IN THE DISTRICT COURT OF OKLAHOMA COUNTY
STATE OF OKLAHOMA

In re CHESAPEAKE SHAREHOLDER DERIVATIVE LITIGATION

Lead Case No. **CJ-2009-3983**

DERIVATIVE ACTION

ORDER SUSTAINING DEFENDANT'S MOTION TO DISMISS WITH LEAVE TO AMEND

This matter came on for hearing before the Court on February 1, 2010, on Defendants Motion to Dismiss Verified Shareholder Derivative Petition. Defendants appeared through their counsel, Robert Varian, James Webb, and Todd Scott. Plaintiffs appeared through their counsel, Timothy DeLange, John Barbush, Robin Winchester, and Marc Gross. Following oral argument, the matter was taken under advisement. Having reviewed all of the pleadings, the case law and the argument presented to the Court, and for the reasons set forth in this Order, the Defendants' Motion to Dismiss is sustained and Plaintiffs are given ninety days from the date of this order to file their amended petition.

Chesapeake Energy Corporation (hereinafter "Defendants"), is an Oklahoma corporation. In the Fall of 2008, Chesapeake CEO and Chairman, Aubrey McClendon, received three consecutive margin calls compelling him to liquidate 94% of his Chesapeake stock. A few days prior to the public disclosure of this event, three other Directors sold over $5.2 million in Chesapeake stock. Chesapeake's Board of Directors (hereinafter "Board") has only one inside director, Mr. McClendon. The remaining eight Directors are Richard Davidson, Burns Hargis, Pete Miller, Frank Keating, Breene Kerr, Charles Maxwell, Donald Nickles, and Fred Whittemore. Following the sale of the majority of Mr. McClendon's Chesapeake holdings, in December of 2008, the Compensation Committee of the Board of Directors met and recommended the re-negotiation of

a new employment contract with Mr. McClendon, who was in the first year of a five-year contract. The following day, the entire Board met and approved, in concept, the new contract and urged that the details be finalized before the end of 2008.

Mr. McClendon's contract, signed December 31, 2008, was for a five-year term. The contract gave Mr. McClendon a $77 million bonus, over $20 million in stock awards, and provided for the purchase of his art collection for the amount he had paid for it, which was $12.1 million. The contract also included a claw-back[1] provision if Mr. McClendon left before the contract expired, and a six month non-compete clause. Mr. McClendon did not directly receive any of this bonus; it was applied to Mr. McClendon's required pro-rated payment of his cost in the Founder Well Participation Program, (hereinafter "FWPP").

In support of their decision to renegotiate Mr. McClendon's employment contract, the Board cited: a need to maximize Mr. McClendon's incentive to remain with Chesapeake; an incentive award for engineering four unique joint venture transactions; and a need to eliminate the threat that Mr. McClendon would resign with just a few days notice (the claw-back provision).

Plaintiffs brought suit asking that Mr. McClendon's 2008 employment contract be rescinded, that the sale of the art collection be set aside, and that Messrs. Whittemore, Nickels and Maxwell disgorge any profits derived from insider trading.

Defendants seek the dismissal of the Consolidated Amended Derivative Petition (hereinafter the "Petition") on the ground that Plaintiffs failed to make or excuse a pre-litigation demand on Defendants. Before bringing a derivative action, shareholders must show that they have sought relief, without success, through appropriate corporate avenues. *Guaranty Laundry Co. v. Pullium*, 1948 OK 30, 191 P.2d 975. Thus, shareholders place "demand" on board members to remedy error except when any request for action within the corporation would have been futile. *Hargrave v. Canadian Valley Electric Coop., Inc.*, 1990 OK 43 ¶12, 792 P.2d 50.

It is undisputed that Plaintiffs have not made a demand on Defendants to address their grievance.[2] In the case at bar, Plaintiffs ask that demand be deemed futile. In support of that request, Plaintiffs claim that the particularized facts[3] pled in the Petition allege that all of the

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[1] The entire amount of the bonus would be paid back.

[2] At the February 1, 2010, hearing the Court was advised that other shareholders placed demand in June of 2009, but the Chesapeake Board has yet to act on the demands, citing their desire to see the outcome of this litigation.

[3] 12 O.S. 2023.1 states, "...[T]he petitioner shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the director or comparable authority and, if necessary, from the shareholders or

members of the Board either negotiated, approved, or performed the amended employment agreement with Mr. McClendon.

Kamen v. Kemper Financial Services, Inc., 500 U.S. 90 (1991), holds that the law of the state of incorporation of the company governs the demand requirement. The Oklahoma General Corporation Act is patterned after the well-known Delaware statute. Accordingly, Defendants urge this Court to rely on various Delaware cases, "...[T]he Oklahoma General Corporation Act is based upon the Delaware General Corporations Act, and should be interpreted in accordance with Delaware decisions.", *Woolf v. Universal Fidelity Life Insurance Company*, 1992 OK CIV APP 129, ¶6, 849 P.2d 1093. The applicable Delaware cases hold: that demand is excused only in "extraordinary," "exceptional," and "rare" circumstances;[4] and further, that demand is futile where the particularized facts pled create a reasonable doubt (1) that a majority of the directors are disinterested and independent, and incapable of exercising their business judgment, or (2) that the challenged transaction was otherwise the product of a valid exercise of business judgment;[5] and the facts rebut the presumption of the "business judgment rule"[6] or show that the Board was corrupted and could not make a fair and independent decision in the best interest of the corporation.[7]

Plaintiffs ask that this Court follow the holding of the Oklahoma Supreme Court in *Hargrave v. Canadian Valley Elec. Co-op., Inc.*, 1990 OK 43, 792 P.2d 50, (Okla. 1990). *Hargrave* is a case in which ratepayers filed a class action suit against a rural electric cooperative corporation and its trustees. The defendants alleged there were no material factual disputes and that ratepayers were procedurally barred from bringing suit because they had not first demanded action be taken by the corporation. *Id.* at ¶ 8, 54. Canadian Valley moved for summary judgment which the trial court granted. On appeal, the Oklahoma Supreme Court first addressed the failure to place demand. The Court stated, "We agree that general rules which apply to shareholder derivative actions apply in this situation..." *Id.* at ¶11. "A demand on the board of trustees or directors should not be required prior to institution of a derivative action if the allegations in the petition permit the inference by the

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members, and the reasons for his failure to obtain the action or for not making the effort.

[4] *See, e.g. Good v. Getty Oil Co.*, 514 A.2d 1104, 1106 (Del.Ch. 1986).

[5] *Aronson v. Lewis*, 473 A.2d 805 (Del.Ch. 1984).

[6] *Warren v. Century Bankcorportion, Inc.*, 1987 OK 14, Fn. 5, "The business judgment rule is a presumption that a rational business decision of the officers or directors of a corporation is proper unless there exist facts which remove the decision from the protection of the rule - such as self-dealing and conflict of interest."

[7] *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 350-51 (Del.Ch.1998), *aff'd with leave to replead*, 746 A.2d 244 (Del.2000).

court that the trustees or directors upon whom demand would be made lack the 'requisite disinterestedness to determine fairly whether the corporate claim should be pursued. *Lewis v. Curtis,*[8] 671 F.2d 779, 785 (3rd Cir. 1982) *cert. denied*, 459 U.S. 880, 103 S.Ct. 176, 74 L.Ed.2d 144 (1982).'" Noting that futility is determined by the facts and circumstances of each case, and lies within the discretion of the trial court,[9] our Supreme Court instructs, "In making this determination, the court should consider 'whether a demand on the directors would be likely to prod them to correct a wrong.'" *Id.* at ¶ 12, 55. The *Hargrave* court found that the trustees who negotiated the contract and allowed the contract to proceed unaltered would be unlikely to respond to a demand. "We cannot agree that a complaint by Ratepayers would have prodded the trustees to action. They were not disinterested parties, but were directly involved in the transaction...Such an act undoubtedly would have been useless and futile, and would have served merely to 'delay suit and remedy.'" *Id.* at ¶13, citing *Lewis v. Curtis*, 671 F.2d at 785.

Although Defendants present a valiant attempt to argue that *Hargrave* should not be applied in the case at bar, the Oklahoma Supreme Court has provided further validation that *Hargrave* does apply. In *Resolution Trust Corporation v. Grant*, 1995 OK 68, 901 P.2d 807, the Court responded to certified questions of law from the United States District Court for the Northern District of Oklahoma. The suit arose when Resolution Trust Corporation was appointed receiver of a savings and loan and sued the directors and officers claiming negligence, gross negligence, breach of contract and breach of fiduciary duty. When the defendants claimed that the statute of limitations barred the action, plaintiff argued that the statute was tolled because the savings and loan was "adversely dominated by its directors." *Id.* at ¶ 3, 810. In explaining that the doctrine of adverse domination does not preclude a non-culpable director or shareholder from filing a derivative action, the Court points out in Footnote 2, "The general rules governing a derivative action were outlined in *Hargrave*. The opinion provides in pertinent part, 'Ordinarily before a court will entertain an action brought by shareholders, the shareholders must first show that they sought relief through corporate channels without success...'" the Court continues quoting liberally from *Hargrave*.

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[8] The third circuit thoroughly discusses the approaches different jurisdictions use in determining whether demand is futile.

[9] Delaware case law beginning with *Aronson v. Lewis*,(Del. 1984), 473 A.2d 805, 814, indicated that the trial court's decision regarding the excuse of pre-suit demand was discretionary and the appellate court would review using an abuse of discretion standard. However, in *Brehm v. Eisner*, (Del. 2000), 746 A.2d 244, Delaware's high court held that the review of these decisions would be *de novo* and plenary. *Id.* at 253.

Thus, Defendants' argument that *Hargrave* should not be applied fails.

Defendants' present their, "Request to Take Judicial Notice" of the following: Form 8-K, filed January 7, 2009; Letter of February 13, 2009, from the SEC to Chesapeake; The Definitive Proxy Statement, Form 14A, filed April 29, 2008; The Definitive Proxy Statement, Form 14A, filed April 30, 2009; "Chesapeake Energy Chief to Remain" by Ben Casselman and published in The Wall Street Journal, January 8, 2009; and Final New York Stock Exchange Corporate Governance Rules. Defendants use these documents to oppose the merits of the Petition and tell their side of the story. In a motion to dismiss, a court must accept the well-pled allegations in the complaint as true and draw all reasonable inferences in favor of the plaintiffs. *Brehm v. Eisner*, 746 A.2d 244, 255 (Del.2000). Thus, Defendants' request for the Court to take judicial notice is overruled.[10]

In the present case, the Petition claims that the Board's Compensation Committee met the day prior to the entire Board meeting. The Compensation Committee then made a recommendation to the entire Board of Directors that Mr. McClendon's employment contract, that had been renewed in 2007, be re-negotiated to include: (1) a five-year employment commitment; (2) a cap on cash salary and bonus compensation for the five-year term of the contract to be capped at 2008 levels; (3) reduce the 2009 stock holding requirement; and (4) award a $75 million 2008 incentive award, which was in addition to Mr. McClendon's annual bonus of $1.9 million. The Board approved the concept and instructed that the contract be finalized as soon as possible. The finalized contract included these provisions as well as the claw-back provision should Mr. McClendon leave before the contract expired and a six-month non-compete agreement. Audit Committee Chairman, Breene Kerr, recommended that Chesapeake purchase a personal art collection that Mr. McClendon displayed at Chesapeake's headquarters for $12.1 million[11] (see ¶80).

The Petition further alleges that: Chesapeake's 2008 profits fell 50% and their stock price plunged 60%, (see ¶1); Mr. McClendon's $124 million "compensation package" represented a 430% increase from 2007, (see ¶2); the Board did not seek any independent expertise to determine the appropriateness of such an award, (see ¶3); within a 24 hour period, the Compensation Committee discussed the new contract then presented their recommendation to the entire Board, (see ¶3); the Board voted themselves hefty pay increases in 2008, (see ¶9); the average total

[10] Using facts outside of the Petition would convert this proceeding into a motion for partial summary judgment. 12 O.S. §2012 B.

[11] The $12.1 million was the amount Mr. McClendon paid for the collection. The dealer also purportedly informed the Board that the collection was worth approximately $20 million.

compensation of a Chesapeake director for their four in-person meetings during 2008, was over $660,000, (see ¶109); the director compensation is more than 3 ½ times that of the median Fortune 500 company director, (see ¶9), that the purchase price of the art collection for $12.1 million was done without an independent appraisal, but instead the Board relied on Mr. McClendon's art agent for the valuation, (see ¶80); the FWPP allowed Mr. McClendon to acquire up to 2.5% working interest in all of Chesapeake's wells as they were drilled, provided he contributed his pro-rata share of drilling costs, (see ¶50); and the proceeds from the art sale and the bonus were used as a net credit against Mr. McClendon's well costs under the FWPP, (see ¶58).

According to Plaintiffs, since taking this action in December of 2008, the Directors have defended their actions as being in the best interest of Chesapeake (see ¶67) and have exhibited antagonism toward the investigation of wrongdoing, (see ¶113). *Hargrave* instructs that a court should consider, "[W]hether a demand on the directors would be likely to prod them to correct a wrong." *Id.* at 55, (quoting *Lewis v. Curtis*, 671 F.2d at 786). Reviewing the allegations taken in the light most favorable to the Plaintiffs, the Chesapeake Directors, like the board members in *Hargrave*, negotiated and approved Mr. McClendon's new contract. However, the *Hargrave* Court did not include the analysis of the spectrum of reasons which support demand futility that are addressed in many Delaware cases.

Herein, Plaintiffs state their reasons why demand is excused against each Director: because Mr. McClendon is an inside Director; (see ¶86); Messrs. Whittemore, Nickles and Maxwell because of illegal insider selling of Chesapeake stock, (see ¶88); Messrs. Maxwell, Keating and Whittemore because they were on the Compensation Committee that brought the proposal to the table, (See ¶91); Mr. Kerr because he is Mr. McClendon's cousin, and the family relationship prevents disinterest, (see ¶98); Messrs. Kerr and Whittemore because they made large personal loans to Mr. McClendon in return for valuable stock options, (see ¶100); Mr. Keating because he has two family members employed at Chesapeake, each earning over $135,000 annually, (see ¶106); Mr. Hargis is President of Oklahoma State University,(hereinafter "OSU"), and Chesapeake makes large contributions to OSU, (see ¶106 (c)); Mr. Miller is CEO of National Oilwell Varco, Inc., which does business with Chesapeake, (see ¶106 (a)); Messrs. Kerr, Maxwell and Whittemore leveraged their Chesapeake stock, (see ¶112); and the entire Board voted themselves over $1.2 million in raises in 2008, (see ¶108).

All manner of demand futility have been fully considered in Delaware law[12]; our Supreme Court has ruled on virtually no case where the Directors are alleged to lack the requisite disinterestedness for so many various reasons as claimed herein. Considering all of the law that has been presented, this Court finds that demand is not excused.

IT IS THEREFORE ORDERED that the Plaintiffs' claims be dismissed, and the Plaintiffs are granted leave to file an Amended Petition within ninety (90) days of the date of this Order. If no Amended Petition is filed within the ninety day period, the claim will be dismissed. Defendants shall respond to the Amended Petition within thirty days after its service.[13]

IT IS SO ORDERED this 26th day of February, 2010.

TWYLA MASON GRAY
DISTRICT JUDGE

Certificate of Service

This is to certify that a true and correct copy of the above was delivered to:

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[12] *See Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961 (Del. Ch. 2003); *Brehm v. Eisner*, 746 A.2d 244 (Del.2000); *Grobow v. Perot*, 539 A.2d 180 (Del.1988).

[13] 12 O.S.§ 2015 provides that, "A party shall respond to an amended pleading…within ten (10) days after the service of the amended pleading, whichever period may be longer, unless the court otherwise orders." Due to the complexity of the issues, the Court believes thirty days to be a more appropriate response time.

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