March 28, 2008

Federal District Court Reaffirms Board Primacy in Dismissing
Shareholder Derivative Action Against Morgan Stanley Directors and Officers

In a decision yesterday dismissing a shareholder derivative suit against certain directors and officers of Morgan Stanley, the Federal District Court for the Southern District of New York powerfully reaffirmed the fundamental principle that boards, not stockholders, are charged with making important corporate business decisions, including whether to file suit against company managers and whether to make discretionary disclosures. *In re Morgan Stanley Derivative Litigation*, No. 05 Civ. 6515 (S.D.N.Y. Mar. 27, 2008).

The plaintiffs' lawsuit made several claims, purportedly on behalf of Morgan Stanley, against former officers of the company and its board in the wake of well-publicized management changes at Morgan Stanley in the summer of 2005. In order to bring their lawsuit in federal court, the plaintiffs tried to manufacture federal securities law claims that focused on Morgan Stanley's receipt in January 2005 of a notice that the staff of the Securities and Exchange Commission's ("SEC") Division of Enforcement had made a preliminary determination to recommend that the SEC pursue an action against Morgan Stanley for allegedly violating federal recordkeeping laws ("Wells Notice"). Morgan Stanley disclosed the Wells Notice in its next quarterly SEC report in April 2005. The plaintiffs claimed that the board of directors and a former officer of the company violated federal securities laws by failing to disclose the Wells Notice two months earlier, when the company issued a proxy statement in connection with its annual shareholder meeting. But rather than first making a demand upon the board of directors that the company bring these claims directly, as both federal and Delaware law require, the plaintiffs attempted to establish that they were excused from making such a demand before filing their lawsuit because of the directors' alleged lack of independence and the existence of supposed conflicts of interest. The Court resoundingly rejected the plaintiffs' attempts to impugn the integrity of the board.

First, the Court held that the plaintiffs could not excuse demand by making generalized, unsupported assertions that the directors sought to retain their positions and would be unwilling to sue themselves, or that business relationships among the directors impaired their impartiality. The Court also concluded that the plaintiffs' allegations regarding the federal securities law violations were too weak to show a likelihood of liability; therefore, the directors were not rendered incapable of considering a demand to bring such claims. Finally, the Court held that the plaintiffs had failed to establish why, in the absence of federal regulations requiring the disclosure of Wells Notices in proxy statements, the decision to omit such notice should not be committed to the board's reasoned business judgment. Accordingly, the Court dismissed the complaint in its entirety, granting plaintiffs leave to renew their claims only upon making a proper demand upon the Morgan Stanley board so that it could consider in its business judgment whether litigating plaintiffs claims is in the best interests of the company. The Court's decision is a strong endorsement of the axiom that corporate governance is the province of boards of directors, not activist shareholders or their lawyers.

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