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01-CV-2009-901494.00

Judge: CLK

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NOTICE OF ELECTRONIC FILING

IN THE CIRCUIT COURT OF JEFFERSON COUNTY, ALABAMA

DAVID LICHTENSTEIN v. C. DOWD RITTER ET AL
01-CV-2009-901494.00

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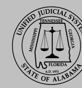

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CV-2009-901494.00
CIRCUIT COURT OF
JEFFERSON COUNTY, ALABAMA
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IN THE CIRCUIT COURT OF JEFFERSON COUNTY, ALABAMA

Louisiana Municipal Police Employees Retirement System,	* * *	
Plaintiff,	* *	
vs.	* *	**CV-2009-1588**
C. Dowd Ritter, et al,	* *	
Defendants.	* *	

Xanthi Grammas, et al,	* *	
Plaintiffs,	* *	
vs.	* *	**CV-2009-901494**
C. Dowd Ritter, et al,	* *	
Defendants.	* *	

Sheet Metal Workers' National Pension Fund, et al,	* * *	
Plaintiffs,	* *	
vs.	* *	**CV-2009-1980**
C. Dowd Ritter, et al,	* *	
Defendants.	* *	

ORDER

Pending are the defendants' motions to dismiss. The parties have submitted significant filings in support of, and in opposition to, these motions. Having carefully reviewed the filings, and the authorities on which the parties rely, this Court determines that the motions are due to be GRANTED in part, and DENIED in part, as described below.

These consolidated actions are brought as derivative actions, purportedly on behalf of Regions Financial Corporation, against current and former members of Regions' board of directors, as well as certain current or former officers of Regions. The *Consolidated Amended Verified Shareholder Derivative Complaint*, filed on December 15, 2009 (hereafter "Complaint"), now constitutes the basis of the plaintiffs' allegations and claims in these actions. The question is whether the Complaint holds up under Rule 23.1 and Rule 12 of the Alabama Rules of Civil Procedure; specifically, the primary focus is whether the plaintiffs are excused from making a demand on Regions' current board to protect the corporation's interests before they filed these lawsuits.

Rule 23.1 of the Alabama Rules of Civil Procedure provides the following:

> In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiff's share or membership thereafter devolved on the plaintiff by operation of law. 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, if necessary, from the shareholders or members, and the reasons for the plaintiff's failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

Because Regions is incorporated under Delaware law, moreover, the Complaint must comply not only with the procedural demand requirements of Ala. R. Civ. P. 23.1, but also with the substantive demand requirements of Delaware law.

"A cardinal precept of the General Corporation Law of the State of Delaware is that directors rather than shareholders, manage the business affairs of the corporation." *Aronson v. Lewis*, 473 A.2d 805, 811 (Del.1984). Since shareholder-derivative suits encroach upon this authority, Rule 23.1 and Delaware law require an aggrieved shareholder to demand that the board take action before bringing suit. A plaintiff may be excused for failing to make a demand upon showing that a demand for action would have been futile. To do so, the "particularized factual allegations of [the] derivative stockholder complaint [must] 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." *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993).

The Delaware Supreme Court has established two approaches to

demand-futility cases. The original test, established in *Aronson*, has two parts, asking "whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." 473 A.2d at 814.

In *Rales*, the Delaware Supreme Court recognized that not all actions "fall into the paradigm addressed by *Aronson* and its progeny." 634 A.2d at 933. The court explained that "[w]here there is no conscious decision by directors to act or refrain from acting, the business judgment rule has no application." *Id.* For such cases, the court created the single-step *Rales* test, in which the only inquiry is "whether or not the particularized factual allegations of a derivative stockholder complaint 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." *Id*. at 934.

Under Delaware law, pleadings "are held to a higher standard under Rule 23.1 than under the permissive notice pleading standard under Court of Chancery Rule 8(a)." *In re Citigroup Inc. Share. Deriv. Litig.*, 964 A.2d 106, 120 (Del.Ch. 2009). The pleadings concerning failure to make a demand "must comply with 'stringent requirements of factual particularity' and set forth 'particularized factual statements that are essential to the claim.' " *Id*. A plaintiff must plead particularized facts showing that a majority of the members of the board were either interested or lacked independence. See *Aronson*, 473 A.2d at 817.

To argue that members of Regions' board should be considered either interested or lacking independence simply because they are named in this lawsuit, by itself, must prove unavailing. See *Guttman v. Huang*, 823 A.2d 492, 500 (Del.Ch. 2003). "[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." *Aronson*, 473 A.2d at 815. Instead, the plaintiffs must show "a substantial likelihood of director liability." *Id.*

To show a substantial likelihood of liability on these particular claims, however, the plaintiffs must surmount yet another obstacle, as Regions' restated certificate of incorporation has an exculpatory clause protecting directors from liability for the breach of the duty of care. Section 102(b)(7) of the Delaware General Corporations Law, Del. Code, tit. 6, § 102(b)(7) (2003), permits a Delaware corporation to include such an exculpatory clause limiting director liability. Such a clause, however, may not shield directors from claims involving alleged breaches of the duty of loyalty/duty of good faith. See, e.g., *In re The Walt Disney Co. Derivative Litigation, 825 A.2d 275 (Del. Ch. 2003).*

In *McCall v. Scott*, 239 F.3d 808 (6th Cir. 2001), the Sixth Circuit reversed a district court's dismissal of stockholder derivative suits. In doing so, it held that demand futility was adequately pleaded against five directors based upon allegations that presented a substantial likelihood of director liability for "intentional *or reckless* breach of the duty of care." Id. at 824 (emphasis added). Rejected was the argument that only intentional conduct would escape the protection of an exculpatory provision under § 102(b)(7). On rehearing, the Sixth Circuit refined its analysis, holding that "allegations of intentional or reckless director misconduct are more commonly characterized as either a breach of the duty of loyalty or a breach of the duty of good faith." *McCall v. Scott*, 250 F.3d 997, 1000 (6th Cir. 2001); see also *In re Abbott Laboratories Derivative Shareholders Litigation*, 325 F.3d 795, 808-09 (7th Cir. 2003).

The Court now turns to the plaintiffs' claims. Much of the complaint focuses on Regions' financial situation between the time of its merger with AmSouth Bank in 2006 and the write down of over $6 billion in goodwill, occurring in January 2009. For purposes of demand futility

analysis, the Court must consider whether at least seven of the current directors face a substantial likelihood of liability because their involvement in what the plaintiffs characterize as a pattern of deception – consisting of concealing the rapidly deteriorating loan portfolio and the persistent refusal to write down goodwill – during this period of time.

The plaintiffs effectively paint a picture describing the collapsing real estate and credit markets beginning in 2006. Such turmoil in the industry, by itself, does not take the plaintiffs where they need to be, however. Their Complaint must also focus on specific problems with Regions and a knowing disregard of obligations owed to the shareholders.

Between October 2007 and January 2009, Regions issued a number of press releases that suggested no significant problem with its financial situation. Filings with the S.E.C. also failed to describe any problem. There was no suggestion that the company's goodwill was impaired in any way. The merger with AmSouth was touted as a success, even though it led to Regions' acquisition of AmSouth's investment in the Florida real estate market, which was collapsing. The S.E.C., apparently concerned by the situation, sent a comment letter to Regions in June 2008, questioning the determination in the 2007 10-K filing that its goodwill balance was not impaired. By October 2008, outside commentators were pointing out obvious problems in Regions' financial statements. It was months, however, before Regions wrote down its goodwill and admitted that the value of its loan portfolio was billions less that what had been reported.

Such facts still do not necessarily suffice – even had the directors been merely negligent or incompetent, no liability would result. The plaintiffs must instead allege facts showing the directors' reckless disregard of their duties of good faith and loyalty in failing to candidly address this situation. This cannot be done simply by arguing that board members signed off on allegedly deceptive

regulatory filings. See *In re Citigroup*, 964 A.2d at 133 n. 88 (explaining that simply "pleading that director defendants 'caused' or 'caused or allowed' the Company to issue certain statements is not sufficient particularized pleading to excuse demand under Rule 23.1.").

The Court concludes that the plaintiffs have met their burden, at least to the extent needed to establish demand futility on this point. Regions' form 10-K for 2008 acknowledged that its loan portfolio had been under pressure for over a year, resulting primarily from the Florida real estate market, which collapsed beginning in 2007. In their Complaint, moreover, the plaintiffs allege that the defendants knew of the true financial situation and misrepresented or concealed those facts.

At that time, five of the current directors – Charles McCrary, Donald DeFosset, James Malone, John Roberts, and Lee Styslinger – were on Regions' audit committee. As the plaintiffs allege, the members of this committee have particular responsibilities and must possess specific qualifications, including a specialized understanding of generally accepted accounting principles ("GAAP"). Under such accounting principles, an analysis of goodwill impairment must be performed at least annually and also in the interim if changing circumstances would likely reduce the fair value below its carrying amount. The audit committee members are charged with the duty of reviewing quarterly reports with the independent auditors, reviewing with management any press releases pertaining to Regions' earnings, and scrutinizing major financial risk exposures.

Given these duties, along with the well-known and heavily publicized deterioration of the real estate market (especially in Florida) and the corresponding collapse in the credit market, and the letter received from the S.E.C. in June 2008, the members of the audit committee can fairly be said to confront a substantial likelihood of liability as a result of Regions' failure to advise its shareholders prior to January 2009 that its financial situation was threatened.

These five members, plus board members Dowd Ritter and O. B. Grayson Hall – who are executives of Regions and whose compensation in the wake of the events since 2006 has also been challenged by the plaintiffs – total seven, which is the minimum needed to overcome the demand futility hurdle.

By contrast, the Court concludes that the plaintiffs have failed to show enough to maintain claims based on alleged failure to adequately oversee Regions' subsidiary, Morgan Keegan & Company. The Delaware Supreme Court has described claims based on oversight failures as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." *Stone ex rel. AmSouth Bancorp. v. Ritter*, 911 A.2d 362, 373 (Del. 2006), quoting *In re Caremark Int'l Inc. Deriv. Litig*., 698 A.2d 959, 968 (Del.Ch.1996). "[T]he necessary conditions predicate for director oversight liability [are]: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention." *Stone*, 911 A.2d at 373.

As a subsidiary corporation, Morgan Keegan has its own board of directors. While the Complaint touches on Morgan Keegan's various problems over the past few years, the plaintiffs fail to show in what particular ways the Regions' board has consciously failed to oversee the operations of its subsidiary.

The Complaint also alleges waste of corporate assets, in the form of excessive and unreasonable compensation and other corporate perks that should not have been provided. From *In re Citigroup*, 964 A.2d 106, comes the following law on corporate waste:

> Delaware law provides stringent requirements for a plaintiff to state a claim for corporate waste, and to

> excuse demand on grounds of waste the Complaint must allege particularized facts that lead to a reasonable inference that the director defendants authorized "an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration." The test to show corporate waste is difficult for any plaintiff to meet; indeed, "[t]o prevail on a waste claim . . . the plaintiff must overcome the general presumption of good faith by showing that the board's decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation's best interests."
>
> * * *
>
> The directors of a Delaware corporation have the authority and broad discretion to make executive compensation decisions. The standard under which the Court evaluates a waste claim is whether there was "an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade." It is also well settled in our law, however, that the discretion of directors in setting executive compensation is not unlimited. Indeed, the Delaware Supreme Court was clear when it stated that "there is an outer limit" to the board's discretion to set executive compensation, "at which point a decision of the directors on executive compensation is so disproportionately large as to be unconscionable and constitute waste."

Id. at 136, 138 (citations omitted). In the *Citigroup* case, the court denied the defendants' motion to dismiss referable to the corporate waste claim.

Similarly, this Court will deny the defendant's motion to the extent that the corporate waste allegations pertain to compensation issues specifically authorized by the directors. Decisions by the board with regard to salaries and/or bonuses of top-level management since Regions' agreement to participate in the federal TARP program create a reasonable doubt as to whether the board's approval was the product of a valid exercise of business judgment. Demand is therefore excused under the second prong of the *Aronson* standard.

The Court declines to recognize certain "perks," such as maintaining an expensive fleet of corporate aircraft and using such assets for personal uses, and receiving gifts from outside parties, as a distinct basis for the plaintiffs' corporate waste claim. While such allegations certainly describe questionable and arrogant behavior of management (if true), the plaintiffs have not sufficiently alleged that the board authorized providing such perks to management, or knew of such gifts. The plaintiffs therefore cannot overcome the demand-futility bar with regard to such matters

Except as may be addressed hereinabove, all other contentions of the defendants in support of their motions to dismiss under Rule 23.1 are hereby denied. The Court here emphasizes that its analysis pertains only to whether the plaintiffs have met their burden under this rule; the above conclusions do not purport to adjudicate the merits of this dispute.

Having determined that the plaintiffs have met the requirements under Rule 23.1 in certain respects, the Court turns to the plaintiffs' specific causes of action.

The Court denies the defendants' motions with regard to Count One of the Complaint, to the extent that the plaintiffs assert the defendants' breach of their fiduciary duties of loyalty and of good faith in connection with the matters described in paragraph 228, subparagraphs (a), (b), (d), (e), (f), (g), & (j).

The Court grants the defendants' motions to dismiss with regard to Count Two. Having interpreted Count One as pertaining to breaches of the fiduciary duties of loyalty and of good faith, the Court interprets Count Two as pertaining to alleged breaches of the duty of due care. Given the exculpatory provision found in Regions' restated certificate of incorporation, no such claim may be maintained.

The Court denies the defendants' motions to dismiss Count Three, except to the extent that this Count alleges a breach of the defendants' duty of due care.

The Court views Count Four, alleging unjust enrichment, as the flip side of Count Three. As such, this count appears to pertain to compensation provided to defendants Ritter, Esteves, and Wells. With this, the Court denies the defendants' motions as to this Count.

The Court here denies all other grounds to dismiss under Rule 12 raised in the pending motions.

A scheduling conference is hereby set for **Thursday, May 20, 2010, at 1:30 p.m.** The Court understands that a number of discovery-related motions are pending – they will also be addressed at this conference.

DONE and ORDERED on this the 6th day of May, 2010.

/s/ Robert S. Vance, Jr.
Circuit Judge