IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN RE DIAMOND FOODS, INC. DERIVATIVE LITIGATION	))	Civil Action No. 7657-CS

MEMORANDUM OPINION

Date Submitted: February 25, 2013
Date Decided: February 28, 2013

Blake A. Bennett, Esquire, Gregory F. Fischer, Esquire, COOCH AND TAYLOR P.A., Wilmington, Delaware; Mitchell M.Z. Twersky, Esquire, Lawrence D. Levit, Esquire, Atara Hirsch, Esquire, ABRAHAM, FRUCHTER & TWERSKY, LLP, New York, New York; Francis A. Bottini, Jr., Esquire, Albert Y. Chang, Esquire, BOTTINI & BOTTINI, INC., San Diego, California, *Attorneys for Plaintiffs David A. Lucia and Board of Trustees of City of Hialeah Employees' Retirement System.*

R. Judson Scaggs, Jr., Esquire, Susan W. Waesco, Esquire, Angela C. Whitesell, Esquire, Frank R. Martin, Esquire, MORRIS, NICHOLS, ARSHT & TUNNELL LLP, Wilmington, Delaware; Dean Kristy, Esquire, Susan S. Muck, Esquire, Jennifer C. Bretan, Esquire, FENWICK & WEST LLP, San Francisco, California, *Attorneys for Nominal Defendant Diamond Foods, Inc.*

STRINE, Chancellor.

Two derivative plaintiffs, an individual and a pension fund, filed a derivative suit in this court against the directors and officers of Diamond Foods, Inc. ("Diamond"), a snack food manufacturer that is incorporated in Delaware and headquartered in California. The plaintiffs allege that, in a period between October 2010 and June 2012, two defendants, Diamond's former CEO and former CFO, breached their fiduciary duties by engaging in a manipulation of the company's financial statements.[1] The plaintiffs also allege that another nine defendants, who were directors of Diamond during the relevant period,[2] breached their fiduciary duty by failing to try in good faith to ensure that the company operated in compliance with law.[3] The motive for this manipulation was to avoid revealing to a major strategic rival, Procter & Gamble—with whose Pringles division Diamond was planning to merge in December 2011—that Diamond was not as financially healthy as Procter & Gamble had believed.[4] This reality would have adversely affected the terms of the merger or even relieved Procter & Gamble of its

[1] These defendants, Michael Mendes and Steven Neil, were placed on administrative leave in February 2012, after Diamond's audit committee determined that the company's financial statements had been manipulated. *See* Def's. Op. Br. Ex. C (Diamond Foods, Inc., Form 8-K (Feb. 8, 2012)); *see also* V. Am. Compl. ¶¶ 25-26.

[2] These defendants are Laurence Baer, Edward Blechschmidt, John Gilbert, Glen Warren, Richard Wolford, Robert Zollars, and Robert Lea, who were directors of Diamond at the time the plaintiffs filed their original complaint in June 2012. In addition, the plaintiffs name as defendants Dennis Mussell, a retired director, and the estate of Joseph Silveira, a director of Diamond who served on the company's audit committee, and who committed suicide after the manipulation of Diamond's financial statements came to light. V. Am. Compl. ¶¶ 27-35.

[3] *See, e.g.*, *Stone v. Ritter*, 911 A.2d 362 (Del. 2006) (affirming the standard for director oversight liability set out in *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996)); *Guttman v. Huang*, 823 A.2d 492 (Del. Ch. 2003) (comparing the standards for pleading demand excusal in *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), and *Rales v. Blasband*, 634 A.2d 927 (Del. 1993), and dismissing the plaintiffs' derivative claims based on allegations that the director defendants had engaged in insider trading and had failed to monitor the corporation's compliance with financial reporting standards).

[4] V. Am. Compl. ¶ 8.

obligation to close.[5] When the manipulation came to light, in November 2011, Diamond was forced to restate its financials, the Procter & Gamble merger cratered, the Diamond CEO and CFO were replaced, and several lawsuits were quickly brought.[6]

The first group of derivative suits was filed rapidly in the California state courts, alleging claims of the same essential nature as those brought in this case.[7] These three suits were consolidated, and the "California State Action" is ongoing, with both proceedings before the court and a settlement process before a mediator.[8] The derivative plaintiffs in this case brought the second set of suits, but not in this court. Rather, these derivative plaintiffs filed suit in the U.S. District Court for the Northern District of California, alleging state law claims of the kind outlined above and claims under § 14(a) of the Securities Exchange Act of 1934, on the grounds that Diamond's proxy statements in 2010 and 2011 were materially misleading.[9] I refer to that suit as the California Federal Action. Because, as will be seen, the derivative plaintiffs here seek to subject

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[5] *Id.* ¶¶ 60, 146-47.
[6] *Id.* ¶¶ 99-104, 109-14.
[7] These suits were *Dean v. Baer*, Case No. 11-515895, filed on November 14, 2011; *Nguyen v. Baer*, Case No. 11-516073, filed on November 22, 2011; and *United Food & Commercial Workers Union v. Baer*, Case No. 11-516933, filed on December 29, 2011.
[8] In February 2012 the plaintiffs filed a consolidated complaint. Compl., *In re Diamond Foods, Inc. S'holder Deriv. Litig.*, Case No. 11-515895 (Cal. Super. Ct. Feb. 16, 2012) [hereinafter Cal. Compl.]. The consolidated plaintiffs entered mediation. After the mediation was unsuccessful, Diamond demurred from the complaint, and the California court sustained the demurrer. Kristy Aff. ¶ 3; Order, *In re Diamond Foods, Inc., S'holder Deriv. Litig.*, Case No. 11-515895 (Cal. Super. Ct. Nov. 13, 2012). Since that time, the plaintiffs have attended another mediation session. Kristy Reply Aff. ¶ 14.
[9] 15 U.S.C. § 78n. These complaints were *Board of Trustees of City of Hialeah Employees' Retirement System v. Mendes*, Case No. 3:11-cv-05692-WHA (N.D. Cal. Nov. 28, 2011), and *Lucia v. Baer*, 3:11-cv-06417-JSC (N.D. Cal. Dec. 19, 2011). The two actions were consolidated, and a consolidated complaint was filed. Cons. Compl., *In re Diamond Foods, Inc. Deriv. Litig.*, Case No. 3:11-cv-05692-WHA (N.D. Cal. Mar. 1, 2012) [hereinafter Fed. Compl.].

Diamond and the defendants to suit in two forums simultaneously, I refer to them as the Dual Forum Plaintiffs.

Before me now is a motion by the defendants to dismiss or stay this derivative action brought by the Dual Forum Plaintiffs under the *McWane* doctrine.[10] In support of that motion, the defendants point out the following. First, the California Federal Action filed by the Dual Forum Plaintiffs was dismissed, with prejudice, by Judge Alsup of the U.S. District Court for the Northern District of California for lack of subject matter jurisdiction.[11] The court found that the Dual Forum Plaintiffs' § 14(a) claims, their sole grounds for federal jurisdiction, failed as a matter of law.[12] With the federal claims dismissed, the court found that it had no jurisdiction over the suit and did not consider any of the state law claims.[13]

One of the Dual Forum Plaintiffs has taken an appeal from that ruling.[14] But only a few weeks after noticing the appeal, the Dual Forum Plaintiffs filed a near-identical complaint in this court, without the federal securities law claims.[15] Thus, the Dual Forum Plaintiffs seek to have the dismissal of the California Federal Action overturned and to proceed in the U.S. District Court for the Northern District of California not only with their federal claims but with the *same* claims as those asserted in this action. The

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[10] *McWane Cast Iron Pipe Corp. v. McDowell-Wellman Eng'g Co.*, 263 A.2d 281 (Del. 1970).
[11] *In re Diamond Foods, Inc. Deriv. Litig.*, 2012 WL 1945814 (N.D. Cal. May 29, 2012).
[12] *Id.* at *5-7.
[13] *Id.* at *7.
[14] Notice of Appeal, *In re Diamond Foods, Inc. Deriv. Litig.*, Case No. 11-cv-5692-WHA (N.D. Cal. June 4, 2012).
[15] The Dual Forum Plaintiffs also dropped claims against Diamond's auditors, Deloitte & Touche. *See* Fed. Compl. ¶¶ 189-216.

defendants argue that it is improper under *McWane* and basic principles of equity for the Dual Forum Plaintiffs to subject Diamond to the excess costs of litigating with the same plaintiffs over the same claims in two forums at once. The defendants are correct.[16]

Second, the defendants accurately point out that the Dual Forum Plaintiffs have failed to distinguish their claims from those being pressed in the California State Action. Those actions were filed *seven months* before the Dual Forum Plaintiffs filed their action in this court.[17] The Dual Forum Plaintiffs' belated Delaware complaint is not distinguishable in terms of quality from the consolidated complaint filed in the California State Action. Because the Dual Forum Plaintiffs' complaint comes so late in comparison to the California complaint, and is not materially different, there is no reason to disturb the orderly course of that litigation and mediation. Furthermore, the Dual Forum Plaintiffs have small stockholdings in Diamond, which makes it unlikely that they have a stronger economic motivation to prosecute their action more effectively on behalf of Diamond than the plaintiffs in the California State Action.[18]

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[16] *McWane Cast Iron Pipe Corp. v. McDowell-Wellman Eng'g Co.*, 263 A.2d 281, 283 (Del. 1970) (noting the "the wasteful duplication of time, effort, and expense that occurs when judges, lawyers, parties, and witnesses are simultaneously engaged in the adjudication of the same cause of action in two courts").

[17] The original complaint in the Delaware action was filed on June 27, 2012. The Dual Forum Plaintiffs did not use the time between June 2012 and the disclosure of Diamond's financial irregularities in November 2011 to put together a complaint with a better chance of success, for example by filing a request for books and records under 8 *Del. C.* § 220. Oddly, it appears that Dual Forum Plaintiff Lucia made a demand for records on Diamond under *California*, not Delaware, law. Diamond refused that demand, and Lucia dropped it. Kristy Reply Aff. ¶ 18.

[18] The Dual Forum Plaintiffs have filed affidavits with the court attesting to their stock ownership. From 2011 on, plaintiff Lucia has held approximately 50 shares, and plaintiff Hialeah has held approximately 1,300 shares. Lucia Aff.; Voorhees Aff. Based on Diamond's closing share price of $15.25 on February 27, 2013, this gives the Dual Forum Plaintiffs a stockholding worth $21,000 in a corporation with a market capitalization of $340 million.

Third, some derivative plaintiffs, who are not affiliated with either the Dual Forum Plaintiffs or the plaintiffs in the California State Action, did make a demand under 8 *Del. C.* § 220 and concluded that given the composition of the Diamond board, a demand to sue should be made.[19] In connection with that argument, the defendants note that Judge Kramer of the California Superior Court dismissed the original California State Action derivative complaint in that Action for failure to plead demand excusal, but gave leave to amend.[20] The Dual Forum Plaintiffs contend that they are better positioned to litigate demand excusal, but this is hardly the case. At the end of June 2012, when the Dual Forum Plaintiffs filed this action in Delaware, the Diamond board had twelve members.[21] Of these twelve members, the Dual Forum Plaintiffs have named seven as defendants. These members were on the Diamond board at the time of the financial manipulation. The Dual Forum Plaintiffs have not alleged that any of the five directors who joined the Diamond board after the events at issue are not independent and cannot consider a demand on the board. Therefore, if the California court was right that even *two* of the seven directors who are named as defendants were independent for purposes of demand excusal, then the Dual Forum Plaintiffs will not be excused from making demand on the ground that at least half the board is not independent.

Diamond Foods, Inc., Yahoo! Finance, http://finance.yahoo.com/q?s=DMND (visited Feb. 27, 2013).

[19] *See* V. Compl., *Astor BK Realty Trust v. Diamond Foods, Inc.*, C.A. No. 7272-ML (Del. Ch. Feb. 22, 2012); Kristy Reply Aff. ¶ 4; *see also* Letter to the Court from Michael W. McDermott, Esq. (Dec. 20, 2012) (describing the efforts of Astor and its coplaintiff, Beaver County Retirement Fund, to obtain books and records under § 220).

[20] Order, *In re Diamond Foods, Inc., S'holder Deriv. Litig.*, Case No. 11-515895 (Cal. Super. Ct. Nov. 13, 2012). The California court did not grant leave to amend on one count, gross mismanagement, on the ground that that is not an independent cause of action.

[21] V. Compl. ¶ 123.

The Dual Forum Plaintiffs point out that the California State Action Plaintiffs must file a new complaint in that Action, and observe that, since June last year, another three of the individual defendant directors have left the board.[22] As a result, the board now has nine members, a majority of whom joined the board after the events at issue, and whose independence neither the California State Action Plaintiffs nor the Dual Forum Plaintiffs have challenged. But, this does not give the Dual Forum Plaintiffs a significantly better chance of avoiding demand. The allegations as to the seven directors whose independence the Dual Forum Plaintiffs challenge are largely identical to the allegations made by the California State Action Plaintiffs, which were rejected by Judge Kramer.[23] Because of this, the Dual Forum Plaintiffs' contention that Diamond is attempting to settle with a weaker plaintiff in California is, in my view, meritless. In any event, it can be addressed by the Dual Forum Plaintiffs intervening in the California State Action, which is proceeding in the same state where they originally chose to sue.

Fourth, the defendants note that much of the relief sought in this action will depend on the outcome of securities litigation filed against Diamond relating to the accounting manipulation.[24] That is, because the derivative actions seek to make the

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[22] The Dual Forum Plaintiffs cite a Diamond press release from January 14, 2013, which they supply in an exhibit. Pls.' Br. in Opp'n 18; *see* Bottini Aff. Ex. 5 (press release). The press release shows that four, not three, of the individual defendants have left the board. These four are Baer, Gilbert, Warren, and Wolford. One of these has been replaced, with the new director being William Tos. Therefore, if the Dual Forum Plaintiffs' argument had any traction (which it does not), the affidavit exhibit that they supply would be more helpful to their position than they in fact recognize.

[23] *Compare* Cal. Compl. ¶¶ 226, 230-33, 235-37, *with* V. Am. Compl. ¶¶ 128-40.

[24] This litigation is also before Judge Alsup in the federal district court. In November last year, the federal district court denied Diamond's and the individual defendants' motions to dismiss. *In re Diamond Foods, Inc. Secs. Litig.*, 2012 WL 6000923 (N.D. Cal. Nov. 30, 2012). The court

derivative defendants indemnify Diamond for any damages or costs it must pay as a result of the securities suits, the derivative actions should be stayed until the securities suits are concluded.[25] I agree.

Fifth, the defendants argue that the Dual Forum Plaintiffs' claim that a Delaware court must hear their derivative claims because they raise novel issues of Delaware law is belied by the actions of the Dual Forum Plaintiffs themselves. The Dual Forum Plaintiffs did not bring their Delaware law claims in this court in the first instance. Instead, they brought them in a federal court, and not even the U.S. District Court for the District of Delaware, which might have more opportunities to apply Delaware corporate law than the U.S. District Court for the Northern District of California. Even now, the Dual Forum Plaintiffs seek to prevail in their federal appeal and to prosecute all of their claims, federal and state, in the federal district court in California. Given the decisional law of this state's courts in cases like *Caremark*,[26] *Stone*,[27] *Guttman*,[28] *AIG*,[29] and *Citigroup*,[30]

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granted the motion to dismiss of the company's auditor, Deloitte & Touche. Since that time, Diamond has filed an answer to the consolidated complaint, and there has been further activity on the docket.

[25] Am. V. Compl. ¶¶ 168-70.

[26] *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996).

[27] *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

[28] *Guttman v. Huang*, 823 A.2d 492 (Del. Ch. 2003).

[29] *In re Am. Int'l Group, Inc., Consol. Deriv. Litig.*, 965 A.2d 763, 798-99 (Del. Ch. 2009) (refusing to dismiss a *Caremark* claim against two director defendants under Court of Chancery Rule 12(b)(6), because the plaintiffs had pled facts supporting an inference that the defendants breached their fiduciary duty by being "directly . . . involved in," or "knowingly fail[ing] to stop," financial wrongdoing).

[30] *In re Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d 106, 129-131 (Del. Ch. 2009) (dismissing plaintiffs' *Caremark* claim alleging that the directors failed to monitor the company's business risk, because the plaintiffs had not "alleg[ed] facts that could demonstrate bad faith on the part of the directors," and contrasting the allegations in that case with the allegations that survived a motion to dismiss in *AIG*, 965 A.2d 106).

the defendants say that the legal principles to be applied are settled, and that the Dual Forum Plaintiffs have not identified any novel question to be litigated. Again, I agree.

Last, the defendants note that when the federal judge refused to exercise supplemental jurisdiction over the Dual Forum Plaintiffs' state claims, he expressly noted that the issues raised by those claims were already before his judicial colleague in the California State Action.[31] Instead of seeking to intervene in those actions and seek lead plaintiff status, the Dual Forum Plaintiffs opened up a third front in this court, subjecting Diamond and therefore its stockholders to excess costs.

In response to these arguments, which are measured and entirely supported by the record, the Dual Forum Plaintiffs simply respond that the wrongdoing alleged, although not of any novel type, is substantial and that a Delaware court should decide the case.[32] *They ignore the obvious reality that they filed the claims in a federal court in California first and continue to try to litigate those claims there*. The Dual Forum Plaintiffs then contend that they are somehow better positioned to plead demand excusal, despite having sought no books and records to enable them to do so, and despite having failed to demonstrate any superiority in pleading over their counterparts in the California State Action.[33] Although this court does not encourage races to the courthouse, the reality is that the Dual Forum Plaintiffs have not demonstrated that their later filings reflected

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[31] *See In re Diamond Foods, Inc. Deriv. Litig.*, 2012 WL 1945814, at *7 (N.D. Cal. May 29, 2012) ("The Court will not exercise supplemental jurisdiction over the remaining state law claims. In light of the fact that there are almost identical state suits pending before Judge Richard Kramer, it would be duplicative to reach these issues here in federal court.").
[32] Pls.' Br. in Opp'n 23-24.
[33] *Id.* at 18-19.

more diligent research and investigation than the prior filed claims made in the California State Action. The complaint that was dismissed without prejudice in that Action was detailed, with 100 pages and 283 paragraphs.

Furthermore, the Dual Forum Plaintiffs belittle those derivative plaintiffs who sought books and records because those plaintiffs concluded that making a demand was the appropriate course of action.[34] But, given the structural independence of most public company boards and the difficulty of proving out a *Caremark* claim, that decision may have reflected sober and sensible legal judgment.[35] The Dual Forum Plaintiffs' blithe assertions that their complaint is superior are unaccompanied by any reasoned arguments in support of that position. Instead, the Dual Forum Plaintiffs make an array of extreme arguments about the good faith of Diamond and the defendants in conducting settlement discussions with the plaintiffs in the California State Action—discussions that occurred with the involvement of a former federal magistrate judge and with the knowledge of my California state colleague.[36] The Dual Forum Plaintiffs allege that these discussions violated an order of Judge Alsup in the federal case, even though these discussions occurred in a case before the courts of another sovereign and after Judge Alsup had

[34] *Id.* at 12 ("On April 3, 2012, the *Astor* Plaintiffs served a litigation demand on the Board, effectively conceding the Board's independence."); *id.* at 19 n.5 ("The *Dean* Plaintiffs' bargaining position is as weak as that of the *Astor* Plaintiffs, who have conceded the Board's independence by making a litigation demand in April 2012.").
[35] As Chancellor Allen wrote, "[t]he theory . . . advanced [in *Caremark*] is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996).
[36] Pls.' Br. in Opp'n 16-17; *see* Kristy Aff. ¶ 3; Kristy Reply Aff. ¶ 12.

entered a final judgment of dismissal in his case.[37] The Dual Forum Plaintiffs' vinegar-laced arguments repeat ones they are simultaneously making about that issue to Judge Alsup and the U.S. Court of Appeals for the Ninth Circuit. The astringency of these arguments is more evident than their plausibility or merit, but the fact that the Dual Forum Plaintiffs seek to have me consider them at the same time as my federal colleague underscores why dismissal of this action is in order.

Given that (i) this action was brought well after these claims were already fairly in litigation in California state court; (ii) the Dual Forum Plaintiffs brought this action after bringing these same claims in a federal court in California and thus after conceding that a non-Delaware court could competently adjudicate the claim; (iii) the Dual Forum Plaintiffs continue to press an appeal that, if successful, will enable them to litigate their claims in federal district court; and (iv) the Dual Forum Plaintiffs have not demonstrated that they are better positioned to represent Diamond than the plaintiffs in the California State Action, the defendants' motion under *McWane* should be granted. The Dual Forum Plaintiffs are seeking a course of action that *McWane* exists to avoid, one in which the interests of justice are eroded by the excessive cost and burden of unnecessary litigation over the same issues in multiple forums.[38] And worst of all, it is *the Dual Forum*

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[37] *See* Kristy Reply Aff. ¶¶ 2, 11. One of the Dual Forum Plaintiffs, Lucia, has filed a motion for an order to show cause why the defendants should not be sanctioned for violating the order barring negotiations. *Id.* ¶ 15. Lucia noticed a hearing for this motion for February 28. Therefore, I do not comment further on the Dual Forum Plaintiffs' contention, except to note that in the unopposed motion to consolidate that the Dual Forum Plaintiffs proposed in August last year, which I granted only because it was unopposed, counsel for the Dual Forum Plaintiffs expressly reserved the "authority to negotiate a settlement." Order of Cons. ¶ 6 (Aug. 7, 2012).

[38] *McWane Cast Iron Pipe Corp. v. McDowell-Wellman Eng'g Co.*, 263 A.2d 281, 283 (Del. 1970).

Plaintiffs themselves who seek to subject the same defendants to litigation with them in two forums. This is costly, inequitable, and unfair to Diamond and the very stockholders whose best interests the Dual Forum Plaintiffs are supposed to be advancing.

Given the evident inequity of their position, the Dual Forum Plaintiffs' claims in this court are dismissed with prejudice to their ability to proceed in this forum, but without prejudice to their ability to proceed in the California Federal Action if their appeal is successful and the federal court decides to exercise supplemental jurisdiction, or their ability to proceed in the California State Action if they seek intervention and *if* the California court grants them a role. But the Dual Forum Plaintiffs may not burden Diamond and its stockholders with litigation in a coastal state bordering the Atlantic, when they themselves chose to sue in the federal courts of a state bordering the Pacific.

For all these reasons, the defendants' motion to dismiss is GRANTED. The defendants shall submit an implementing order, upon approval as to form by the Dual Forum Plaintiffs, within five days.