is not void or voidable *solely* because of the conflict of interest. 'While non-compliance with §§ 144(a)(1), (2)'s disclosure requirement by definition triggers fairness review rather than business judgment rule review, the satisfaction of §§ 144(a)(1) or (a)(2) alone does not always have the opposite effect of invoking business judgment rule review . . . . Rather, satisfaction of §§ 144(a)(1) or (a)(2) simply protects against invalidation of the transaction 'solely' because it is an interested one. As such, § 144 is best seen as establishing a floor for board conduct but not a ceiling." Thus, equitable common law rules requiring the application of the entire fairness standard on grounds other than a director's interest still apply.

891 A.2d at 185. Moreover, the Director Defendants' purported compliance may not be a matter amendable to resolution on the basis of the pleadings. *See supra* note 182.

Therefore, demand is excused as to the BlueStar acquisition of Count IV.[202]

The Director Defendants also argue that, since Covad's Amended and Restated Certificate of Incorporation exempts directors from liability for breaches of the duty of care pursuant to 8 *Del.C.* § 102(b)(7), all claims against the Director Defendants involving duty of cares must be dismissed. However, "when a duty of care breach is not the *exclusive* claim, a court may not dismiss based upon an exculpatory provision." *Alidina v. Internet.com Corp.*, 2002 WL 31584292, at *8 (Del. Ch. Nov. 6, 2002) (citing *Emerald Partners v. Berlin*, 787 A.2d 85, 91 (Del. 2001); *see also Malpiede v. Townson*, 780 A.2d 1075 (Del. 2001).

Additionally, charter provisions adopted under § 102(b)(7) merely work to exculpate liability, but do not erase the underlying breach of fiduciary duty. As a consequence, a tension potentially exists between the effect of § 102(b)(7) provisions on analysis under *Rales* and under the second-prong of *Aronson*. For instance, the pertinent question under *Rales*, in this context, is whether a director faces a "substantial likelihood" of personal liability, which, if it exists, would then be deemed as compromising the director's capacity to consider demand. *See, e.g.*, *Guttman*, 823 A.2d at 501. If a mere breach of a duty of care is the exclusive well-pleaded claim, however, then, in the presence of a § 102(b)(7) provision, the question posed by *Rales*, above, will likely be answered in the negative. *See id.* With respect to analysis under *Aronson*'s second prong, however, courts are instructed to ask whether the "challenged transaction was otherwise the product of a valid exercise of business judgment"—*i.e.*, the pertinent question, in this context, is whether an underlying breach has occurred and not whether a substantial threat of liability exists, regardless of breach. The crucial factor, however, would seem to be questions of the potential for personal liability which affect capacity to consider demand. *See id.* ("When . . . there are allegations that a majority of the board that must consider a demand acted wrongfully, the *Rales* test sensibly addresses concerns similar to the second prong of *Aronson.* To wit, if the directors face a 'substantial likelihood' of personal liability, their ability to consider a demand impartially is compromised under *Rales*, excusing demand."); *see also Aronson*, 473 A.2d at 815 ("[T]he mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterestedness of directors, although in rare cases a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists.").

[202] With respect to the Defendants' motion under Court of Chancery Rule 12(b)(6), the Court's conclusion here that demand is excused under the more demanding standard of *Aronson*'s second-prong necessarily moots analysis under Rule 12(b)(6).

The Defendants contend that the challenge to the BlueStar acquisition is barred by laches (or the "borrowed" three-year statute of limitations) because the Original Complaint was filed more than three years after the Covad Board's approval of the transaction. *See* Mem. in Supp. of Dirs.' Mot. to Dismiss Am. Deriv. & Class Action Compl. ("Dirs.' Op. Br. to Dismiss") at 26-27 (citing *Kahn v. Seaboard Corp.*, 625 A.2d 269, 271 (Del. Ch. 1993); *In re Marvel Entm't Group, Inc.*, 273 B.R. 58, 73-74 (D. Del. 2002)). *But see* Pls.' Ans. Br. to Dirs.' Mot. to Dismiss. at 21 (citing *Kaufman v. Albin*, 447 A.2d 761 (Del. Ch. 1982); *Dofflemyer v. W.F. Hall Printing Co.*, 558 F. Supp. 372

The Court, furthermore, will not conduct business judgment analysis examining the BlueStar earn-out settlement separately. The two aspects of the BlueStar investment, proximate in time, as well as presenting issues of fact and law not easily bifurcated, are best tackled by treating them as one for demand excusal purposes. Thus, demand is also excused with respect to claims the Plaintiffs asserted in Count IV involving the BlueStar earn-out settlement.[203]

(D. Del. 1983)). The motion to dismiss, with respect to the Defendants' affirmative defense of laches, is reviewed under Court of Chancery Rule 12(b)(6). Because the Court is unable to discern with reasonable certainty from the complaint that laches applies, the Court cannot grant the Defendants' motion on this ground at this time. *See, e.g.*, Amended Compl. at ¶ 144; Reply in Supp. of Dirs.' Mot. to Dismiss Am. Deriv. & Class Action Compl. ("Dirs.' Reply Br. to Dismiss") at 9 (alluding to "requirement" that BlueStar shareholders "approve the transaction by tendering their shares on September 22, 2000").

[203] Although the acquisition appears disastrous with the benefit of hindsight, the Court cannot permit the *ex post* results of a decision to cloud analysis of a board's *ex ante* judgment. *See, e.g.*, *White*, 783 A.2d at 554; *Ash*, 2000 WL 1370341, at *8; *Greenwald*, 1999 WL 596276, at *7 (citing *In re Walt Disney Co. Deriv. Litig.*, 731 A.2d 342, 361-62 (Del. Ch. 1998), *aff'd in part and rev'd in part, sub nom. Brehm*, 746 A.2d 244; *Litt v. Wycoff*, 2003 WL 1794724, at *10 (Del. Ch. Mar. 28, 2003); William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *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, 454-55 (2002).

BlueStar's performance has been characterized as "dismal," but the Court notes the possibility that the ultimate failure of the deal may have had much to do with exogenous market forces affecting all of the telecommunications industry during this time. The failure to anticipate and avoid these reversals of fortune may perhaps not have been the result of, for example, bad faith, but rather aggressive and overly-optimistic business strategies that, in times of better economic fortune, are lauded as demonstrative off entrepreneurial skill and wisdom.

C. *The Dishnet Settlement*[204]

Again, the Plaintiffs challenge the Covad Board's alleged failure to employ certain procedural devices (*e.g.*, a special committee) in approving the Dishnet Settlement.[205] As above, such allegations do not establish a *per se* rebuttal of the business judgment rule, as the Plaintiffs suggest. The Plaintiffs make only a conclusory allegation that the agreement was entered into "without the benefit of the necessary financial and legal analysis . . . ."[206] This clearly fails to meet the requirement that the Plaintiffs plead particularized facts. Although the Plaintiffs' briefs rely heavily, and expand, upon this "fact," the Court must look to the Amended Complaint to determine whether the Plaintiffs have satisfied their pleading burden—and they have not.[207]

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[204] Although the Plaintiffs cast aspersions on Covad's decision to invest in Dishnet, they have not pursued any attack with particularized allegations.

[205] Amended Compl. at ¶ 141. At the time of the Dishnet settlement, McMinn, Shapero, Lynch, Marshall, Hawk, Hoffman, Irving, and Runtagh comprised the Covad Board. The Amended Complaint does not allege which directors participated in review and approval of the settlement. Although Paragraph 93 of the complaint addresses McMinn's "course and conduct in connection with the failed Dishnet investment" and provides that "the other Covad directors at the time—including Shapero, Lynch, Marshall, Hawk, Hoffman, Irving and Runtagh—acquiesced knowingly in, and as a group supported," McMinn's conduct, the Court cannot draw any conclusions with regard to director participation on the basis of the pleadings under the standard governing motions to dismiss.

[206] *Id*. at ¶ 92. The Plaintiffs also make the highly conclusory allegation that, with respect to Dishnet, "the other Covad directors at the time," excluding McMinn, "acquiesced knowingly in, and as a group supported, McMinn's breach of duty. *Id*. at ¶ 93.

[207] Although the Plaintiffs point out that McMinn was director of both Dishnet and Covad at this time, the Plaintiffs do not allege that McMinn participated in the meeting or voted

The Plaintiffs' allegations regarding the Dishnet settlement appear principally, if not exclusively, directed toward corporate waste. The allegations of the Amended Complaint do not amount to waste because it cannot be said that the benefits received by Covad from the settlement are "so inadequate in value that no person of ordinary, sound business judgment would deem it worth that which the corporation has paid."[208] It is not, however, outside the realm of business reasonableness to conclude that Covad was better off settling with Dishnet and putting the Dishnet ordeal behind it than to engage in a drawn-out battle with the risk of losing.[209] There are certainly instances in which settling claims—even though of questionable merit—is the prudent course of conduct. Based on the facts alleged, the Plaintiffs have failed to plead that the Covad Board's decision to enter into the Dishnet settlement was beyond the business judgment rule.[210]

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to approve the settlement. The Amended Complaint essentially sets forth only the terms of the settlement. *See, e.g.*, *id*. at ¶¶ 89, 92. This is significant in light of Paragraph 80 of the Amended Complaint, which, in addressing the Board's consideration of the BlueStar earn-out settlement, provides that "under normal Covad practice, self-interested directors would have left any Board meeting when matters pertaining to their self-interest are discussed and voted upon . . . ."

[208] *See* note 177, *supra*.

[209] If, as the Plaintiffs allege, the key principal of Dishnet "had a highly mixed reputation in Asia," *id.* at ¶ 88, it may not have been outside the realm of business judgment to determine that an immediate disentanglement from Dishnet was worth the cost.

[210] The Director Defendants' opening brief contends that this action should be dismissed on the grounds that the Plaintiffs have failed to state a claim under Court of Chancery Rule 12(b)(6). *See* Dirs.' Op. Br. to Dismiss at 1, 3. In support of their argument, the Director Defendants contend that their approvals of the transactions are protected under the business judgment rule. *See* Dirs.' Op. Br. to Dismiss at 34-35. In their answering

V. AIDING AND ABETTING CLAIMS

The Plaintiffs assert claims in Count VI of the Amended Complaint against Crosspoint for aiding and abetting poorly behaving fiduciaries with respect to the Certive and BlueStar transactions. The Court has already determined that the Plaintiffs' claims regarding Certive must be dismissed for failure to make demand upon the Board. The Court now addresses the Plaintiffs' aiding and abetting claim with respect to the BlueStar transactions.

> A third party may be liable for aiding and abetting a breach of a corporate fiduciary's duty to the stockholders if the third party "knowingly participates" in the breach. To survive a motion to dismiss, the complaint must allege facts that satisfy the four elements of an aiding and abetting claim: "(1) the existence of a fiduciary relationship, (2) a breach of the fiduciary's duty, . . . (3) knowing participation in that breach by the defendants," and (4) damages proximately caused by the breach.[211]

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brief to the Director Defendants, the Plaintiffs raised certain arguments questioning applicability of the protections of the business judgment rule. *See* Pls.' Ans. Br. Dirs.' Mot. to Dismiss at 30, 43-46. As the Plaintiffs chose only to address these arguments to the Director Defendants' briefing with respect to Rule 12(b)(6), in this context, the Court neither addresses them with respect to demand excusal nor expresses a view as to their potential applicability in light of dismissal of the various claims under Rule 23.1. *Compare* Pls.' Ans. Br. to Covad's Mot. to Dismiss 40-43.

[211] *Malpiede*, 780 A.2d at 1096 (quoting *Gilbert v. El Paso Co.*, 490 A.2d 1050, 1057 (Del. Ch. 1984) ("It is well settled that a third party who knowingly participates in the breach of a fiduciary's duty becomes liable to the beneficiaries of the trust relationship."), *aff'd*, 575 A.2d 1131 (Del. 1990)); *Penn Mart Realty Co. v. Becker*, 298 A.2d 349, 351 (Del. Ch. 1972)); *see also Laventhol, Krekstein, Horwath and Horwath v. Tuckman*, 372 A.2d 168, 170-71 (Del. 1976) ("[P]ersons who knowingly join a fiduciary in an enterprise which constitutes a breach of his fiduciary duty of trust are jointly and severally liable for any injury which results.").

The Court notes first the distinction between the party who stands in a fiduciary relationship (described by the first and second elements of the test) and the non-fiduciary defendant (described by the test's third element) against whom the aiding and abetting claim is brought.[212] Of course, the Covad Board at the time of the BlueStar acquisition owed fiduciary duties to Covad and its shareholders, thereby satisfying the first element of an aiding and abetting claim. Moreover, the Court has already determined that the Plaintiffs' claims with respect to the BlueStar transactions survive the motion to dismiss; thus, the second element of the test is satisfied here, as well. Similarly, the Amended Complaint sufficiently alleges that, in the event a breach of fiduciary duty is proved, damages were proximately caused.[213] As to the requirement that there be "knowing participation" in the breach by the non-fiduciary defendant (*i.e.*, Crosspoint), "[a] claim of knowing participation need not be pled with particularity. However, there must be factual allegations in the complaint from which knowing participation can be reasonably inferred."[214] Shapero's status as a Covad

[212] *See, e.g.*, *In re Gen. Motors (Hughes) S'holder Litig.*, 2005 WL 1089021, at *24 (Del. Ch. May 4, 2005), *aff'd*, 2006 WL 722198 (Del. Mar. 20, 2006).
[213] *See also Hughes*, 2005 WL 1089021, at *23 (requiring that "damages to the plaintiff resulted from the concerted action of the fiduciary and the non-fiduciary" (quoting *Jackson Nat'l Life Ins. Co. v. Kennedy*, 741 A.2d 377, 386 (Del. Ch. 1999)).
[214] *Hughes*, 2005 WL 1089021, at *24 (quoting *In re Shoe-Town, Inc. S'holders Litig.*, 1990 WL 13475, at *8 (Del. Ch. Feb. 12, 1990)). Crosspoint's motion to dismiss the Plaintiffs' aiding and abetting claim is reviewed under Court of Chancery Rule 12(b)(6).

director and General and Managing Partner of Crosspoint is sufficient to impute knowledge of Shapero's conduct with respect to the BlueStar acquisition to Crosspoint, for purposes of this motion to dismiss.[215] The allegations of the Amended Complaint support the reasonable inference that Shapero, and therefore Crosspoint, knew of BlueStar's gloomy business prospects at the same time he was touting the potential acquisition.[216] Moreover, the allegations permit the reasonable inference that Shapero—by his statements and influence over, at least, Knowling—initiated, induced, and contributed to the underlying breach of Covad's Board.[217] The Amended Complaint sets forth that "Shapero lobbied Knowling through lengthy emails on the weekend of May 20-21, 2000, to have Covad acquire BlueStar and NewEdge."[218] Additionally, the Complaint alleges:

> According to Covad's amended Form S-4/A, filed with the Securities and Exchange Commission on August 30, 2000, BlueStar's directors, which included defendants McMinn and Shapero, suggested that the CEOs of BlueStar and Covad meet initially to discuss a possible business combination. In fact, the

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[215] *See, e.g.*, *Carlson v. Hallinan*, 2006 WL 771722, at *20 - *21 (Del. Ch. Mar. 21, 2006) (imputing majority shareholder's knowledge to nonfiduciary defendant-entities for which shareholder serves as director and officer) (citing *In re HealthSouth Corp. S'holders Litig.*, 845 A.2d 1096, 1108 n.22 (Del. Ch. 2003), *aff'd*, 847 A.2d 1121 (Del. 2004) (TABLE)).

[216] *See* Amended Compl. at ¶¶ 58, 59, 62, 63.

[217] Because Shapero serves as General and Managing Partner of Crosspoint, his acts permit the Plaintiffs to charge Crosspoint with "participation" in the context of the third element of the aiding and abetting claim. Indeed, the emails sent by Shapero to Knowling were from Shapero's Crosspoint email account and are signed "Rich Shapero, Managing Partner, Crosspoint Venture Partners." Calder Decl., Ex. Q.

[218] Amended Compl. at ¶ 62.

> documents produced in the § 220 action clearly show that Shapero, a member of Covad's compensation committee, repeatedly and directly lobbied (and ultimately persuaded) Knowling, the CEO whose compensation was determined by Shapero and his other committee members, that Covad should acquire BlueStar.[219]

Crosspoint contends that documents produced as a consequence of the § 220 action, and on which the Plaintiffs in part rely,[220] fail to demonstrate that Shapero acted improperly.[221] Specifically, Crosspoint argues that document LWDK 0002013 shows that Shapero's statements were not improper, but merely constituted permitted "expression" of Shapero's views.[222] The Court

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[219] *Id.* at ¶ 72. The Amended Complaint additionally provides:

> Each of Messrs. McMinn, Hawk and Shapero and/or Crosspoint were significant stockholder of BlueStar. Specifically, McMinn was the beneficial owner of approximately 656,942 shares of BlueStar common stock. Shapero's venture capital firm, Crosspoint, owned approximately 30 million shares of BlueStar stock, which represented approximately 41.9% of all of BlueStar's issued and outstanding common stock. Hawk, a Special Limited Partner of Crosspoint, was also a significant shareholder of BlueStar stock. BlueStar's CEO, Robert Dupuis, had previously worked for Crosspoint and thus had ties to Shapero and Hawk.

Id. It should be noted that McMinn was not a member of Covad's Board at the time of the acquisition, having resigned on November 1, 1999, and rejoining only in "late October 2000." *Id.* at ¶ 8.

[220] *See* Pls.' Ans. Br. in Opp'n to Def. Crosspoint Venture Partners, L.P.'s Mot. to Dismiss Am. Deriv. & Class Action Compl. ("Pls.' Ans. Br. to Crosspoint's Mot. to Dismiss**"**) at 33 (citing Calder Decl., Exs. Q (LWDK0002013-2015), R (LDWK0002987-2988); *see also* Amended Compl. at ¶ 72 (stating that "the documents produced in the § 220 action clearly show" Shapero's involvement).

[221] Reply Br. in Further Supp. of Def. Crosspoint Venture Partners, L.P.'s Mot. to Dismiss Pls.' Am. Deriv. & Class Action Compl. ("Crosspoint's Reply Br. to Dismiss") at 26.

[222] *See id.* at 25-26. Crosspoint states that "[a]n interested director's expression of his views does not taint the decision of the disinterested directors." *Id.* (citing *In re Ply Gem Indus. Inc. S'holders Litig.*, 2001 WL 755133 (Del. Ch. June 26, 2001); *Lewis v. Leaseway Transp. Corp.*, 1990 WL 67383 (Del. Ch. May 16, 1990)). Shapero, however, is alleged to have moved well beyond merely "expressing his views." Moreover, the

need not resolve the question of the characterization of the disputed emails, however, since a reasonable inference to draw from the allegations in the Amended Complaint is that Shapero's power to infect the decisions of Knowling and the Board, and the process by which this was accomplished, were premised not solely on his salesmanship (as reflected in this limited email chain), but, *inter alia*, on his power over Knowling's compensation as a member of Covad's compensation committee. Thus, the Court concludes that, based on the allegations before it, the Plaintiffs' claim against Crosspoint for aiding and abetting, with respect to the BlueStar transactions, cannot be dismissed.[223]

VI. *RESPONDEAT SUPERIOR* CLAIM

In Count VII of the Amended Complaint, the Plaintiffs also assert claims against Crosspoint under the doctrine of *respondeat superior*. The Court concludes that these claims must be dismissed in their entirety. The

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inference can be drawn that he was well aware of BlueStar's dismal circumstances and prospects.

[223] The Plaintiffs asserted fiduciary duty claims against Crosspoint arising out of the Certive matters because, at that time, Crosspoint controlled a significant, even if less than half, portion of Covad's outstanding stock. Those claims were dismissed for failure to make demand on the Board. By the time of the BlueStar Transaction, Crosspoint had eliminated (or substantially reduced) its holdings in Covad and, thus, no longer owed (if it ever did) fiduciary duties to Covad.

Additionally, in the context of the motion to dismiss, the Court cannot conclude that, *inter alia*, that the transaction was the product of arms-length negotiations sufficient to preclude aiding and abetting liability. *Compare Hughes*, 2005 WL 1089021, at *26 - *28.

Plaintiffs have not cited any authority demonstrating that such claims are permissible, in this context. "*Respondeat superior* imposes liability upon a principal for the torts of his agent committed within the scope of their agency relationship."[224] As has already been described above, Crosspoint stands as a *non-fiduciary* defendant in this litigation vis-à-vis Covad and its shareholders with respect to the BlueStar matters.[225] Indeed, this is a critical element of the Plaintiffs' aiding and abetting claim against Crosspoint. To permit recovery, in this circumstance, under the common law tort law doctrine of *respondeat superior* "would work an unprecedented, revolutionary change in our law, and would give investors in a corporation reason for second thoughts about seeking representation on the corporation's board of directors."[226] As a consequence, the Court determines that the

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[224] *Arnold v. Soc'y for Sav. Bancorp, Inc.*, 1995 WL 376919, at *8 (Del. Ch. June 15, 1995) (citing *Fields v. Synthetic Ropes, Inc.*, 215 A.2d 427, 432 (Del. 1965)). Count VI also briefly mentions the "Certive Transaction." *See* Amended Compl. at ¶ 181.

To the extent that the Plaintiffs may seek to plead an aiding and abetting claim against Crosspoint for matters arising out of events described by Counts I through III—which have been dismissed for failure to make demand on the Board, as described above—the Plaintiffs may not assert a claim for aiding and abetting, since the underlying claims may not be pursued.

[225] *Cf. Emerson Radio Corp. v. Int'l Jensen Inc.*, 1996 WL 483086, at *20 (Del. Ch. Aug. 20, 1996) ("As a stockholder, [defendant third-party entity] could attain fiduciary status only if it were a majority shareholder or it actually controlled the affairs of [defendant corporation].").

[226] *Emerson Radio Corp.*, 1996 WL 483086, at *20 n.18 (analogizing plaintiffs' claims in that case to claims brought under theory employed by the Plaintiffs in this litigation). *Cf. USAirways Group, Inc. v. British Airways PLC*, 989 F. Supp. 482, 494 (S.D.N.Y. 1997) (denying recovery under this theory of tort law since it would "undermine" and "circumvent[ ] clear limitations imposed by Delaware corporate law").

Plaintiffs' claim for *respondeat superior* is insufficient as a matter of law, under these circumstances, and, therefore, must be dismissed.

VII. PROXY STATEMENT DISCLOSURES

The Plaintiffs also assert direct claims against McMinn, Shapero, Hawk, Lynch, Marshall, Irving, Hoffman, Runtagh, Crandall, and Jalkut for material omissions from Covad's Proxy Statements from 2002, 2003, and 2004. The Plaintiffs allege that Covad shareholders might not have elected the directors who were up for election during those years had the omitted information been disclosed. Specifically, the Plaintiffs allege that the following material information should have been disclosed:

1. Khanna's June 19, 2002 letter to the Covad Board. (2002, 2003, & 2004)
2. The Standstill Agreement with Khanna. (2002)
3. "The real reasons for and circumstances relating to the removal of Khanna as General Counsel and his intention, expressed to them, of taking legal action, if necessary, to seek redress for the harm defendants had caused Covad." (2002, 2003, and 2004)
4. The earn-out criterion for the BlueStar transaction had not been met, and Shapero, McMinn, and Hawk derived a great benefit from the settlement. (2002, 2003, and 2004)

5. "[D]efendant McMinn, during the time period of February to November 1999 when he purported to be working for Covad full-time, was actually working for himself and Crosspoint to find new investment vehicles." (2002)
6. Generalized information with respect to Khanna's allegations—specifically, which transactions and which directors challenged. (2003 & 2004)

In 2002, McMinn, Hawk, and Hoffman were slated for election and were re-elected. In 2003, Jalkut, Irving, and Lynch were slated for election and were re-elected. In 2004, Crandall and Runtagh were slated for election and were re-elected. Each of these elections was apparently uncontested.

A. *Legal Standards*

1. Motion to Dismiss

The standards governing this Court's analysis of motions to dismiss under Rule 12(b)(6) have recently been reiterated:

> (i) all well-pleaded factual allegations are accepted as true; (ii) even vague allegations are "well-pleaded" if they give the opposing party notice of the claim; (iii) the Court must draw all reasonable inferences in favor of the non-moving party; and (iv) dismissal is inappropriate unless the "plaintiff would not be entitled to recover under any

> reasonably conceivable set of circumstances susceptible of proof."[227]

Although the Court must "accept as true all of the well-pleaded allegations of fact and draw reasonable inferences in the plaintiff's favor,"[228] it is "not . . . required to accept as true conclusory allegations 'without specific supporting factual allegations.'"[229] Instead, the Court must "accept only those 'reasonable inferences that logically flow from the face of the complaint' and 'is not required to accept every strained interpretation of the allegations proposed by the plaintiff.'"[230] It should also be noted that the standard governing motions under Court of Chancery Rule 12(b)(6) is "less stringent" than the standard employed in demand futility analysis under Court of Chancery Rule 23.1.[231]

2. Fiduciary Duty with Respect to Disclosure

Delaware common law of fiduciary duty requires that directors disclose fully and with complete candor all material facts in soliciting

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[227] *Hughes*, 2006 WL 722198, at *3 (quoting *Savor, Inc. v. FMR Corp.*, 812 A.2d 894, 896-7 (Del. 2002)).
[228] *Id.* (citing *Malpiede*, 780 A.2d at 1082).
[229] *Id.* (citing *In re Santa Fe Pac. Corp. S'holder Litig.*, 669 A.2d 59, 65-66 (Del. 1995)); *see also Solomon v. Pathe Commc'ns Corp.*, 672 A.2d 35, 38 (Del. 1996).
[230] *Hughes*, 2006 WL 722198, at *3 (quoting *Malpeide*, 780 A.2d at 1082).
[231] *Malpiede*, 780 A.2d at 1082-83 (citations omitted); *see also Rabkin v. Philip A. Hunt Chem. Corp.*, 498 A.2d 1099, 1104 (Del. 1985).

proxies from shareholders.[232] Although it has been held that this duty is "best discharged through a broad rather than a restrictive approach to disclosure,"[233] only material facts must be disclosed. "An omitted fact is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding how to vote."[234]

In order to allege adequately a violation of disclosure requirements, a plaintiff must plead "some basis for a court to infer that the alleged violations were material. For example, a pleader must allege that facts are missing from the proxy statement, identify those facts, state why they meet the materiality standard and how the omission caused injury."[235] The test for

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[232] *Arnold v. Soc'y for Sav. Bancorp, Inc.*, 650 A.2d 1270, 1277 (Del. 1994); *see also Malpiede*, 780 A.2d at 1086 (explaining that "duty of disclosure" does not exist as an independent fiduciary duty).

[233] *Zirn v. VLI Corp.*, 621 A.2d 773, 779 (Del. 1993); *see also Loudon* v. *Archer-Daniels-Midland Co.*, 700 A.2d 135, 144 (Del. 1997) (declining to adopt "bright line" test for disclosure violations, even though it might be "better practice" for directors "to be more candid and forthcoming in their communications to stockholders when presenting a slate for election to the board").

[234] *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 944 (Del. 1985) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)) ("Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."). In order to be material, however, it need not be demonstrated that disclosure of a fact would have changed the shareholder's vote.

[235] *Loudon*, 700 A.2d at 141; *see also M&B Weiss Family Ltd. P'ship of 1996 v. Davie*, C.A. No. 20303, slip op. at 5, Chandler, Ch. (Bench Ruling Del. Ch. Apr. 12, 2005). *Cf. Orman*, 794 A.2d at 31 ("In order for a plaintiff to state properly a claim for breach of a disclosure duty by omission, he must 'plead facts identifying (1) material, (2) reasonably available, (3) information that (4) was omitted from the proxy materials.'" (quoting *O'Reilly v. Transworld Healthcare, Inc.*, 745 A.2d 902, 926 (Del. Ch. 1999)); *accord Wolf v. Assaf*, 1998 WL 326662, at *1 (Del. Ch. June 16, 1998).

whether an omitted fact is material is context-specific, and, therefore, determinations of materiality will not frequently be appropriate on a motion to dismiss.[236] Nevertheless, this Court may resolve such questions at the motion to dismiss stage if it is satisfied with reasonable certainty that no set of facts could be proved that would permit the plaintiffs to obtain relief under the allegations made.[237] Even though the Court's analysis in this context is not overly stringent, "it is inherent in disclosure cases that the misstated or omitted facts be identified and that the pleading not be merely conclusory."[238]

3. Self-flagellation

A long-standing principle of disclosure jurisprudence provides that a board need not engage in "self-flagellation."[239] Notwithstanding the requirement that directors disclose fully all material facts in the solicitation of proxies from shareholders, a board of directors is not required to "confess to wrongdoing prior to any adjudication of guilt,"[240] nor must it "draw legal

[236] *See, e.g.*, *Alessi v. Beracha*, 849 A.2d 939, 949 n.68 (Del. Ch. 2004).
[237] *Seagraves v. Urstadt Property Co., Inc.*, 1989 WL 137918, at *5 (Del. Ch. Nov. 13, 1989); *see also In re Encore Computer Corp. S'holders Litig.*, 2000 WL 823373, at *8 - *9 (Del. Ch. June 16, 2000); *In re JCC Holding Co., Inc.*, 843 A.2d 713, 720 (Del. Ch. 2003); *Orman*, 794 A.2d at 32.
[238] *Loudon*, 700 A.2d at 140.
[239] *See, e.g.*, *Stroud v. Grace*, 606 A.2d 75, 84 n.1 (Del. 1992).
[240] *Loudon*, 700 A.2d at 145.

conclusions implicating itself in a breach of fiduciary duty from surrounding facts and circumstances prior to a formal adjudication of the matter."[241]

4. Laches

"The essential elements of laches are: (1) the plaintiff must have knowledge of the claim and (2) there must be prejudice to the defendant arising from an unreasonable delay by the plaintiff in bringing the claim."[242] Essentially,

> [l]aches is defined as an unreasonable delay by a party, without any specific reference to duration, in the enforcement of a right. An unreasonable delay can range from as long as several years to as little as one month. The temporal aspect of the delay is less critical than the reasons for it, because in some circumstances even a long delay might be excused.[243]

Determination of what constitutes "unreasonable delay" is most often necessarily a factual and context-specific inquiry and, therefore, not generally appropriate for resolution on a motion to dismiss. If, however, the pleadings make reasonably certain that laches is applicable and there can be no facts reasonably supporting a contrary inference, then no insurmountable

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[241] *Stroud*, 606 A.2d at 84 n.1. *Compare Big Lots Stores, Inc. v. Bain Capital Fund VII, LLC*, 2006 WL 846121, at *10 (Del. Ch. Mar. 28, 2006).
[242] *U.S. Bank Nat'l Ass'n v. U.S. Timberlands Klamath Falls, L.L.C.*, 864 A.2d 930, 951 (Del Ch. 2004), *vacated on other grounds*, 875 A.2d 632 (Del. 2005) (TABLE).
[243] *Steele v. Ratledge*, 2002 WL 31260990, at *3 (Del. Ch. Sept. 20, 2002) (footnotes omitted).

procedural hurdle exists to prevent the Court from resolving the issue on a motion to dismiss claim.[244]

5. Incorporation and Consideration of Matters Outside the Complaint

"The complaint generally defines the universe of facts that the [Court] may consider in ruling on a . . . motion to dismiss. When the [Court] considers matters outside of the complaint, a motion to dismiss is usually converted into a motion for summary judgment and the parties are permitted to expand the record."[245] The Court may, however, "in some instances and for carefully limited purposes," consider documents referred to in the complaint in order to rule on a motion to dismiss.[246] Additionally, the Court may take judicial notice "of matters that are not subject to reasonable dispute."[247] As a consequence, the Court will consider the challenged Covad proxy statements, as well as other documents incorporated into the Amended Complaint, in its analysis of the motion to dismiss.

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[244] *See Bay NewFoundland Co., LTD. v. Wilson & Co., Inc.*, 28 A.2d 157 (Del. Ch. 1942), *aff'd*, 37 A.2d 59 (Del. 1944); *cf. Steele*, 2002 WL 31260990, at *3 (applying doctrine of laches on summary judgment when "undisputed material facts" established applicability). Although this Court is frequently reluctant to apply laches on a motion to dismiss, *see, e.g.*, *Goldman v. Pogo.com, Inc.*, 2002 WL 1358760, at *2 n.16 (Del. Ch. June 14, 2002), there is no *per se* bar to its application when it is clearly appropriate.

[245] *Hughes*, 2006 WL 722198, at *3 (citations omitted); *see also* CT. CH. R. 12(b).

[246] *See Hughes*, 2006 WL 722198, at *3 (citing *In re Santa Fe Pac. Corp.*, 669 A.2d at 69).

[247] *See id.* (citing DEL. R. EVID. 201(b)).

B. *Analysis*

The Plaintiffs have identified information they allege was omitted from Covad Proxy Statements and have explained it was material because its omission permitted the re-election of particular directors who would perhaps not have been re-elected otherwise. The Plaintiffs ask the Court to grant equitable relief by overturning the 2002, 2003, and 2004 elections. "The courts of this state 'have long held that inequitable conduct by directors that interferes with a fair voting process may be set aside in equity.'"[248] Therefore, "voiding results of directorial elections and ordering a new election is an appropriate remedy when an election occurs using materially false and misleading proxy materials."[249]

Below, the Court addresses first the application of laches to the Plaintiffs' 2002 Proxy disclosure claims. The Court then turns to each of the Plaintiffs' remaining 2003 and 2004 Proxy disclosure claims and addresses them *seriatim*.

[248] *Millenco L.P. v. meVC Draper Fisher Jurvetson Fund I, Inc.*, 824 A.2d 11, 15 (Del. Ch. 2002) (quoting *Linton v. Everett*, 1997 WL 441189, at *9 (Del. Ch. July 31, 1997)).
[249] *Shamrock Holdings of Cal., Inc. v. Iger*, 2005 WL 1377490, at *5 n.37 (Del. Ch. June 6, 2005). The Court notes that the Amended Complaint does not specifically request that the Court order a new election.

1. Analysis of Plaintiffs' 2002 Proxy Claims Under Laches Doctrine[250]

As stated above, laches does not, in the mill run of cases, present a proper basis on which the Court may dismiss a plaintiff's claims, since determination of what constitutes "unreasonable delay" is frequently a factual and context-specific inquiry. Notwithstanding the Court's general reluctance to employ laches at the motion to dismiss stage, the Court will, however, dismiss claims when "unreasonable delay" may be found from the face of the pleadings and it is reasonably certain that no set of facts can be proved which would otherwise preclude such a finding.

In the present litigation, the chronology relevant to laches analysis is undisputed. The Plaintiffs seek now to overturn the 2002 election for directors. The directors elected in 2002 have since completed their three-year terms of office. This fact alone makes equitable relief with respect to the 2002 Proxy claim impossible.

[250] This action was filed on September 15, 2003, well before Covad's issuance of the 2004 Proxy Statement on April 30, 2004, and the 2004 Covad Board meeting on June 10, 2004.

It should also be noted that the Plaintiffs did not file their Amended Complaint asserting claims for omissions in the 2004 Proxy until August 3, 2004. Whether the Plaintiffs' 2004 Proxy claims should be dismissed because they were not sooner filed is a question the Court need not decide here, given its analysis below.

The 2002 Proxy Statement is JTX 16; the 2003 Proxy Statement is JTX 24; and the 2004 Proxy Statement appears at Calder Decl., Ex. E.

Moreover, the Court is troubled by Khanna's delay of more than a year after the 2002 board elections in filing his Original Complaint challenging the adequacy of 2002 Proxy Statement. The Draft Complaint presented to the Covad board by Khanna on July 9, 2002 (as well as his letter to the board of June 19, 2002) demonstrates that he was aware of the facts underlying his disclosure claims before the 2002 board meeting, at the latest (and probably much earlier). Indeed, Khanna served as General Counsel of Covad when the transactions he now challenges (and which underlie the bulk of his disclosure claims) took place. Very few shareholders would stand in a better position to know the relevant facts than a corporation's General Counsel.[251]

Although this Court may overturn a board election, a plaintiff seeking such relief must present her claims with reasonable alacrity if useful

[251] The Plaintiffs also argue that an issue of fact as to Khanna's delay in filing this action is created by a letter from Covad's outside counsel to Khanna's counsel, dated February 13, 2003, Pls.' Ans. Br. to Covad's Mot. to Dismiss at 46-47. JTX 62. The Court notes, first, that the February 13, 2003 letter was actually in response to a letter from Khanna's counsel sent two days earlier, on February 11, *see* JTX 63, and not an email from Khanna, dated November 13, 2002, *see* JTX 33. Moreover, although the February 13 letter does provide that Khanna's disclosure objections would be "refer[ed] . . . to the Company, which is being advised by separate counsel on its disclosure obligations," the Court does not view this as potentially mitigating Khanna's already by then extensive delay in seeking the wide-ranging equitable relief he now requests.

equitable relief is to be granted.[252] Moreover, finality and predictability with respect to a corporation's governing structure clearly are not of insignificant benefit to the corporate enterprise.[253] Khanna, with his knowledge of the facts he now asserts were improperly omitted, could have acted at the time of the 2002 election. Similarly, he could have filed an action for equitable relief promptly following the 2002 election. The Plaintiffs have offered the Court no persuasive explanation for his delay of more than one year.

The Court concludes that, in light of equitable principles guiding the exercise of its jurisdiction, it would be inequitable to award the Plaintiffs the relief they seek with respect to their 2002 Proxy disclosure claims. Khanna served as Covad's General Counsel during the period the challenged transactions were approved; however, Khanna filed suit only after his termination, thus generating concern that his actions were motivated by his

[252] The policy considerations animating this view in the context of challenges to board elections also apply in the context of challenges to mergers, although perhaps with more severe consequences for the dilatory plaintiff. *Cf. In re J.P. Morgan Chase & Co.*, 2005 WL 1076069, at *12 (holding that failure to file TRO in merger context resulted in "equitable [being] relief is no longer practicable," since the "'eggs' ha[d] been irretrievably 'scrambled' and there [was] no possibility of effective equitable relief"); *see also Arnold*, 678 A.2d at 537. *But see Loudon*, 700 A.2d at 138 (in context of board election, stating that "[a] timely complaint, properly pleaded and supported by proof sufficient to invoke preliminary equitable relief, could result in an *early* injunction or the imposition of corrective disclosures *before* the complained-of corporate activity had been consummated" (emphasis added)).

[253] *Compare Bay Newfoundland Co. v. Wilson & Co.*, 37 A.2d 59, 62 (Del. 1944) (addressing certainty interests in the distinct, but analogous context of corporate act approval).

employment dispute.[254] Khanna's role at Covad provided him with knowledge and a platform from which the problems could have been addressed. Khanna now seeks to employ that knowledge against the corporation, and its directors, well after the fact.[255] Moreover, the addition of Sams and Meisel, as plaintiffs, fails to ameliorate the Court's concerns.[256] The Court cannot permit the Plaintiffs in this instance to have stood effectively idle until more than a year after the 2002 annual meeting to bring their challenge before this Court. Fundamentally, this is not an instance in which the grant of equitable relief would comport with its general notions of equity, and, as a consequence, the Plaintiffs' claims with respect to the 2002 Proxy Statement must be dismissed under the doctrine of laches.[257]

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[254] The Court acknowledges the Plaintiffs' allegations that Khanna objected to the transactions and that he was investigated internally for sexual harassment as a result of his objections, *but see* Pls.' Ans. Br. to Covad's Mot. to Dismiss at 42 n.14 (explaining that Khanna's objections with respect to Dishnet—and presumably the other transactions, as well—were business advice only, and not legal advice); however, the Court does not view Khanna's termination as isolated from Khanna's filing litigation against the defendants soon thereafter—*i.e.*, the timing of events is not mere coincidence. Indeed, given the Court's treatment of Khanna's June 19 letter to the Covad Board as made in the employment context (which is a treatment that the Plaintiffs necessarily desire), the Court will not now view the present litigation as unrelated (*i.e.*, not to gain advantage in what may perhaps be viewed as a substitute for convoluted employment litigation).

[255] This does not diminish, however, the Court's ruling, below, that certain information is not subject to attorney-client privilege.

[256] The Court holds Sams and Meisel, as co-plaintiffs with Khanna, charged with the behavior of Khanna that took place prior to their appearance in this action.

[257] The Court also notes that prior decisions have held claims for equitable relief moot when the challenged directors' terms have expired. *See Loudon*, 700 A.2d at 138; *see also M&B Weiss Family Ltd. P'ship of 1996*, C.A. No. 20303, slip op. at 5. This applies to Hawk, and it also likely applies to the claims against McMinn and Hoffman. Because

2. Analysis of Plaintiffs' Individual Proxy Disclosure Claims

a. *Disclosure Claim #1: Khanna's June 19, 2002 Letter to the Covad Board (2002, 2003, and 2004 Proxy Statements)*

The Plaintiffs first claim that the failure to disclose Khanna's June 19, 2002 letter to the Covad Board constituted a material omission from Covad's 2002 Proxy Statement.[258] Based on the foregoing analysis, this claim must be dismissed.

The claims presented in the Amended Complaint with respect to the 2003 and 2004 Proxy Statements do not specifically identify the letter as a material omission.[259] Nevertheless, assuming *arguendo* that the Amended Complaint does set forth such claims, they would be dismissed as well.

First, any such claims involving the 2003 and 2004 Proxy Statements fail principally because, as explained above, Khanna's June 19, 2002 letter must be viewed primarily as part of an on-going employment dispute between Covad and Khanna. Therefore, the letter is a document that the Company is not required to disclose, standing alone. This Court has already ruled in the Plaintiffs' favor on this issue, deeming the letter not to have

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McMinn and Hoffman were re-elected on expiration of their terms in 2005, however, the Court declines to rely on this principle.

[258] Amended Compl. at ¶ 194.

[259] *Compare id.* at ¶ 194, *with* ¶¶ 204, 213. Indeed, as explained above, failure to identify the omitted facts which form the basis of a plaintiff's claim is, in itself, cause to dismiss. *See Loudon*, 700 A.2d at 140.

been a demand on the Covad Board, but the Plaintiffs must endure the consequences along with the benefits of this conclusion. Moreover, the Plaintiffs' claims with respect to the letter fail because disclosing the letter (and its characterization of the challenged transactions) would amount to a requirement that the Covad Board disclose and adopt Khanna's pejorative characterization of the challenged conduct. This would amount to "self-flagellation."

b. *Disclosure Claim #2: Standstill Agreement (2002 Proxy Statement)*

As explained above, this claim must be dismissed because it is a challenge to the 2002 Proxy Statement. The Court also briefly notes, however, that the Plaintiffs have failed to satisfy the materiality standard necessary to survive the motion to dismiss this claim, as well. On June 10, 2002, the Proxy Statement was issued. On June 19, 2002, Khanna sent the Covad Board his letter. The directors were elected on July 25, 2002. Thus, with regard to the 2002 disclosure of the Standstill Agreement, the question becomes whether this was material before July 25, 2002. The Court concludes that it was not. Since the Standstill Agreement related solely to

Khanna's employment claims, it was not relevant to shareholders, at least in the way that the Amended Complaint alleges.[260]

c. *Disclosure Claim #3: "Real Reasons" for Khanna's Termination as General Counsel of Covad (2002, 2003, & 2004 Proxy Statements)*

As with the above discussion of the June 19, 2002 letter, the Plaintiffs' third disclosure claim (that the "real reasons" behind Khanna's termination should have been disclosed) would constitute admissions of wrongdoing, which the Defendants contest, before a final adjudication on the merits. This constitutes a request that the Board engage in classic "self-flagellation," and, therefore, this claim is dismissed as well.[261] Moreover,

[260] As discussed above, Khanna's June 19, 2002 letter—read it in the light most favorable to the Plaintiffs—relates to Khanna's employment dispute. The corporate governance allegations are subordinate to the employment demands. Similarly, the Standstill Agreement relates to Khanna's employment claims. The Amended Complaint does not allege that this understanding changed while the Standstill Agreement was in effect between July 10, 2002 and July 26, 2002. Obviously, at some point the posture of Khanna's claims against Covad purportedly changed from being centered on his termination to seeking redress for shareholders in general. When the nature of these claims changed is unclear from the Amended Complaint. However, it is clear that it was after July 25, 2002.

Moreover, the Amended Complaint alleges that the omissions from Covad's 2002 Proxy Statement led to the election of McMinn, Hawk, and Hoffman and that the omitted facts would have been material to this decision. It is not at all clear how disclosure of the Standstill Agreement would have been material to the decision of whether to reelect these directors.

[261] The Court also views the additional disclosures the Plaintiffs seek here to be not material to shareholders' decisions of whether to elect particular directors, especially since they relate to an employment dispute. Moreover, the only directors whom the Plaintiffs allege tried to "intimidate" Khanna (McMinn and Hoffman) were re-elected in 2002.

the Plaintiffs' challenges to the 2002 Proxy must also be dismissed with respect to this claim for the reasons stated above.[262]

d. *Disclosure Claim #4: Failure to Satisfy the BlueStar Earn-Out Criteria (2002, 2003, & 2004 Proxy Statements)*

The Plaintiffs also allege that the failure of BlueStar to meet the earn-out criteria set forth in the BlueStar Acquisition constituted a material omission from all three challenged Covad Proxy Statements. Specifically, the Plaintiffs allege: "Defendants also did not disclose that the earn-out criteria for the BlueStar transaction had not been met, but that they decided to pay out the 3,250,000 shares. Defendants Crosspoint, Shapero, McMinn, and Hawk derived great benefit by, between them, receiving almost 50% of the 3,250,000 shares issued by Covad in this transaction."[263]

At the outset, the Court notes that the 2002 Proxy disclosure claims must be dismissed for the reasons set forth above. The Court, therefore, addresses only the Plaintiffs' claims with respect to the 2003 and 2004 Proxies. With respect to these two proxy statements, the Amended

[262] With respect to their 2002 Proxy claim, the Plaintiffs additionally assert that the Defendants failed to "disclose . . . [Khanna's] intention, expressed to them, of taking legal action, if necessary, to seek redress for the harm defendants had caused Covad." Amended Compl. at ¶ 196. This claim is set forth in the same paragraph as the alleged omission of the "real reasons" for Khanna's termination. Khanna's purported "intentions," as a shareholder or even as a former General Counsel, cannot be said to be a material fact that a board must disclose in its proxy statement in this context.

[263] *Id.* at ¶¶ 197, 206, 215.

Complaint fails to set forth allegations sufficient to survive the Defendants' motion to dismiss. The materiality of any disclosure must be analyzed within the scope of the pleadings. Thus, the fact that BlueStar failed to meet its earning targets must be considered in light of its materiality to shareholders' decision to elect particular directors (*i.e.*, in the context in which the Plaintiffs bring their disclosure claims). Viewed in this light, BlueStar's earning disclosure cannot be viewed as material.[264]

The only potential argument as to why disclosure would be material to shareholders, in the context of the board elections, is that the directors' approval of the earn-out payment may have been relevant in deciding whether or not to elect a particular director. This rationale alone, however, is not sufficient to mandate disclosure. A large quantity of information may exist regarding any director that *could* be useful to shareholders in making a decision whether or not to elect a particular director. Yet, the question is not merely whether a disclosure might be helpful in deciding to elect a director, but, instead, whether the information reaches the necessary threshold of

[264] The BlueStar acquisition and earn-out settlement had occurred more than two years before the 2003 proxies were solicited. Shareholder approval was not required for the BlueStar earn-out settlement. If approval had been required, then disclosure of this information would likely have been material to that decision.

materiality.[265] The business decision of a board to settle certain disputed claims is not, standing alone, within the class of information that is the proper subject of disclosure when shareholder action is not requested with respect to that action but, instead, in the context of a director election.[266] Because the BlueStar earn-out settlement was just one of many decisions that Covad's directors made, and given the passage of time following the earn-out settlement, the Court concludes that disclosure of BlueStar's financial data measured against Covad's earn-out obligations to former BlueStar shareholders in the 2003 and 2004 Proxy Statements was not material to the Covad shareholders in this context. Disclosure would not have significantly altered the total mix of information available to shareholders in deciding how to cast their votes in the 2003 and 2004 elections for disinterested directors.[267]

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[265] A proxy statement need not disclose the details of all transactions in which uninterested directors slated for re-election participated. Certainly, broad disclosure is preferred, *see, e.g.*, *Zirn*, 621 A.2d at 779, but the Plaintiffs' expectations are too expansive in this context.

The Amended Complaint does not identify the lack of detail about Lynch's role in negotiating the BlueStar transaction as an improper omission from the 2003 Proxy Statement. *See* Amended Compl. at ¶¶ 197, 206, 215.

[266] *Cf. Loudon*, 700 A.2d at 145. ("The details of a corporation's inner workings and its day-to-day functioning are not the proper subject of disclosure.").

[267] The Court takes a dim view of the 2002 Proxy Statement's vague (if at all extant) references to the interests of McMinn and Hawk in the BlueStar earn-out settlement. Had the Plaintiffs' 2002 Proxy claims not been dismissed in their entirety, the Court may have found the disclosure shortcomings in this context material for purposes of the motion to dismiss.

Moreover, Covad had already disclosed facts relevant to the BlueStar acquisition and settlement in its 2002 Proxy Statement, and Covad's 2003 10-K describes BlueStar's subsequent liquidation. Indeed, the disclosures of the 2002 Proxy approach, if not fulfill, disclosure of the information the Plaintiffs contend was improperly omitted. Although the Proxy Statement does not explicitly set forth that the criteria were not met, it does make clear that (1) the full amount BlueStar stockholders were originally to receive under the earn-out provisions was not paid, (2) settlement occurred before the full earn-out period had passed, and (3) the settlement was agreed-to "in exchange for a release of all claims against [Covad]."[268]

Were the Court to conclude that the failure to meet the earn-out criteria was material to the shareholders' decision and did not constitute self-flagellation—*e.g.*, if the proxy had been sent to solicit shareholder approval

[268] According to the 2002 Proxy Statement:

> In connection with our acquisition of BlueStar, we agreed to place approximately 800,000 shares of our common stock in a third-party escrow account. Up to 5,000,000 additional common shares of our common stock were to be issued if BlueStar achieved certain specified levels of revenues and earnings before interest, taxes, depreciation and amortization in 2001. However, in April 2001, we reached an agreement with the BlueStar stockholders' representative to resolve this matter, as well as the matters that caused 800,000 of the Company's common shares to be held in escrow as of December 31, 2000, by providing the BlueStar stockholders with 3,250,000 of the 5,000,000 shares, in exchange for a release of all claims against the Company. BlueStar's former stockholders received the additional shares of the Company's common stock during 2001. The 800,000 common shares held in escrow were ultimately returned to the Company under this agreement.

of the settlement—then the prior disclosures of material information would be insufficient to grant a motion to dismiss.[269] The Plaintiffs' claim presents a distinct set of issues, however. In the context of a director election, the Court, in this instance, must ask questions similar to those considered in both *Loudon v. Archer-Daniels-Midland Co.*[270] and *Wolf v. Assaf*[271]: Where can it be said that a bright-line rule should apply requiring disclosure of mere facts concerning a past action of the board that would otherwise appear to have bearing on a director's election no greater (unless the conclusion is made that the conduct was "wrongful") than any other facts regarding the numerous business decisions with which the director has been involved? Such a rule would seem to invite overwhelming disclosure of a broad range of information in the context of director elections (*e.g.*, information

[269] *Compare Wolf*, 1998 WL 326662, at *3 ("Including the description of the federal class action in the 10-K and attaching it to the proxy statement creates a substantial likelihood that the reasonable shareholder would have been on notice to review and would have been likely to review its contents."), *with ODS Techs., L.P. v. Marshall*, 832 A.2d 1254, 1261-62 (Del. Ch. 2003) (granting preliminary injunction since omissions of purpose and effect underlying proposed amendments "cross the line" to become "affirmatively misleading," and rejecting argument that reference by 10-K mailed with proxy to attachment sent to shareholders in unrelated distribution years earlier was sufficient as it would create "a 'super' shareholder standard and create almost limitless opportunities for deception of the 'reasonable' shareholder"). *Cf. Bren v. Capital Realty Group Senior Housing, Inc.*, 2004 WL 370214, at *9 (Del. Ch. Feb. 27, 2004) (although denying summary judgment and motion to dismiss, stating: "All material facts to the action must be disclosed. This does not require, however, that all material information that was previously disclosed be disclosed again with the specific correspondence requesting action." (citations omitted)).

[270] 700 A.2d 135 (Del. 1997).

[271] 1998 WL 326662 (Del. Ch. June 16, 1998).

surrounding *all* transactions which the director has voted to approve) in order to avoid potential future litigation. Although broad disclosure is encouraged, it is also possible for such disclosure to become so extreme as to render proxies confusing and not particularly useful to shareholders in casting an informed vote.[272]

The Plaintiffs might respond that BlueStar's shareholders were so undeserving of the earn-out payment, and Covad's decision to make any earn-out payment were so egregious, that disclosure of BlueStar's earnings would have been material to Covad shareholders, because it would have alerted them that Covad's directors were not pursuing Covad's best interest. This argument, however, accepts Khanna's pejorative description of the BlueStar earn-out settlement, which the Covad Board was not required to disclose because it would constitute the legal characterization of facts (and not a statement of facts). Disclosure of the failure of BlueStar to meet the earn-out criteria would be material to shareholders in this context only if approval of the settlement by the directors up for re-election had been wrongful.[273] Thus, the Plaintiffs seek a disclosure "which by inference

[272] *Cf. Brown v. Perrette*, 1999 WL 342340, at *8 (Del. Ch. May 14, 1999) (noting that "disclosure of a single unadorned fact can quickly snowball into wide-ranging disclosure of facts and opinions that otherwise would never come before the shareholders" (citing *Wolf*, 1998 WL 326662, at *4)).
[273] *Cf. Loudon*, 700 A.2d at 145.

would convey" a breach of fiduciary duty.[274] Disclosure of the single, unadorned fact of the failure to meet the earn-out criteria, standing alone in the proxy to elect directors—especially in 2003 and 2004, two and three years after the settlement—would likely invite, if not require, the Board to explain its reasons why the settlement was warranted. The Court, then, views this as sufficiently analogous to other plaintiffs' prior "attempt[s] to 'skirt' the 'self-flagellation' rule," which would ultimately place the Court on a "well greased slippery slope" and on which the Court declines to tread.[275]

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[274] *See Wolf*, 1998 WL 326662, at *4.

[275] *Id*.; *accord Loudon*, 700 A.2d at 145. *But cf. Brown*, 1999 WL 342340, at *7 (discussing, in context of Court's analysis of disclosures with respect to a transaction approval, potential drawbacks of application of self-flagellation rule).

Finally, the Court views as pertinent to the Court's discussion in *Wolf* of the plaintiff's arguments that the omission in that action was "material to [the director's] character, competence, or fitness for office" is instructive:

> Delaware law does not, however, require a proxy statement to impugn a director's character or draw negative inferences from his past business practices. It only requires a summary of his credentials and his qualifications to serve on the board as well as a description of any conflicts of interest. Nothing in our law requires a masochistic litany of management minutiae. If we required companies to include a detailed, subjective assessment of a director's character and past performance in proxy statements before an election, I do not see how this Court could avoid a flood of second-guessing, hindsighted shareholders seeking to contest admittedly subjective conclusions. This form of subjective titillation has never been required as spice for the "total mix."

1998 WL 326662, at *5. The Plaintiffs' claims with respect to the 2002 Proxy Statement have been dismissed for the reasons described above. Moreover, the Plaintiffs do not challenge the summary of credentials and qualifications or of any conflicts of interest with respect to the 2003 or 2004 Proxies.

e. *Disclosure Claim #5: McMinn's Status at Covad While Creating Certive (2002 Proxy Statement)*

The Plaintiffs' fifth disclosure claim alleges that the 2002 Proxy "did not disclose that defendant McMinn, during the time period of February to November 1999 when he purported to be working for Covad full-time, was actually working for himself and Crosspoint to find new investment vehicles."[276] A requirement that the board make this type of disclosure would implicate considerations similar to those discussed, above, with respect to the Plaintiffs' fourth disclosure claim. Moreover, it would require that Covad adopt Khanna's interpretation of McMinn's employment status, as well as his conformity or non-conformity with the conditions on his compensation. As such, the claim must be dismissed. Additionally, this claim constitutes a challenge to the 2002 Proxy Statement, and therefore must be dismissed for the reasons set forth above.

f. *Disclosure Claim #6: Disclosure of Challenged Directors, Officers, and Transactions (2003 & 2004 Proxy Statements)*

The Plaintiffs also make generalized claims with respect to the 2003 and 2004 Proxy Statements.[277] They variously allege that the directors failed to disclose "anything about Khanna's allegations regarding the Certive, Bluestar or Dishnet transactions;" "[t]he substance of Khanna's allegations;"

[276] Amended Compl. at ¶ 198.
[277] *Id.* at ¶¶ 204, 213.

or "the information showing the pattern and practice of self-dealing and other malfeasance by the directors . . . ."[278] The only omissions they point to with any reasonable specificity is that "Defendants did not identify which directors and officers or which transactions were the subject of Khanna's allegations."[279]

As explained above, "it is inherent in disclosure cases that the misstated or omitted facts be identified and that the pleading not be merely conclusory."[280] Certainly, the threshold is relatively low in order for a claim to be considered well-pleaded on a motion to dismiss under Court of Chancery Rule 12(b)(6). Nevertheless, in order to state a claim for material omission from a proxy statement, a plaintiff must, *inter alia*, identify the facts that were improperly omitted.[281] The Plaintiffs claim here could be fairly read to challenge non-disclosure of all facts asserted in the Plaintiffs' Amended Complaint (or Khanna's June 19, 2002 letter to the Covad board or his July 9, 2002 Draft Complaint). The Court will not attempt, however, to parse a broadly generalized claim for non-disclosure for the benefit of the

[278] *Id.* at ¶¶ 204, 205, 213, 214.
[279] *Id.* at ¶¶ 204, 213.
[280] *Loudon*, 700 A.2d at 140.
[281] *See id.* at 141; *id.* at 144 (upholding trial court's ruling that complaint "failed to 'identify any specific fact that should have been disclosed.'"); *see also M&B Weiss Family Ltd. P'ship of 1996*, C.A. No. 20303, slip op. at 5.

Plaintiffs—it is their responsibility to identify in a reasonable manner the facts which they allege were improperly omitted.

As a consequence, the Court understands the Plaintiffs to be asserting a claim for failure to identify the directors, officers, and transactions that were the subject of Khanna's allegations.[282] At the outset, the Court notes that, once Khanna had filed his Original Complaint on September 15, 2003, after the 2003 election, the subsequent 2004 Proxy discloses both the initiation of the lawsuit and lists the former and current directors named as defendants.[283] Though the 2004 Proxy Statement does not specifically identify the Certive, Bluestar, and Dishnet transactions as being the subject of his suit, it does describe in sufficient detail the history of Covad's dealings with Khanna, the steps it took in investigating his claims, the result of that investigation, and the general claims he now asserts.[284] Indeed, a requirement that the proxy statement disclose details (and conclusions that

[282] Although the Amended Complaint is not clear, it does provide in the first sentence of the relevant paragraphs that "defendants did not disclose anything about Khanna's allegations regarding the Certive, BlueStar or Dishnet transactions." *See* Amended Compl. at ¶¶ 204, 213. The Court, therefore, understands the Plaintiffs to be claiming that these listed transactions should have been disclosed as having been the "subject of Khanna's allegations." *See id.*

[283] *See* 2004 Proxy Statement at 6-7.

[284] Neither Crandall nor Runtagh, the directors slated for re-election in 2004, was interested in any of the challenged transactions, and the Court does not view disclosure of these particular transactions as being the "subject of Khanna's allegations" as material to these directors' re-election. Covad's disclosure puts any shareholder who is concerned by Khanna's allegations on notice that the Covad Board is "too cozy" and that the shareholder should either vote no as to Covad's slate of directors or seek the nomination of fresh candidates.

could be drawn from those details) to the degree the Plaintiffs apparently wish would most likely cross into self-flagellation. Therefore, the Court concludes that the Plaintiffs have failed to state a claim with respect to the 2004 Proxy Statement.

With respect to the 2003 Proxy Statement, no lawsuit had been filed during most important period (*i.e.*, before the 2003 election).[285] Although the Plaintiffs seek to characterize this information (*i.e.*, the directors, officers, and transaction that were the subject of Khanna's allegations) as "facts," information of this sort is not normally the subject of proper disclosure claims. The Court, instead, views the Plaintiffs' claim in this context as analogous to prior instances in which this Court has held that proxy statements need not set forth the "opinions of stockholders" who have merely voiced opposition to a transaction, even if they are "large holders of . . . stock."[286]

The Plaintiffs' contention that Khanna's opinions, as a former General Counsel of Covad, carry more weight and therefore merit different treatment

[285] Though Khanna had filed his § 220 demand on Covad on June 10, 2003 (and a related § 220 action in this Court on August 11, 2003, *see Khanna*, 2004 WL 187274), the date relevant to the present analysis is that on which he filed the present litigation.

[286] *In re Triton Group Ltd. S'holders Litig.*, 1991 WL 36471, at *9 (Del. Ch. Feb. 22, 1991), *aff'd sub nom. Glinert v. Lord*, 604 A.2d 417 (Del. 1991) (TABLE); *see also Seibert v. Harper & Row, Publishers, Inc.*, 1984 WL 21874, at *6 (Del. Ch. Dec. 5, 1984). Khanna is the largest, or one of the largest, individual shareholders of Covad.

is unpersuasive.[287] That Khanna's allegations came forth only contemporaneously with a contentious employment dispute, after Khanna had failed to take affirmative action when the transactions occurred, makes the Court less willing to draw a distinction for these Plaintiffs.

Moreover, in response to Khanna's letter, Covad appointed a special committee to investigate whether there was any substance to his claims. An independent law firm was then retained by the committee to aid its investigation.[288] The committee, comprised of Crandall, Runtagh, and Jalkut,[289] directors whom the Court has already determined are disinterested and independent, informed Khanna of its conclusion that the allegations had no merit on December 26, 2002.[290] Khanna's allegations, the investigation, and the investigation's conclusions were disclosed in Covad's March 2003 10-K.[291] In view of Covad's actions, then, to require more would constitute self-flagellation. Because the Court finds that the Plaintiffs' 2003 Proxy

[287] *See* Pls.' Ans. Br. to Dirs.' Mot. to Dismiss at 27.
[288] Amended Compl. at ¶ 133 (quoting Covad's March 2003 10-K).
[289] The Amended Complaint provides that the Covad Board determined, on July 18, 2002, that Crandall and Runtagh "had the authority to add" Jalkut to the investigation committee. *Id*. at ¶ 126. It also alleges that Jalkut's appointment "most likely" occurred "after Khanna's September 2002 meetings with counsel for the Committee," but before February 19, 2003, when Khanna was informed of Jalkut's appointment. *Id*. at ¶ 130.
[290] Amended Compl. at ¶ 133.
[291] *Id.* at ¶¶ 133. The Amended Complaint also provides that similar disclosures were made in Covad's May 2003 10-Q. *Id.* at ¶ 204.

disclosure claim does not, in this instance, properly state a claim for omitted material facts, it must also be dismissed.

VIII. MOTIONS TO CONTINUE TO SEAL/UNSEAL THE RECORD AND TO STRIKE PORTIONS OF THE AMENDED COMPLAINT

The Court now turns to motions addressing whether certain allegations should be given confidential treatment.

A. *Motion to Strike Portions of the Amended Complaint*

1. Whether the Amended Complaint Contains Privileged Information

Covad maintains that Paragraphs 52, 54, 55, and 57 of the Amended Complaint contain privileged information. Rule 502 of the Delaware's Rules of Evidence defines the attorney-client privilege:

> A client has a privilege to refuse to disclose and to prevent any other person from disclosing confidential communications made for the purpose of facilitating the rendition of professional legal services to the client . . . between the client or the client's representative and the client's lawyer or the lawyer's representative . . . .[292]

In order for the communication to be confidential, the communication must not have been "intended to be disclosed to third persons other than those to whom disclosure is made in furtherance of the rendition of professional legal services to the client or those reasonably necessary for the transmission of

[292] DEL. R. EVID. 502(b)(1). Although Khanna's professional obligations may be defined by California, the parties have pointed to no material difference between the lawyer conduct rules of California and Delaware.

the communication."[293] Although the identity of one's attorney is usually not privileged,[294] the subject matter of the communications is privileged.

In the case at hand, the Amended Complaint, at times, reveals the subject matter of communications between Covad and Wilson Sonsini Goodrich & Rosati, P.C. ("Wilson Sonsini"), the law firm representing it—namely that the Certive transaction was a possible corporate opportunity for Covad. It is fair to read Paragraphs 52[295] and 54[296] as revealing confidential information—specifically, the general subject matter of Covad's communications with its inside- and outside-counsel.

Although paragraphs 52 and 54 reveal the subject matter of Wilson Sonsini's representation of Covad, it is less clear why paragraphs 55 and 57 are privileged. Paragraph 55 states that "[the Board] even disregarded the

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[293] DEL. R. EVID. 502(a)(2).

[294] *See, e.g.*, *Gotham Partners v. Hallwood Realty*, 1999 WL 252377, at *1 (Del. Ch. Mar. 31, 1999) ("Neither the status nor identity of an attorney whose communications are privileged are privileged facts.").

[295] Amended Compl. at ¶ 52 ("Khanna voiced his opposition to the [Certive] deal, and raised with defendant Knowling and [Wilson Sonsini] the issue of Certive being a possible corporate opportunity for Covad."). This paragraph discusses both the opinions of Khanna, Covad's inside-counsel, of the Certive transaction and the subject matter of Covad's conversations with Wilson Sonsini, its outside-counsel.

[296] *Id.* at ¶ 54 ("[T]he Board adopted (with the counsel of the conflicted Wilson Sonsini firm) a corporate opportunity policy which expressly required the prior approval of the Board before a fiduciary of Covad could take a corporate opportunity for himself . . . ."). This reveals that Wilson Sonsini worked with Covad on its corporate opportunity policy, which, of course, reveals the subject matter of Wilson Sonsini's representation of Covad. Furthermore, if the information alleged in the Amended Complaint was gained from Khanna's attendance at the board meeting as General Counsel, then the information may be privileged for this reason as well.

very obvious conflict of counsel to Covad, Wilson Sonsini, serving as counsel for Certive during the period when McMinn was founding Certive while on Covad's payroll as a full-time employee and representing Certive in the very transaction by which Covad acquired its Certive shares."[297] Paragraph 55 then goes on the describe Wilson Sonsini's interest in Certive.[298] Neither of these statements is privileged. Moreover, the fact of Wilson Sonsini's representation of Covad during the Certive transaction is not privileged because the identity of one's attorney does not constitute privileged information.[299]

Paragraph 57 states that "while at Covad and on Covad's time, and using Covad's outside counsel, Wilson Sonsini, [McMinn] developed and pursued the Certive business opportunity . . . ."[300] As with Paragraph 55, Paragraph 57 only reveals the identity of Covad's outside counsel and, therefore, is not privileged.

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[297] *Id.* at ¶ 55.

[298] The Court notes that Wilson Sonsini's interest in Certive is not privileged because it does not reveal any confidential information that Covad provided to (or advice received from) Wilson Sonsini. Instead, Paragraph 55 merely discusses Wilson Sonsini's independent ownership interest in Certive. Covad holds no privilege with regard to this information.

[299] *See supra* note 294 and accompanying text.

[300] Amended Compl. at ¶ 57.

2. Whether the Privilege was Waived with Regard to the Information in the Amended Complaint

Because the Court has determined that Paragraphs 52 and 54 contain privileged information, it must now consider whether the attorney-client privilege, with respect these Paragraphs, has been waived by Covad.

> The doctrine of waiver is expressly codified by Rule 510 of the Delaware Uniform Rules of Evidence which provides that "[a] person upon whom these rules confer a privilege against disclosure waives the privilege if he or his predecessor while holder of the privilege voluntarily discloses or consents to disclosure of any significant part of the privileged matter."[301]

The Court first considers Khanna's argument that Covad waived its privilege by disclosing information to him when he was wearing his "Vice President hat," as opposed to his "General Counsel hat." Khanna cites authority, including *United States v. Vehicular Parking, Ltd.*,[302] for the proposition that "legal advice that is merely incidental to business advice may not be protected."[303] In *Vehicular Parking*, the court, ruling on the defendants' claims of privilege, held that "the communications in question indicate [that the defendants' attorney] was advising on matters of business.

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[301] *The Cove on Herring Creek Homeowners' Ass'n, Inc. v. Riggs*, 2001 WL 1720194, at *2 (Del. Ch. Dec. 28, 2001).
[302] 52 F. Supp. 751 (D. Del. 1943).
[303] Pls.' Ans. Br. in Opp'n to Covad Commc'ns Group, Inc.'s Mot. to Disqualify Pls. & Mot. to Strike Portions of Am. Deriv. & Class Action Compl. ("Pls.' Ans. Br. to Mot. to Disqualify") at 22.

Privilege is not accorded to such communications."[304] Privilege as to the communications at issue in that case, however, was not a close call. The court had no difficultly separating the roles of attorney and businessman. As the court explained, "[The set of communications in question] is more than attorney-talk. It is big—as well as basic—business diction."[305]

It is significantly more difficult, however, to relate the understanding that "business diction" occurring between an attorney and her client is not privileged to the case at hand. Khanna provides no specific evidence—other that stating that he was a Vice President at Covad—to buttress his assertion that the information Covad deems privileged was obtained outside his legal capacity. Instead, the Plaintiffs cite authority that would place the burden on Covad to demonstrate that the information it wishes to protect was given in Khanna's legal capacity.[306] The Court of Appeals in *In re Sealed Case*,[307] ruling on a corporation's claim that certain communications were privileged and could not be testified to by its former general counsel, explained that it was "mindful . . . that [the general counsel] was a Company vice president,

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[304] 52 F. Supp. at 753.
[305] *Id.*; *see also* DEL. R. EVID. 502(a)(2) (describing "confidential information" as "disclosure made in the furtherance of the rendition of professional *legal* services" (emphasis added)).
[306] *See, e.g.*, *In re Sealed Case*, 737 F.2d 94, 99 (D.C. Cir. 1984) ("The Company can shelter [in-house counsel's] advice only upon a clear showing that [in-house counsel] gave it in a professional legal capacity.").
[307] 737 F.2d 94 (D.C. Cir. 1984).

and had certain responsibilities outside the lawyer's sphere. The Company can shelter [the General Counsel's] advice only upon a clear showing that [the General Counsel] gave it in a professional legal capacity."[308] The Court of Appeals also explained, however, that "advice does not spring from lawyers' heads as Athena did from the brow of Zeus,"[309] and, since some nonlegal background is necessary for lawyers to give legal advice, the mere mention of nonlegal information does not negate the attorney-client privilege.[310]

In re Sealed Case was written in the context of the attorney and client, on the same side of litigation, trying to protect privilege. It was *not* written in the context of the attorney trying to break the attorney-client privilege. In other words, *In re Sealed Case* deals with an attorney and client attempting to deploy the attorney-client privilege as a shield, not an attorney trying to break the privilege and use the information as a sword. Given the importance this Court places on the attorney-client privilege and an

[308] *Id.* at 99; *see also id.* ("It remains the claimant's burden, however, to present to the court sufficient facts to establish the privilege; the claimant must demonstrate with reasonable certainty that the lawyer's communication rested in significant and inseparable part on the client's confidential disclosure." (citations omitted)).
[309] *Id.*
[310] *Id.*

attorney's ethical duties to his former client,[311] in the situation where an attorney is seeking to use potentially privileged information as a sword against a former client, the inquiry has been framed as:

> whether it can reasonably be said that in the course of the former representation the attorney might have acquired information related to the subject of this subsequent representation. [The Court] will not inquire into their nature and extent. Only in this manner can the lawyer's duty of absolute fidelity be enforced and the spirit of the rule relating to privileged communications be maintained.[312]

In the present litigation, because Khanna served as General Counsel of Covad, it can reasonably be inferred that Khanna received information regarding the Certive transaction in his legal capacity. Furthermore, Khanna's response on learning information regarding the transaction was of a legal nature,[313] which leads one to infer that the information was provided to him in the context of seeking legal advice. Finally, the fact that, as Khanna claims, he was "told to leave the meeting when the Board was ready to *discuss* and vote on the Board's ratification of the McMinn and

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[311] *See, e.g., Continental Ins. Co. v. Rutledge & Co., Inc.*, 1999 WL 66528, at *1 (Del. Ch. Jan. 26, 1999) ("The importance of the attorney-client privilege is central to the American model of adversarial litigation.").

[312] *T. C. Theatre Corp. v. Warner Bros. Pictures, Inc.*, 113 F. Supp. 265, 268-69 (S.D.N.Y. 1953). This Court has previously followed portions of *T. C. Theatre Corp.*—namely its "substantial relationship" test. *See Ercklentz v. Inverness Mgmt. Corp.*, 1984 WL 8251 (Del. Ch. Oct. 18, 1984).

[313] *See* Amended Compl. at ¶ 52 (noting that Khanna voiced his opposition to the deal as a possible corporate opportunity and objected to Shapero sitting on the board of a competitor).

Crosspoint investments in Certive"[314] leads one to believe that his *business* opinion was not valued (even for discussion purposes) and, thus, it is unlikely that he would have originally been given the information to provide a business opinion. For these reasons, the Court finds Khanna's argument, that the information in Paragraphs 52 and 54 of the Amended Complaint is not privileged because he was wearing his "Vice President hat" when he learned the information, to be unpersuasive.

The only issue remaining, with regard to whether Paragraphs 52 and 54 are privileged, is whether Covad waived its privilege through disclosure during the § 220 trial.[315] The Court addresses Paragraph 52, first.

This Court has previously held that the attorney-client privilege does not apply "when the party holding the privilege waives the privilege in one of two basic ways: (1) the party injects the communications into the litigation, or (2) the party injects an issue into the litigation, the truthful resolution of which requires an examination of the confidential communications."[316] Additionally, the "attorney-client privilege may be waived by the public disclosure of information that was formerly

[314] *Id.* at ¶ 53 (emphasis added).
[315] *See supra* note 301, and accompanying text.
[316] *Baxter Int'l, Inc. v. Rhone-Poulenc Rorer, Inc.,* 2004 WL 2158051, at *3 (Sept. 17, 2004).

confidential."[317] A fair reading of Joint Exhibit 119 from the § 220 trial, which is a letter from Khanna's counsel to an attorney for a subcommittee of Covad's Board, demonstrates that Covad waived privilege with respect to Paragraph 52. Covad used Joint Exhibit 119 at the § 220 trial. Perhaps Covad's intent was to introduce only letter itself and not the subsequent chronology (authored by Khanna) attached to the letter. Permitting Covad to introduce the document as evidence at the § 220 hearing, and then allowing Covad to shield an integral and incorporated attachment to that document (and clearly referenced in the document itself),[318] would defeat the purpose of the "inject into litigation" exception to attorney-client privilege.[319] Joint Exhibit 119 clearly references, on multiple occasions, the attachment; and the letter can be viewed as a summary of that attachment. Since the attachment was so integral to the letter, the introduction, by Covad, of part of Joint Exhibit 119 into litigation waives the attorney-client privilege as to the entire document. Thus, the Court concludes that Paragraph 52 does not contain any currently privileged information because privilege was waived.

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[317] *Texaco, Inc. v. Phoenix Steel Corp.*, 264 A.2d 523, 525 (Del. Ch. 1970).

[318] JTX 119 (Letter from Grellas to Poss, at 1 (9/10/2002) ("We have attached a detailed chronology prepared by Mr. Khanna . . . .")).

[319] According to *Baxter Int'l*: "The [inject into litigation] exception is based on the principles of waiver and of fairness, so that the party holding the privilege cannot use it as both a sword and a shield." 2004 WL 2158051, at *3.

Waiver issues with regard to Paragraph 54 are relatively easy to resolve. The information alleged to be privileged (*i.e.*, Wilson Sonsini's involvement in shaping Covad's Corporate Opportunity Policy) can be inferred from documents produced by Covad in the § 220 production. Specifically, document LWDK 0003485 contains the policy, and document LWDK 0003473 lists the attendees at the board meeting at which the policy was adopted. This list includes a Wilson Sonsini attorney, acting as secretary. These two facts, made available through the § 220 production, lead to the inference that the Covad Board adopted its Corporate Opportunity Policy with the advice of a Wilson Sonsini attorney, who was present at the meeting.

* * * *

In conclusion, the information in Paragraphs 55 and 57 of the Amended Complaint is not protected by the attorney-client privilege. Covad placed the information contained in Paragraph 52 into litigation and, thus, waived attorney-client privilege with regard to the pertinent documents. Finally, the information contained in Paragraph 54 can be deciphered from the documents produced in the § 220 production. For these reasons, the Court denies Covad's motion to strike Paragraphs 52, 54, 55, and 57 from the Amended Complaint.

B. *Motions to Seal/Unseal the Amended Complaint*

Much of the briefing with regard to sealing and unsealing overlaps the Court's analysis, above, concerning the motion to strike portions of the Amended Complaint. Specifically, Covad argues that the Amended Complaint should remain sealed because Paragraphs 52, 54, 55, and 57 contain privileged information and Paragraphs 43, 44, and 74 contain trade secrets and unnecessarily embarrass Covad executives and board members.

The sealing of Court records is addressed in Court of Chancery Rule 5(g), which states:

> (1) Except as otherwise provided in this Rule . . . all pleadings and other papers . . . filed with the Register in Chancery shall become a part of the public record of the proceedings before this Court.
>
> (2) Documents shall not be filed under seal unless and except to the extent that the person seeking such filing under seal shall have first obtained, for good cause shown, an order of this Court specifying those documents . . . which should be filed under seal; provided, however, the Court . . . may determine whether good cause exists for the filing of such documents under seal.[320]

For the reasons discussed above, the challenged portions of the Amended Complaint do not contain currently privileged information. It necessarily follows that the record should not be sealed on this basis. Additionally, this

[320] CT. CH. R. 5(g)(1)-(2); *see also Romero v. Dowdell*, C.A. No. 1398-N, slip op. (Del. Ch. Apr. 28, 2006).

Court is unable to determine what are the "trade secrets" revealed by Paragraphs 43, 44, and 74. Although these Paragraphs perhaps reveal some internal matters at Covad, they are relevant to the Plaintiffs' case and simply are not sufficiently sensitive to counteract the strong policy reasons as to why the record is presumed to be public unless good cause is shown as to why it should be otherwise. Additionally, although perhaps Marshall's admission of a mistake is embarrassing, this information, disclosed in Paragraph 74, is relevant to the Plaintiffs' claim in that a member of Covad's board thought the BlueStar transaction was a disaster and yet Covad, as alleged, unnecessarily made a performance-based earn-out payment to BlueStar's former shareholders. While perhaps embarrassing, it is nonetheless relevant. An unfortunate consequence of litigation is that information sometimes surfaces that parties would prefer to keep in the dark.[321] Sealing any complaint that contains mildly embarrassing information would defeat the presumption, set forth in Rule 5(g), that a record is public unless good cause is shown as to why it should be sealed.

Therefore, the Court denies Covad's Motion for the Continued Sealing and Resealing of Documents and grants the Plaintiffs' Cross-Motion to Unseal the Record.

[321] *See Romero*, C.A. No. 1398-N, slip op. at 5-7.

IX. DISQUALIFICATION OF THE PLAINTIFFS

The remaining issue for the Court to address is Covad's motion to disqualify Khanna, Sams, and Meisel as derivate and class plaintiffs in this action. This motion presents two questions: first, whether Khanna may continue as a representative plaintiff in the litigation; and second, if the Court finds Khanna not a proper representative plaintiff, whether Sams and Meisel may nevertheless continue as plaintiffs. The Court addresses these issues in turn, below.[322]

Khanna served as Covad's General Counsel for approximately six years, until mid-2002 when he was relieved of his duties. The parties adopted an overtly hostile posture soon thereafter.[323] During his time at Covad, Khanna served as a senior executive with supervisory responsibilities over Covad's legal department, in addition to the matters on which he worked directly. Khanna was Covad's General Counsel during the relevant periods for all of the challenged transactions.[324]

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[322] The Court, in considering whether each of the Plaintiffs may bring this case, is not restricted solely to the face of the Amended Complaint and documents incorporated into it. When necessary, the Court may, in this context, look to affidavits submitted by the parties, as well as documents and testimony submitted as part of the related, earlier § 220 action. *But cf. Canadian Commercial Workers Indus. Pension Plan v. Alden*, 2006 WL 456786, at *8 - *9 (Del. Ch. Feb. 22, 2006) (applying summary judgment standard in that instance).

[323] *See, e.g.*, JTX 123 (June 19, 2002 letter to Covad Board from Khanna's counsel).

[324] The Dishnet Subscription Agreement was dated February 15, 2001, and the Dishnet Settlement was entered into by Covad in February 2002. *See* Amended Compl. at ¶¶ 86,

Plaintiffs seeking to maintain derivative claims must satisfy the adequacy requirements implicit in Court of Chancery Rule 23.1.[325] "[A] derivative plaintiff serves in a fiduciary capacity as representative of persons whose interests are in plaintiff's hands and the redress of whose injuries is dependent upon her diligence, wisdom and integrity."[326] In a challenge to a particular plaintiff's adequacy, however, the burden rests with the defendant.[327] "The defendant must show a substantial likelihood that the derivative action is not being maintained for the benefit of the shareholders."[328]

A number of factors may be considered in determining whether a plaintiff is deemed "adequate" for these purposes:

> (1) economic antagonisms between the representative and the class;
> (2) the remedy sought by plaintiff in the derivative litigation;
> (3) indications that the named plaintiff was not the driving force behind the litigation;

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92. Khanna was told of the charges of sexual impropriety against him on May 9, 2002, *see* JTX 106; JTX 123 at 8, and suspended from his position the following month.

[325] *See, e.g.*, *Youngman v. Tahmoush*, 457 A.2d 376, 379 (Del. Ch. 1983). The analysis of the Plaintiffs' capacity to serve as derivative plaintiffs will, in this instance, be the same as the analysis of the propriety of their service as class representatives. *See, e.g.*, *In re Fuqua Indus. S'holder Litig.*, 752 A.2d 126, 129 n.2 (Del. Ch. 1999) ("[A]nalysis of adequacy requirements is generally the same under Rules 23 and 23.1 as cases decided under Rule 23(a)(4), *i.e.*, the adequacy requirement of Rule 23, may be used in analyzing the adequacy requirements of Rule 23.1." (citations omitted)).

[326] *In re Fuqua Indus.*, 752 A.2d at 129 (citing *Katz v. Plant Indus., Inc.*, 1981 WL 15148, at *1 (Del. Ch. Oct. 27, 1981)).

[327] *See Emerald Partners v. Berlin*, 564 A.2d 670, 674 (Del. Ch. 1989).

[328] *Id.*; *see also Canadian Commercial Workers Indus. Pension Plan*, 2006 WL 456786, at *8.

> (4) plaintiff's unfamiliarity with the litigation;
> (5) other litigation pending between plaintiff and defendants;
> (6) the relative magnitude of plaintiff's personal interests as compared to her interest in the derivative action itself;
> (7) plaintiff's vindictiveness toward defendants; and
> (8) the degree of support plaintiff was receiving from the shareholders she purported to represent.[329]

This list, however, is not exhaustive.[330] "Typically, the elements are intertwined or interrelated, and it is frequently a combination of factors which leads a court to conclude that the plaintiff does not fulfill the requirements of 23.1 . . . ."[331] It is possible that the inadequacy of a plaintiff may be concluded from a "strong showing of only one factor[; however,] that factor must involve some conflict of interest between the derivative plaintiff and the class."[332]

The Court finds Khanna an inadequate representative plaintiff, one who must therefore be disqualified, for two principal reasons.[333] First,

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[329] *In re Fuqua Indus.*, 752 A.2d at 130.

[330] *See Katz*, 1981 WL 15148, at *2 (explaining that the factors are "[a]mong the elements which the courts have evaluated").

[331] *Id.*, at *2 (quoting *Davis v. Comed, Inc.*, 619 F.2d 588, 593-94 (6th Cir. 1980); *see also In re Fuqua Indus.*, 752 A.2d at 130 n.5.

[332] *In re Fuqua Indus.*, 752 A.2d at 130; *see also Canadian Commercial Workers Indus. Pension Plan*, 2006 WL 456786, at *8 (explaining that "economic" conflicts are often the primary consideration); *Youngman*, 457 A.2d at 379 (noting exception that "fact that the plaintiff may have interests which go beyond the interests of the class, but are at least co-extensives with the class interest, will not defeat his serving as a representative of the class"). The Court in *Youngman* also explained that "purely hypothetical, potential or remote conflicts of interests never disable the individual plaintiff." *Id.* (citation omitted).

[333] The Court's analysis addresses only the issue of whether Khanna may serve a representative plaintiff, which implicates considerations distinct from affording an attorney the opportunity to vindicate rights *personal to him*. *See, e.g.*, *Doe v. A Corp.*,

Ercklentz v. Inverness Management Corp.[334] effectively controls disposition of this issue. In *Ercklentz*, the Court granted the defendants' motions to disqualify the plaintiff's law firm, which had formerly represented the defendant corporation, and the plaintiff, who had formerly served as general counsel (and director) of the defendant corporation. In granting the motion to disqualify the plaintiff, the Court ruled that "the ethical considerations which bar an attorney from acting as counsel against his former client also preclude him from acting as a class or derivative plaintiff against his former client."[335] The Court determined that, because the general counsel's former representation of his corporate employer involved issues that were "substantially related" to the claims he sought to assert derivatively, the plaintiff would be disqualified.[336] The parties agree that this is the standard to be applied.[337]

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709 F.2d 1043 (5th Cir. 1983) (disqualifying former in-house attorney as representative plaintiff in suit against former corporate employer, but permitting him to continue suit asserting personal cause of action).

[334] 1984 WL 8251 (Del. Ch. Oct. 18, 1984).

[335] *Id.* at *4 (citing *Richardson v. Hamilton Int'l Corp.*, 469 F.2d 1382 (3d Cir. 1972); *Doe*, 709 F.2d 1043).

[336] *See Ercklentz*, 1984 WL 8251, at *4 - *5; *see also* DELAWARE LAWYERS' RULES OF PROFESSIONAL CONDUCT ("D.L.R.P.C.") 1.6, 1.9. *Cf. Richardson*, 469 F.2d 1382; *Doe v. A Corp.*, 330 F. Supp. 1352 (S.D.N.Y. 1971), *aff'd sub nom., Hall v. A Corp.*, 453 F.2d 1375 (2d Cir 1972).

[337] *See* Pls.' Ans. Br. to Mot. to Disqualify at 15**;** Mem. in Supp. of Covad Commc'ns Group, Inc.'s Mot. to Disqualify Pls. ("Covad's Op. Br. to Disqualify") at 8.

> To determine whether matters are "substantially related" for purposes of a conflict of interest with a former client the Court must evaluate: the nature and scope of the prior representation at issue; the nature and scope of the present lawsuit against the former client; and whether during the course of the previous representation the client may have disclosed confidential information that could be used against the former client in the current lawsuit. Matters may be substantially related if they involve the same transaction or legal dispute or there is substantial risk that confidential information obtained in the former representation could materially advance the client's position in the current matter. The former client is not required to reveal specific details of the information shared with the attorney, rather the Court may determine whether information regularly shared in that type of representation creates an unavoidable conflict with the current case.[338]

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[338] *Hendry v. Hendry*, 2005 WL 3359078, at *4 (Del. Ch. Dec. 1, 2005) (citing *Sanchez-Caza v. Estate of Whetstone*, 2004 WL 2087922, at *3 (Del. Super. Sept. 16, 2004)); D.L.R.P.C. 1.9 cmt. 3.

In the parties' briefs, much is made of the effect of language from *T. C. Theatre Corp.*, which is quoted by the Court in *Ercklentz*: "In cases of this sort the Court must ask whether it can reasonably be said that in the course of the former representation the attorney *might* have acquired information related to the subject of his subsequent representation." *Ercklentz*, 1984 WL 8251, at *2 (quoting *T. C. Theatre Corp.*, 113 F. Supp. at 269 (emphasis added)). In *Ercklentz*, the Court noted that this test set forth a strict standard that, although followed by the Third Circuit, *see Richardson*, 469 F.2d at 1385, had been modified by the Second Circuit, which instead required that the "issues involved in the two representations have been 'identical' or 'essentially the same'" in order to find that a substantial relationship existed. *Ercklentz*, 1984 WL 8251, at *2. Ultimately, the Court concluded that it need not decide which standard to apply, since the defendants had met the higher burden of demonstrating that the two representations were essentially the same. *See id*. at *4; *see also* ABA Formal Op. 99-415 (Sept. 8, 1999) ("Representation Adverse to Organization by Former In-House Lawyer") (describing, in Part A(2), tests for "same or substantially related matters," and indicating approval of Second Circuit formulation).

The standard articulated in Comment 3 of D.L.R.P.C. 1.9, adopted in response to revisions of the ABA's Model Rules of Professional Conduct following the report of the ABA's Ethics 2000 Commission, appears to craft a middle approach between the two previously competing tests described above. *See also* E. Norman Veasey, *Ethics 2000: Thoughts and Comments on Key Issues of Professional Responsibility in the Twenty-First Century*, 5 DEL. L. REV. 1, 13 (2002).

Specifically, Comment 3 to D.L.R.P.C. 1.9 provides that "[a] conclusion about the possession of such information may be based on the nature of the services the lawyer provided the former client and information that would in ordinary practice be learned by a lawyer providing such services." Additionally, "[i]n the case of an organizational client, general knowledge of the client's policies and practices ordinarily will not preclude a subsequent representation; on the other hand, knowledge of specific facts gained in a prior representation that are relevant to the matter in question ordinarily will preclude such a representation."[339] These principles govern the Court's analysis of whether Khanna's prior representation of Covad as its General Counsel is substantially related to the matters at issue in the present litigation.

The Plaintiffs' principal argument as to why Khanna should not be disqualified is that the information he received regarding the challenged transactions was in his capacity as an officer and shareholder of Covad, and not as Covad's General Counsel.[340] The Plaintiffs contend that Khanna's duties as General Counsel were primarily related to telecommunications regulatory work and that Covad's board members actively sought to "keep

[339] D.L.R.P.C. 1.9 cmt. 3.
[340] *See* Pls.' Ans Br at 16 (citing Amended Compl. at ¶¶ 108-11).

Khanna 'out of the loop'" with respect to the challenged transactions.[341] The Plaintiffs add that Khanna "was wholly preoccupied with hotly contested telecommunications regulatory matters and related litigation" and that, even if the board had not kept him "'out of the loop,' the reality is that he likely still would not have even had time to participate in the transactions as counsel."[342]

These arguments are not persuasive, however, in light of Khanna's status as Covad's senior in-house counsel. In his testimony at the § 220 trial, Khanna claimed that he "owned" corporate governance issues for Covad and that he would have had a "role to play" in such areas.[343] Indeed, Khanna's Original Complaint sets forth that, as General Counsel, he was "charged with the role of reviewing all conflict of interest matters for Covad.[344] Khanna's June 19, 2002 letter to the Covad Board states that, with respect to the BlueStar acquisition: "Mr. Khanna had seriously objected, both on pure legal grounds (concerning the Clayton Act violations) and on legal/business grounds (waste and self-dealing)."[345]

[341] Pls.' Ans. Br. to Mot. to Disqualify at 16, 22.
[342] *Id.* at 16 n.3.
[343] Trial Tr. 121, 136-37.
[344] *See* Original Compl. at ¶ 40.
[345] JTX 123.

Khanna's contention that board members did not solicit his advice does not dampen the Court's concerns as to the source of his information and the circumstances under which he obtained it. The Court finds that a "substantial risk" exists that an attorney in Khanna's position would, in the ordinary course, have learned confidential information relating to the challenged transactions. This concern is supported by the fact that Khanna, acting as board secretary, signed the minutes of the June 15, 2000 Covad board meeting at which the BlueStar acquisition was approved.[346] The Plaintiffs argue that Khanna was ordinarily excluded from board meetings when transactions of this nature were approved; however, the Plaintiffs cite only to board minutes regarding the Certive transaction.[347] Although it is the Defendants' burden to demonstrate that disqualification should occur, the Court concludes that this burden has been satisfied with respect to demonstrating a "substantial risk" that Khanna learned confidential information relating to the present litigation.[348] Moreover, document LDWK 0002012, an email from Knowling to several Covad employees,

[346] *See* JTX 117.

[347] Moreover, even assuming, *arguendo*, that Khanna was excluded during the portions of the meeting discussing the BlueStar transaction, this would not diminish the substantial risk (indeed, likelihood) that Khanna learned confidential information either before his temporary absence or after rejoining the Board's meeting.

[348] The Plaintiffs also argue that, unlike in *Ercklentz*, Khanna was not a member of the board and did not approve of the challenged transactions. That, however, is not a requirement for disqualification.

including Khanna, dated May 21, 2000, more than two weeks before the Board's vote, states, "Here is the game plan. I've asked Bear Stearns to move forward with BlueStar ASAP with an objective to come to terms on a deal this week. Tim, *Drhuv*, Davenport and Lach *are the handlers on this transaction*."[349] It is unreasonable for Khanna now to argue that he was not involved with the BlueStar acquisition (claiming to have been fully engaged in regulatory matters or otherwise kept in the dark by the Covad Board about what was a major transaction, even though he served as Covad's General Counsel).

In this instance, the issue of adequacy as a representative plaintiff, however, is not confined exclusively to Khanna's ethical responsibilities as Covad's former General Counsel. Indeed, the Court need not embrace here a *per se* rule of disqualification applicable to former in-house lawyers as representative plaintiffs.[350] Additional factors support, under these circumstances, the Court's decision that, with respect to Khanna, a substantial likelihood exists that the representative action is "not being maintained for the benefit of the shareholders." Specifically, Khanna's employment dispute with Covad has impaired Khanna's capacity to

[349] Calder Decl., Ex. R. (emphasis added).
[350] The Court recognizes that, in a derivative suit, relief is not sought from the company; this distinction was afforded no substance in *Ercklentz*. *See* 1984 WL 8251, at *4 - *5.

vindicate shareholders' best interests. The June 19, 2002 letter to the Covad Board, demonstrates a self-interested motivation that is not consistent with the continued pursuit of a derivative and class action by this plaintiff—a plaintiff on whom the Covad shareholders would be relying. The June 19, 2002 letter makes clear that Khanna's initial motive in threatening to bring the action was to provide leverage in his attempt to regain (and enhance) his position at Covad after his suspension as General Counsel. The letter lays out numerous requirements to be imposed on the Covad Board, including that Khanna be appointed to the Covad Board "with a not less than 15-year contract[, subject only to a vote of the general shareholders based on the classified Board seat]," "be given a role as Executive Vice President for Corporate Strategy," "be compensated at all times not less than a comparable officer that serves as both an officer and as a director," and be permitted to name five individuals who would report directly to him. None of these requirements inures directly to the benefit of the shareholders, if at all—instead, the benefit is directed almost exclusively, if not solely, to Khanna. The letter continues on to threaten that

> Mr. Khanna is more than prepared to act to defend himself, and his reputation for tenacity in this regard well precedes him. But he does not desire to light a legal fuse unless his is given no choice. The choice, then, belongs to the company and its Board. We can only hope that it is wisely made.

The Court acknowledges that mere selfish motives[351] and past bad behavior[352] do not necessarily disqualify an individual from serving as a derivative plaintiff. The posture of these parties, however, demonstrates ample history of bad will creating a substantial likelihood that Khanna will not maintain and prosecute the action according to the best interests of the shareholders.[353]

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[351] *See Youngman*, 457 A.2d at 382. ("Though the plaintiff may well have in part a selfish motive in bringing this action, which is not unusual, he will be permitted to continue to act on behalf of [the class].")

[352] *See Emerald Partners*, 564 A.2d at 674-75. The Court notes that, in support of Khanna's argument that his actions during the initial stages of this dispute should be overlooked by the Court, Khanna has purported to waive any employment claims he may have had against Covad. Trial Tr. at 47. Khanna refers the Court to *Emerald Partners*, where this Court permitted a plaintiff who had engaged in "greenmail" in the past to continue as a derivative plaintiff because "Emerald further asserts that it no longer seeks to 'make a quick buck' from the situation. In support of this contention, Emerald has presented evidence that it rejected offers of 'greenmail' payments . . . . I am not persuaded, therefore that Emerald is maintaining this suit solely in its own interest, or that it will be unable to fairly and adequately represent the interests of . . . other shareholders." 564 A.2d at 674-75. However, concerns about "greenmail" are far different from the concerns surrounding Khanna. The concern with a derivative plaintiff engaging in greenmail is that the plaintiff will sell out too quickly, will not pursue corporate governance reform involving the nominal defendant, or will seek personal financial reward at the expense of the corporate enterprise to the detriment of shareholders in general. These concerns are not unfounded. However, in the greenmail situation, the prospective plaintiff's goal is economic in nature and, once a greenmail offer has been rejected, the concerns discussed *supra* are not applicable. In the case at hand, Khanna's objectives are more qualitative in nature. One can reasonably infer that many of Khanna's issues with Covad's Board are personal in nature and, therefore, the fact that Khanna has offered to forego these claims carries less weight than in a less personal situation, such as one involving greenmail.

[353] The Plaintiffs also point to the Court's ruling in the § 220 action that Khanna's § 220 demand was brought under a "proper purpose." The Court's ruling in that context, however, involved different standards and policies than those considered in the Court's analysis of Khanna's adequacy as a representative plaintiff.

In concluding that Khanna must be disqualified as a representative plaintiff, the Court relies primarily on Khanna's position as Covad's former General Counsel and the ethical quagmire that follows. This result is significantly supported, however, by the cloud hanging over the litigation created by the tangential and acrimonious employment dispute between Khanna and his former employer. Although the existence of a substantial relationship between Khanna's prior representation of Covad and the matters presently at issue is likely sufficient grounds to deem Khanna inadequate as a representative plaintiff under *Ercklentz*,[354] the Court ultimately concludes that, as a consequence of these two "intertwined and interrelated" considerations described above, Khanna must be disqualified as a representative plaintiff in this action.[355]

Covad asserts two grounds for the disqualification of Sams and Meisel, in addition to Khanna: (1) that they are not the "driving force"

[354] This conclusion may be viewed as equivalent to the "strong showing" of one factor, demonstrating a conflict of interest, necessary to disqualify a plaintiff as an adequate representative. *See In re Fuqua Indus*., 752 A.2d at 130.

[355] The Defendants have asked that the Court enter an injunction preventing Khanna from further participating in this litigation and from aiding any other persons in bringing their claims, in this context. No evidence has yet been presented to the Court requiring entry of injunctive relief—indeed, the Court's disqualification of Khanna relies in substantial part on the presumption that a danger exists that confidences will be revealed where a "substantial relationship" has been found. The Court presumes that Khanna will conform his behavior with his ethical obligations as a member of the bar; however, the Court may revisit this issue, if necessary.

behind the litigation and (2) that they have been improperly tainted by Khanna. Covad, as movant, must satisfy its burden of demonstrating inadequacy with respect to Sams and Meisel, in addition to Khanna. The evidence before the Court does not, as yet, constitute a sufficient showing of conflict to conclude in this context either that the remaining Plaintiffs are not the "driving force" behind the litigation,[356] or that the same potential taint

[356] Although whether a plaintiff is the "driving force" behind litigation is among the factors to be considered in determining adequacy for purposes of Court of Chancery Rule 23.1, *see, e.g.*, *Youngman*, 457 A.2d at 379-80, Covad has yet to present persuasive evidence pointing to more than the potential that Sams and Meisel may not be sufficiently interested and involved to continue with this action. *See, e.g.*, Trial Tr. 54. This potential is insufficient. *Compare Nolen v. Shaw-Walker Co.*, 449 F.2d 506, 508-10 (6th Cir. 1971) (finding strong showing of evidence that plaintiff was a front for person in actual control of litigation, who also had ties to corporations with which court concluded that litigation was intended to force nominal defendant to merge), *with In re Fuqua Indus.*, 752 A.2d at 130-36 (denying motion to disqualify, and, although addressing motion to disqualify focusing on one factor and thereby necessitating "strong showing," suggesting that "driving force" factor, in order to impact analysis, requires satisfaction of a fairly demanding burden by defendants).

Covad's "driving force" arguments would have significant impact were the Court to conclude that Sams and Meisel's ability to maintain this action relied solely or in large part on information received from Khanna that was privileged or confidential—this, of course, would implicate considerations addressed with respect to Covad's second basis for arguing that Sams and Meisel should be disqualified, as well. Indeed, Covad contends that Sams and Meisel are not among the contemplated parties having proper access to documents produced as a consequence of the earlier § 220 trial under the Confidentiality Agreement resulting from that action. Covad states that "the Confidentiality Agreement provides that the Discovery Material produced in that action may be made available to . . . parties *to that litigation*, i.e., the Section 220 Action. . . . It provides that additional parties that are joined *in that litigation* may sign the Confidentiality Agreement and thereby receive access to the Discovery Material. . . . However, plaintiffs Sams and Meisel *were not parties to the Section 220 Action*, and therefore they were *not* eligible to receive the Discovery Material produced in that action." Covad Commc'ns Group, Inc.'s Reply to Pls.' Ans. Br. to Covad Commc'ns Group, Inc.'s Mot. to Disqualify Pls. ("Covad's Reply Br. to Disqualify") at 25-26 (emphasis in original). The Court, however, rejects this argument. The present litigation was initially filed during the pendency of the prior § 220 action, and the Court does not

surrounding Khanna extends to Sams and Meisel.[357] Moreover, the Court is not satisfied that the evidence before it merits the disqualification of Sams and Meisel when these factors are viewed together. Counsel for the Plaintiffs have represented to the Court that "there has been no disclosure of privileged information by Khanna to the other plaintiffs or to any of plaintiffs' counsel."[358] It is within the Court's discretion, then, to rely on their representations as officers of the Court.[359] The Court may, however, reconsider disqualification of Sams and Meisel at a later date, should it become necessary.[360]

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view this as a fair reading of the parties' intent. Given that the Amended Complaint contains no improperly divulged privileged or confidential information and that Sams and Meisel have access to the § 220 action documents, the Court finds Covad's "driving force" arguments unpersuasive on the record before it.

[357] The Court recognizes the potential for abuse in this context. Khanna's disqualification ultimately results from the Court's consideration of more than one factor. The Court is not, however, persuaded that the case law cited by Covad creates a *presumption* that Khanna's presence has improperly tainted Sams and Meisel, in this context. Meisel has separate counsel. The record is unclear whether Sams is similarly represented by separate counsel. Moreover, much of Covad's argument is premised on its contention that the Amended Complaint contained, and therefore evidenced the improper sharing of, privileged and confidential information; this, however, was rejected by the Court, above.

[358] Pls.' Ans. Br. to Mot. to Disqualify at 27-28; *see also* Toll Aff., Ex. C at 3; Amended Compl. at ¶ 3 n.1.

[359] *See IMC Global, Inc. v. Moffett*, 1998 WL 842312, at *3 (Del. Ch. Nov. 12, 1998) ("Where, as officers of the Court, attorneys can represent the full extent of information flow between them to the Court it is within the Court's discretion to rely on those representations where there is seemingly no danger of intrusion on the fairness of the adjudication process.").

[360] *See, e.g.*, *Canadian Commercial Workers Indus. Pension Plan*, 2006 WL 456786, at *10. The issue of whether Sams is, and has been, represented by separate counsel may, for example, present a matter for the Court's further consideration with respect to his adequacy as plaintiff when the record on this point is clarified.

X. CONCLUSION

For the reasons stated above, the Defendants' motions to dismiss are granted as to Counts I, II, III, V, VII, VIII, IX, and X of the Amended Complaint; the motions are, however, denied as to Counts IV and VI.[361] Khanna is dismissed as a representative plaintiff. In addition, Covad's motion to continue to seal the record is denied and the Plaintiffs' cross-motion to unseal the record is granted. Finally, Covad's motion to strike is denied.

IT IS SO ORDERED.

[361] Crosspoint's motion to dismiss is, however, granted as to the Certive Claims asserted in Count VI.