

## Federal pleading standards and the business judgment rule after *Twombly* and *Iqbal*

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Received: 24th June, 2010

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### ABSTRACT

The business judgment rule is a standard of judicial review that shields directors and officers from liability unless a plaintiff can overcome the presumptions that corporate directors and officers acted on an informed basis, in good faith, and in the honest belief that their actions were taken in the best interests of the company. Although Delaware courts have long considered the business judgment rule at the motion-to-dismiss stage of litigation, federal courts have been hesitant historically to do so under Federal Rule of Civil Procedure 8. Two recent Supreme Court decisions interpreting Federal Rule 8, however,

appear to have brought federal pleading standards in line with Delaware. In *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007), and *Ashcroft v. Iqbal*, 129 S. Ct. 1937 (2009), the Supreme Court announced that the previous 'no set of facts' standard had earned its retirement and that plaintiffs must now plead a plausible claim for relief in order to state a claim under Federal Rule 8. This paper examines the business judgment rule and its application at the motion to dismiss stage in federal courts. The authors submit that, based on the Court's decisions in *Twombly* and *Iqbal*, the traditional analysis of the business judgment rule under the 'no set of facts' standard is no longer viable.

**Keywords:** business judgment rule, *Iqbal*, *Twombly*, 'Rule 8', Tower Air

### INTRODUCTION

The business judgment rule is a fundamental doctrine in corporate law. It is the lens through which courts scrutinise any challenged action or inaction by corporate directors and officers. This standard of judicial review shields directors and officers from liability unless a plaintiff can overcome the presumptions that corporate

directors and officers acted on an informed basis, in good faith, and in the honest belief that their actions were taken in the best interests of the company.<sup>1</sup> The business judgment rule is not a standard of liability. It is a 'doctrine of abstention pursuant to which courts in fact refrain from reviewing board decisions unless exacting preconditions for review are satisfied'.<sup>2</sup> Unless the business judgment rule is rebutted, directors are not subject to liability.<sup>3</sup>

The contours of the business judgment rule have been litigated and honed in scores of state and federal cases. Despite its ubiquity, the question of whether — and to what extent — the business judgment rule should be applied at the pleading stage has received disparate treatment by state and federal courts. Courts in Delaware, the national authority on issues of corporate law, have long considered the business judgment rule in deciding whether a complaint states a claim pursuant to Delaware Chancery Court Rule 8 (Delaware Rule 8).<sup>4</sup> In contrast, some federal courts have traditionally not afforded the same treatment under Federal Rule of Civil Procedure 8 (Federal Rule 8) on the basis that the business judgment rule is a fact-based defence that is inappropriate for consideration at the motion-to-dismiss stage.<sup>5</sup> Two recent landmark decisions by the United States Supreme Court, however, bring Federal Rule 8 more in line with Delaware Rule 8.

In *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007), and *Ashcroft v. Iqbal*, 129 S. Ct. 1937 (2009), the Supreme Court announced that the previous 'no set of facts' standard had earned its retirement and that plaintiffs must now plead a plausible claim for relief in order to state a claim under Federal Rule 8.<sup>6</sup> These decisions provide compelling support for the proposition that, in order to state a plausi-

ble claim for relief and survive dismissal in federal court, a complaint must plead facts that, if true, are sufficient to rebut the presumptions of the business judgment rule.

This paper examines the development of Federal Rule 8, as interpreted by the Supreme Court, and its effect on the application of the business judgment rule at the motion-to-dismiss stage in federal court. The authors submit that, based on the Court's decisions in *Twombly* and *Iqbal*, the traditional analysis of the business judgment rule under *Conley's* 'no set of facts' standard is no longer viable. In other words, Federal Rule 8 should no longer provide cover for plaintiffs seeking to avoid application of the business judgment rule at the motion-to-dismiss stage.

#### **APPLICATION OF THE BUSINESS JUDGMENT RULE BY FEDERAL COURTS BEFORE *TWOMBLY* AND *IQBAL***

Even before *Twombly* and *Iqbal* changed the pleading standard, some federal courts considered the business judgment rule at the motion-to-dismiss stage. See, for example, *Fleet Nat'l Bank v. Boyle*, No. Civ.A. 04CV1277LDD, 2005 WL 2455673, at \*16 (E.D. Pa. 12th Sept., 2005) (dismissing claims in part based on failure to overcome presumptions of the business judgment rule); see also *Lippe v. Bairnco Corp.*, 230 B.R. 906, 917 & n. 6 (SDNY 1999) (applying business judgment rule at Rule 12(b)(6) stage to dismiss claims).

Most federal courts, however, declined to apply the business judgment rule at the motion-to-dismiss stage prior to *Twombly* and *Iqbal*. The Third Circuit's decision in *In re Tower Air, Inc.*, 416 F.3d 229 (3d Cir. 2005) is cited frequently for the proposition that the business judgment rule should not be considered at the pleading stage. In *Tower Air*, the bankruptcy trustee

for a defunct international charter airline — Tower Air, Inc. — sued the company's former directors and officers for grossly mismanaging the company, wasting corporate assets, and breaching their fiduciary duties of loyalty, good faith, and due care. These allegations focused on the defendants' alleged failure to act in good faith by declining to repair engines in the company's planes, approval of certain business strategies without proper consideration, and failure to keep themselves adequately informed regarding various operational problems.<sup>7</sup>

The district court granted the defendants' motion to dismiss because the trustee failed to plead any basis for overcoming the protections of the business judgment rule. The district court held that, although 'the directors may, indeed, have exercised poor business judgment in borrowing and authorising the purchase and lease of new jet engines, the facts that Plaintiff alleges, taken in the light most favorable to the Plaintiff, do not constitute such egregiously bad decisions as to abrogate the business judgment rule'.<sup>8</sup> The district court cited Delaware law to support its holding that the trustee was required to rebut the business judgment rule in his complaint.<sup>9</sup>

On appeal, the issue was whether the district court had applied a more onerous pleading standard than is required under Federal Rule 8. The Third Circuit held that the district court had applied a Delaware Rule 8 pleading standard rather than the Federal Rule 8 standard and reversed most of the district court's dismissal.<sup>10</sup>

Although the language of Delaware Rule 8 mirrors Federal Rule 8, the Third Circuit in *Tower Air* held that Delaware courts 'interpret Delaware Rule 8 to require pleading facts with specificity'.<sup>11</sup> This Delaware version of notice pleading, according to the Third Circuit, 'bears scant

resemblance to the federal species'.<sup>12</sup> Rather than requiring any factual specificity, the federal standard required — under *Conley v. Gibson* — a defendant to demonstrate 'beyond doubt that the plaintiff can prove no set of facts in support of his claims[s] which would entitle him to relief'.<sup>13</sup>

The Third Circuit noted it had 'recently rejected an appellee's argument that a complaint "lacked sufficient factual support" with the terse declaration that "a plaintiff need not plead facts"'.<sup>14</sup> The court held, therefore, that by assuming Delaware notice pleading law was interchangeable with federal notice pleading law, the district court had erroneously preempted discovery on the trustee's claims by imposing a heightened pleading standard not required by Federal Rule 8.<sup>15</sup>

The Third Circuit also held that the business judgment rule is an affirmative defense that ordinarily cannot be considered in ruling on a Rule 12(b)(6) motion.<sup>16</sup> The trustee's complaint, however, specifically declared that the business judgment rule did not bar his claims. In other words, the words 'business judgment rule' appeared on the face of the complaint. Thus, the court held that the complaint was required to overcome the presumptions created by the business judgment rule because the defense was mentioned in the complaint.<sup>17</sup>

Despite its consideration of the business judgment rule, the court reversed the district court's dismissal of four of the five counts in the trustee's complaint, holding that the trustee had stated enough to avoid dismissal under Federal Rule 8. The Third Circuit's holding regarding the circumstances in which the business judgment rule may be considered at the Rule 12(b)(6) stage typifies the view held by most federal courts prior to *Twombly* and *Iqbal*. Accordingly, some federal decisions have rejected arguments made by corpor-

ate directors and officers that the business judgment rule should be considered at the motion-to-dismiss stage.<sup>18</sup>

Even prior to *Twombly* and *Iqbal*, however, there was reason to question the Third Circuit's holding in *Tower Air*. In *IT Group Inc. v. D'Aniello (In re IT Group Inc.)*, District Court Judge Jordan from the District of Delaware — the same Judge who authored the district court decision that was reversed in *Tower Air* — did just that.<sup>19</sup> Just as he had in *Tower Air*, Judge Jordan held in *IT Group* that the breach of fiduciary duty claims lacked well-pled allegations.<sup>20</sup> The court, however, held that it was bound to hold the complaint's allegations to be sufficient in light of the Third Circuit's *Tower Air* decision because the complaint put the defendants on notice generally regarding the nature of the claims against them.<sup>21</sup>

Despite its holding, the court in *IT Group* added a long footnote disagreeing with the reasoning of the Third Circuit in *Tower Air*. First, although acknowledging that Supreme Court precedent requires that federal courts apply federal rules of procedure,<sup>22</sup> the court held that Delaware Rule 8's requirement that a plaintiff plead around the business judgment rule was a matter of substance, not procedure.<sup>23</sup> The court reasoned that 'the pleading requirements shape the substance of fiduciary duty claims by enforcing the business judgment rule'.<sup>24</sup> The court pointed to Delaware case law stating that the business judgment rule operated both as a procedural and a substantive rule of law.<sup>25</sup> Moreover, the court held that the business judgment rule is designed to prevent courts from 'injecting themselves into a management role for which they were neither trained nor competent'.<sup>26</sup> The court concluded that requiring a plaintiff to plead facts raising a rational inference that he can rebut the business judgment rule represents 'an entirely deliberate deci-

sion of substantive Delaware law, not a procedural peccadillo'.<sup>27</sup>

The *IT Group* court's conclusion is supported by the business judgment rule's purpose as a doctrine of abstention.<sup>28</sup> In order to fulfill the purposes of the business judgment rule, the doctrine must be able to operate at all stages of litigation. Delaware's pleading requirements exist to ensure that directors and officers are not subject to onerous litigation merely because a plaintiff can artfully avoid reference to the business judgment rule in his complaint.<sup>29</sup> In this sense, Delaware's standards may be viewed as having a substantive impact. The Third Circuit's holding in *Tower Air*, however, permits federal courts to determine in a vacuum whether conduct alleged in a complaint constitutes a breach of fiduciary duty without first determining whether such a review is permissible — *viz.*, whether there are any facts pleaded to indicate the defendants acted in bad faith or were uninformed. By ignoring the business judgment rule at the pleading stage, federal courts give plaintiffs 'a powerful and perverse incentive to "dummy-up" about the obvious implications of the business judgment rule when drafting their complaints in the first instance'.<sup>30</sup>

### **TWOMBLY AND IQBAL: A PARADIGM SHIFT IN FEDERAL NOTICE PLEADING**

The question of whether Delaware's pleading requirements for the business judgment rule are procedural or substantive may now be academic. As demonstrated above, the *Conley v. Gibson* standard for federal notice pleading placed the onus on the reviewing court to determine whether it was 'beyond doubt that the plaintiff can prove no set of facts in support of his claim that would entitle him to relief'.<sup>31</sup> Defenses, such as the business

judgment rule, were not part of the court's review unless they were plainly applicable based on the complaint's allegations.<sup>32</sup> Until recently, this standard stood in stark contrast to Delaware Rule 8, which requires that plaintiffs 'must sufficiently plead facts, which if true would take defendants' actions outside the protection afforded by the business judgment rule'.<sup>33</sup>

It is widely recognized that the Supreme Court's decisions in *Twombly* and *Iqbal*, however, have altered the landscape of federal notice pleading.<sup>34</sup> The Supreme Court's decisions in *Twombly* and *Iqbal* provide support for the conclusion that a plaintiff in federal court must now plead sufficient facts that, if true, overcome the presumptions of the business judgment rule.

The death knell for the 'no set of facts' pleading standard came in 2007, when the Supreme Court decided *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007). The case involved claims brought by a putative class of subscribers of local and/or high-speed internet services against Bell Atlantic and other telephone companies under Section 1 of the Sherman Act.<sup>35</sup> The complaint alleged that the companies had conspired to restrain trade by taking actions to inhibit upstart telephone companies and by agreeing not to compete with one another.<sup>36</sup>

The US District Court for the Southern District of New York dismissed the complaint for failure to state a claim.<sup>37</sup> The district court held that 'parallel business conduct, taken alone, does not state a claim under § 1; plaintiffs must allege additional facts that "ten[d] to exclude independent self-interested conduct as an explanation for defendants' parallel behaviour".<sup>38</sup> The Second Circuit Court of Appeals, however, reversed the district court, holding that it had applied the wrong pleading standard under Rule 8.<sup>39</sup> The court held that 'to rule that allega-

tions of parallel anticompetitive conduct fail to support a plausible conspiracy claim, a court would have to conclude that there is no set of facts that would permit a plaintiff to demonstrate that the particular parallelism asserted was the product of collusion rather than coincidence'.<sup>40</sup> The Supreme Court granted certiorari 'to address the proper standard for pleading an antitrust conspiracy through allegations of parallel conduct'.<sup>41</sup>

The ground-breaking portion of the Court's decision came in its discussion of the pleading standard under Federal Rule 8. The Court held that, in order to survive dismissal, a complaint must state plausible grounds for relief by pleading 'enough fact[s] to raise a reasonable expectation that discovery will reveal evidence' in support of its claims.<sup>42</sup> The Court explained the need for this new plausibility standard based on the practical realities of modern litigation. The Court noted that, under the *Conley* standard, 'a plaintiff with a largely groundless claim [may] be allowed to take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value'.<sup>43</sup>

A plausibility standard, in the Court's view, would prevent plaintiffs from obfuscating baseless claims in their complaints intentionally in order to survive dismissal and receive nuisance-value settlements. The Court also rejected the proposition that groundless claims could 'be weeded out early in the discovery process through "careful case management"' because district courts have not monitored discovery adequately.<sup>44</sup> Summary judgment is similarly not a viable alternative because 'the threat of discovery expense will push cost-conscious defendants to settle even anaemic cases before reaching those proceedings'.<sup>45</sup>

The Court determined that '*Conley's* no set of facts language has been questioned,

criticised, and explained away long enough'.<sup>46</sup> Accordingly, the Court held that 'after puzzling the profession for 50 years, this famous observation has earned its retirement'.<sup>47</sup> The decision in *Twombly* marks a shift from a 'conceivability' federal notice pleading standard to a 'plausibility' standard.<sup>48</sup> Under this standard, the Court reversed the Second Circuit, holding that the complaint failed to state a claim because 'plaintiffs ... ha[d] not nudged their claims across the line from conceivable to plausible'.<sup>49</sup>

Two years later, the Supreme Court expounded upon the plausibility standard in *Ashcroft v. Iqbal*, 129 S. Ct. 1937 (2009). The *Iqbal* decision is important in a number of respects, especially regarding the relationship between federal pleading standards and the business judgment rule. The Court removed any doubt that *Twombly*'s holding was limited to antitrust suits because the plausibility standard announced in *Twombly* was interpreting Federal Rule 8, which is applicable to 'all civil actions' filed in federal court.<sup>50</sup>

The *Iqbal* case originated with a *Bivens* action filed by a Muslim-Pakistani plaintiff in the wake of the terrorist attacks on September 11, 2001 for an alleged deprivation of his constitutional rights by federal law enforcement personnel.<sup>51</sup> The defendants 'raised the defense of qualified immunity and moved to dismiss the suit'.<sup>52</sup> The district court denied the motion to dismiss, and the Second Circuit affirmed.<sup>53</sup> The issue before the Supreme Court was whether the plaintiff 'plead[ed] factual matter that, if taken as true, states a claim that petitioners deprived him of his clearly established constitutional rights' — *viz.*, whether the plaintiff's complaint stated facts that, if true, were sufficient to overcome the qualified immunity defence.<sup>54</sup>

The Court in *Iqbal* provided a clear, two-step process for courts to employ in making

a plausibility determination under *Twombly*. First, the court must accept as true all factual allegations in the complaint.<sup>55</sup> The court reiterated, however, that 'the tenet that a court must accept as true all of the allegations contained in a complaint is inapplicable to legal conclusions'.<sup>56</sup> Secondly, having accepted only the well-pleaded factual allegations as true, the court must determine whether the complaint 'states a plausible claim for relief'.<sup>57</sup> The Court held that '[d]etermining whether a complaint states a plausible claim for relief will ... be a context-specific task that requires the reviewing court to draw on its judicial experience and common sense'.<sup>58</sup> Using this framework, the Court determined that the plaintiff's complaint had not 'nudged [his] claims ... across the line from conceivable to plausible'.<sup>59</sup>

The Court's holding in *Iqbal* supports the notion that plaintiffs must rebut the presumptions of the business judgment rule in order to survive dismissal. The business judgment rule precludes courts from reviewing the conduct of corporate directors and officers unless a plaintiff first overcomes the presumptions that such actions were taken on an informed basis, in good faith, and in the honest belief that their actions were taken in the best interests of the company.<sup>60</sup> It is impossible to determine whether, as required by *Twombly* and *Iqbal*, there is a 'reasonable inference that the defendant is liable for the misconduct alleged' without considering whether those presumptions may be rebutted under the facts alleged in the complaint.<sup>61</sup> If there are no well-pleaded facts to rebut the presumptions of the business judgment rule, there can be no plausible claim for liability. Refusal to consider this ubiquitous doctrine, therefore, runs contrary to the requirement set forth in *Iqbal* that a reviewing court look to the context of the particular claims at issue and use its experience and common

sense to determine whether a claim is plausible.<sup>62</sup>

The Court's decision in *Iqbal* also clarified that the business judgment rule's status as a defense will not prevent its applicability at the pleading stage. *Iqbal* turned on the Court's consideration of the defense of qualified immunity. Many parallels can be drawn between qualified immunity and the business judgment rule. Both doctrines are so enconced with their corresponding causes of action that they must be considered in conjunction with the substantive elements of liability. Each of these doctrines serves not only as 'a defense not only from liability, but also from suit'.<sup>63</sup> Just as a governmental officer's discretionary actions cannot be reviewed unless the plaintiff overcomes the qualified immunity defence, the actions of a corporate director or officer are protected until the business judgment rule has been rebutted.

### THE BUSINESS JUDGMENT RULE AFTER *TWOMBLY* AND *IQBAL*

The weight of the federal authority decided post-*Twombly* and *Iqbal* supports the conclusion that the pleading standard can be satisfied only if the plaintiff pleads facts that rebut the business judgment rule's presumptions plausibly.<sup>64</sup> As one district court held recently:

'In asserting breach of fiduciary duty claims, it should have been obvious to the Trustee that the business judgment rule would be implicated. For that reason, the Trustee was required to plead that he can overcome the presumption created by the business judgment rule in order to survive a motion to dismiss under FRCP 12(b)(6).'<sup>65</sup>

The federal pleading standard is now consistent with the pleading standard under Delaware Rule 8. Indeed, after the

Supreme Court decided *Twombly*, one Delaware court observed that 'our nation's high court has now embraced the pleading principle that Delaware courts have long applied, which is that a complaint must plead enough facts to plausibly suggest that the plaintiff will ultimately be entitled to the relief she seeks.'<sup>66</sup>

### CONCLUSION

After *Twombly* and *Iqbal*, federal courts are still in the process of determining the proper application of federal pleading standards to the business judgment rule. Recent authority recognises that the business judgment rule should be considered at the motion-to-dismiss stage. The Federal Rule 8 construction in *Twombly* and *Iqbal*, like the Delaware standard, now prevents courts from 'injecting themselves into a management role' where a complaint does not rebut the business judgment rule plausibly.<sup>67</sup>

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- (2) Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 87 (2004).
- (3) *Aronson*, 473 A.2d at 812.
- (4) See *In re J.P. Morgan Chase & Co. S'holder Litig.*, 906 A.2d 808, 824 (Del. Ch. 2005) (citing *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 286 (Del. Ch. 2003)).
- (5) See *Stanziale v. Nachtomi (In re Tower Air, Inc.)*, 416 F.3d 229 (3d Cir. 2005); *Shamrock Holdings v. Arensen*, 456 F. Supp. 2d 599, 609 (D. Del. 2006); *FDIC v. Stahl*, 840 F. Supp. 124, 128 (S.D. Fla. 1993).
- (6) *Twombly*, 550 US at 555.
- (7) *Ibid* at 233-234.
- (8) *Stanziale v. Nachtomi (In re Tower Air, Inc.)*,

- 330 B.R. 56, 61 (D. Del. 2004) (Jordan, J.).
- (9) *Ibid* at 60–61.
- (10) *Tower Air*, 416 F.3d at 236.
- (11) *Ibid*. See *Grobow v. Perot*, 539 A.2d 180, 188 n. 6 (Del. 1988); see also *In re Tri-Star Pictures, Inc., Litig.*, 634 A.2d 319, 326 (Del. 1993); *Crescent/Mach I Partners L.P. v. Turner*, 846 A.2d 963, 984 (Del. Ch. 2000).
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- (19) No. 02–10118, 2005 WL 3050611 (D. Del. 15th November, 2005).
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- (21) *Ibid* (“Thus, while I seriously doubt that the conclusory allegations of control in the Complaint would survive a 12(b)(6) motion in the Delaware Court of Chancery, they do put Defendants on notice that the claim here is based on the Carlyle Defendants’ actual control of the IT Group and the lack of independence of the directors concerning payments to this controlling group.”).
- (22) *Ibid* at \*8 n.10 (citing *Hanna v. Plumer*, 380 U.S. 460 (1965)).
- (23) *Ibid*.
- (24) *Ibid*.
- (25) See *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 64 (Del.1989) (“The [business judgment] rule operates as both a procedural guide for litigants and a substantive rule of law.”).
- (26) *IT Group*, 2005 WL 3050611, at \*8 n.10 (quoting *Weiss v. Temporary Inv. Fund*, 692 F.2d 928, 941 (3d Cir. 1982)).
- (27) *Ibid*.
- (28) See Bainbridge, at ref. 2 above, at 87.
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- (42) *Ibid* at 556.
- (43) *Ibid* at 558 (quoting *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 347 (2005)).

- (internal quotation marks omitted)).
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