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CORPORATE LAW SYMPOSIUM

THE DUTY OF CARE, COMPENSATION, AND STOCK OWNERSHIP*

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In the United States today, many corporate executives are paid much more than their performance seems to justify.¹ The public fury generated by the popular perception of this fact has increasingly dominated the nation's legislative, political, and financial agendas.² In light

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1. The following Article draws from and expands upon an earlier work that examines the executive compensation controversy in substantial detail. See Charles M. Elson, Executive Overcompensation — A Board-Based Solution, 34 B.C. L. REV. 937 (1993). The prior article explored the history of the compensation problem and critiqued as either ineffective or harmful to corporate well-being the solutions offered by other commentators, including heightened disclosure, tax-based remedies, judicial involvement, institutional shareholder activism, strengthened board compensation committees, and a market-based approach. It suggested that the solution to the controversy rested in substantial stock ownership on the part of corporate outside directors and presented an empirical study to support its conclusion.

2. The recent legislative and political attention that has been directed toward the executive compensation issue is best evidenced by the 1993 tax bill proposed by President Clinton and approved by Congress. Omnibus Revenue Reconciliation Bill of 1993, H.R. 2264, 103d Cong., 1st Sess. (1993). The legislation imposed a 10% surtax on any annual salary in excess of $250,000 and prohibited publicly held corporations from deducting executive compensation in excess of $1 million per annum unrelated to performance. Id.; see also The FOB Loophole, WALL ST. J., Oct. 1, 1993, at A16 (questioning the disparate impact of the tax bill on Hollywood celebrities and chief executives). Promoting passage of the legislation, President Clinton stated that "the tax code should no longer subsidize excessive pay of chief executives and other high executives." David E. Rosenbaum, Business Leaders Urged by Clinton to Back Tax Plan, N.Y. TIMES, Feb. 12, 1993, at A1; see also Charles M. Elson, A Board-Based Solution to Overpaid CEOs, WALL ST. J., Sept. 27, 1993, at A22 (suggesting that stock ownership by directors is a key in the overcompensation controversy) [hereinafter Elson, A Board-Based Solution]. However, attacks on excessive executive compensation have not come exclusively from the President and members of his political party. As a political cause, the excessiveness of executive salaries has cut across party lines. During the 1992 campaign season, Republican Vice-President Dan Quayle joined then-presidential candidate Bill Clinton in criticizing the high salaries received by some of the nation's corporate executives. Jeffrey H. Birnbaum, From Quayle to Clinton, Politicians Are Pouncing on the Hot Issue of Top Executives' Hefty Salaries, WALL ST. J., Jan. 15, 1992, at A14.

The Securities and Exchange Commission (SEC) has also directed its attention toward the public outcry over excessive executive compensation by implementing regulations requiring heightened disclosure of corporate executive compensation practices. Executive Disclosure, Ex-
of this problem, we must consider whether some sort of legal response is necessary and, if so, what form it should take. Unfortunately, the problem of executive overcompensation is not an isolated and particularized corporate malady, but is merely one manifestation of a much larger, more generalized problem affecting our entire system of corporate governance. The solution requires a fundamental reexamination of the way in which our law regulates corporate conduct—more specifically, the present legal structure of the corporate director's fiduciary duty of care.

In many of America's leading corporations, management is supervised by a board of directors largely appointed by management. This


3. See ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 184, 193 (1994). Although director candidates are recommended to the board by the nominating committee, "the CEO plays an important, even dominant role in the selection of director candidates." Id. at 193. Furthermore, Monks and Minow noted that a 1991 study found that 82% of board
situation, in which board members owe their positions to executive largesse, creates an environment in which corporate directors have little incentive to monitor management, but great reason to acquiesce to any management initiative. This problem, more commonly referred to as "management capture," is the real cause of the overcompensation problem. Excessive compensation results when passive boards beholden to management agree to salary packages on demand in the absence of spirited negotiation. Thus, any solution to the executive overcompensation controversy must first address the problem of the passive board.

How can we motivate a board, compositionally suited to passivity, to become an active monitor of management? Traditionally, we have attempted to compel effective board behavior through the imposition of a legal duty of care, violation of which led to personal liability on the part of an offending director. The Delaware Supreme Court attempted to bolster compliance with this duty in its landmark Smith v. Van Gorkom decision, which resulted in the creation of certain guidelines to decisionmaking that a board must follow to avail itself of the protection of the business judgment rule to avoid liability for a duty-of-care violation. As will be discussed, this decision has not lessened, but has in some respects created a costlier form of, board passivity. It was a triumph of form over function. The solution to the problem of the passive board lies not in using the threat of legal liability to force compliance with some theoretical standard of care, but in creating an environment where a board finds it in its own self-interest to engage in active oversight.

Some reform in board structure is warranted to create better board-level review of executive compensation and to promote more effective management monitoring. The outside directors must be made to consider management initiatives, not from the perspective of one engaged by and beholden to management, but from the viewpoint of the stockholders.

vacancies were filled as a result of recommendations by the CEO. Id.

"[I]n life as in the law the power to hire implies the power to fire. A director who has been brought on board by a chief executive—as outside directors typically are—is therefore likely to regard himself as the latter’s sufferance." Id. at 147; see also Myles L. Mace, Directors: Myth and Reality 72–73 (1986) (discussing the powers of control in a corporation); Robert A.G. Monks & Nell Minow, Power and Accountability 73–79 (1991) (opining that directors are often captive because "they are selected by management, paid by management, and ... informed by management").

5. 488 A.2d 858 (Del. 1985). In Van Gorkom, the Delaware Supreme Court held that the directors of Trans Union Corporation breached their fiduciary duty of care when they approved a merger without making an "informed" decision on the fairness of the offered price. Id. at 874. For a detailed examination of Van Gorkom and a discussion of the director's duty of care, see infra notes 48–84 and accompanying text.
holders to whom they are legally responsible. The best way to create this perspective is to appeal directly to these directors' pecuniary interests. To ensure that they will examine a management proposal in the best interests of the stockholders, we must make them stockholders as well. Corporations should pay their directors' annual fees in company stock that is restricted as to resale during the directors' terms in office. In a few years, each director will have accumulated a reasonably substantial portfolio and will, therefore, possess a powerful financial incentive to act more independently of management. Additionally, directors' term lengths must be significantly expanded. This would ensure that their equity positions will reach the level necessary to influence their decisionmaking; by stretching out the time between elections, the chilling effect of a management threat not to renominate the director to the board is mitigated.

For an equity-based approach to the problem of board passivity to be effective, it must first be demonstrated that equity ownership has a salutary effect on outside director behavior—that board members who own substantial amounts of company stock are, in fact, more effective monitors of corporate performance. Recently, two independent business

6. The salutary effects of directors' ownership of a substantial amount of stock have been well documented. See, e.g., MACE, supra note 4, at 61–65 (noting that outside directors who own substantial amounts of stock in their companies are more likely to ask discerning questions than their nonstockholding counterparts); Charles M. Elson, Board Pay Affects Executive Pay, CORP. BOARD, Mar.-Apr. 1994, at 7–11 (stating that directors with substantial equity in companies are more inclined to keep pay tied to performance); James J. Fitzsimmons, A Better Approach to Director Pay, DIRECTORS & BOARDS, Spring 1992, at 48, 49–50 (concluding that directors paid in stock are more closely aligned with shareholders and in a better position to ensure that management is paid based upon performance); Edmund W. Littlefield, A Stake with Restricted Stock, DIRECTORS & BOARDS, Spring 1985, at 51, 52 (stating that "[p]laying directors in meaningful amounts of restricted stock gives them a common stake with the shareholders"); Joann S. Lublin, Director's Cut, WALL ST. J., Apr. 13, 1994, at R5 (stating that companies are increasingly turning to stock options as compensation for outside directors); David J. McLaughlin, The Director's Stake in the Enterprise, DIRECTORS & BOARDS, Winter 1994, at 53–59 (studying the relationship between outside director stock ownership and corporate performance); Pearl Meyer, The Rise of the Outside Director as an Equity Owner, DIRECTORS & BOARDS, Spring 1986, at 41 (observing that, historically, directors owned a large amount of stock and that they may be returning to this compensation scheme); Robert Stobaugh, Director Compensation: A Lever to Improve Corporate Governance, DIRECTOR'S MONTHLY, Aug. 1993, at 1–4 (comparing the performance of companies with a high degree of stock ownership by its directors with companies whose directors' stockholdings are relatively small). See generally Elson, supra note 1, at 981–96 (stating that the key to independent and dutiful outside directors is not simply stock ownership, but substantial stock ownership).

7. For instance, some commentators have called for fixed five-year terms that would help to establish a corporate "long-term view" and benefit corporate "vitality." Martin Lipton & Steven A. Rosenblum, A New System of Corporate Governance: The Quinquennial Election of Directors, 58 U. CHI. L. REV. 187, 216 (1991); see also Elson, supra note 1, at 983–87 (discussing the benefits of combining quinquennial elections and an increase in directors' stockholdings).
researchers conducted empirical studies of the relationship between outside director stock ownership and corporate performance. They found that companies with substantial outside director equity ownership tended to outperform companies whose directors had insubstantial holdings. Expanding on this research, I conducted a broader study that yielded similar results. I found that companies with boards composed of outside directors with significant shareholdings tend to be considered better managed and to outperform those companies without such equity-holding boards. Those companies that are viewed as being poorly managed had fewer outside directors with significant holdings in the business. On the other hand, those businesses viewed as being well-managed tended to have a greater number of outside directors with significant equity holdings. An alignment of the directors' interests with those of the shareholders, rather than with those of management, through the development of substantial equity holdings that result in more effective management oversight would explain this phenomenon. Despite vigorous judicial enforcement of the duty of care exemplified by the Van Gorkom ruling, the passive, management-captured board has flourished, bringing in its wake executive overcompensation and poor overall corporate performance. Because of this apparent link between effective oversight and equity ownership, an equity-based approach to the problem of the passive board appears to be highly desirable and, as this Article argues, is the most effective

8. The first of these studies was conducted by Professor Robert Stobaugh of the Harvard Business School. See Stobaugh, supra note 6, at 1—4. Stobaugh found that compensating directors in stock resulted in improved corporate performance. Id. at 4. The study examined and compared investors' returns from two groups of corporations. The first group was comprised of nine companies that "were corporate governance 'targets' of at least three shareholder groups," and the second group consisted of the nine highest ranked companies on the Fortune list of "most admired companies." Id. at 2. Professor Stobaugh discovered that the average stockholding of directors at the "most admired" companies was much greater than that of the directors at the poorly performing companies. Id. As a result of his study, Stobaugh concluded that there was an apparent correlation between corporate performance and stockholding by members of the board of directors. Id. at 2—3. Consequently, he recommended paying half of a director's annual compensation in company stock until "stock ownership by corporate directors ... increased to a level at which the value of the director's stock ownership is perhaps ten times the director's annual compensation." Id. at 4.

David J. McLaughlin, the president of a Connecticut management consulting firm, conducted the second of these studies. See McLaughlin, supra note 6, at 53—59. McLaughlin's study examined the stock holdings of outside directors at 70 companies, comparing the performance of companies with a high degree of director stock ownership to those with a low degree of director stock ownership. Id. at 54. The study found that the companies with the highest degree of director stock ownership "delivered a return of 174% to their shareholders over five years from 1988 to 1992, while those with the lowest delivered only a 73% return." Id. For further discussion of the Stobaugh and McLaughlin studies, see infra notes 105—14 and accompanying text.
solution.

Part I of this Article considers the problem of executive overcompensation and its root cause—inequitable bargaining resulting from passive boards. Part II examines the corporate director’s fiduciary duty of care, which has been the traditional route the law has taken to counteract board inactivity and its consequent dilatoriness effect on corporate well-being. Subsequent judicial application of this duty—most notably the Delaware court’s decision in *Smith v. Van Gorkom*—although seeking to compel active board monitoring, instead has had the opposite effect and has compounded the passivity problem. The duty-of-care standard need not be abandoned, but judicial attempts to compel adherence through compliance with rigidly prescribed board procedure are ineffective and should be reconsidered. Part III focuses on stock ownership and lengthened board terms as an alternative and preferred approach to preventing board passivity and encouraging active oversight. This Section examines the link between substantial equity holdings by directors and more effective corporate performance and argues that companies should create such holdings in their outside directors. In this light, the facts of *Van Gorkom*, most notably the stockholdings of the outside members of the defendant Trans Union Board, are reexamined to lend support to this equity-based proposal. A director equity-ownership program should create more reasonable executive compensation practices and, of greater importance, a more effective and competitive corporation.

I. THE OVERCOMPENSATION CRISIS AND ITS CAUSE

Excessive compensation results when individuals are paid more for their labor than is warranted in return for services rendered. To determine what part of one’s pay is deserved and what part is not, we must first determine the precise value of one’s services. Unfortunately, this is not an easy task; for what is the true value of the deployment of human capital? Although human effort is in one sense easily quantifiable, limited to the physical capacity of the worker and the time limitation of the twenty-four-hour day, human capital is highly differentiated. The tasks required to maintain a complex economy are incredibly varied and require vastly different skills. Some skills are valued more highly by society and are compensated at higher levels. What those levels may be is determined through the routine function of the market.

9. 488 A.2d 858 (Del. 1985). It is interesting to note that the defendant Trans Union directors held little equity in the company. For a detailed examination of this point and its implications for the duty of care, see infra notes 128–30 and accompanying text.
How much individuals are compensated for their labor is the result of an implicit or explicit bargaining process. One party has labor to offer, and another has a need for the skill. The resulting compensation is the product of the matching of expectations—what one expects to receive and what the other is willing to give. These expectations, created through ordinary market function, determine compensation levels. What others are giving or receiving for similar tasks produces the expectations that determine particular compensation levels for particular skills. The value of a particular skill is not implicit in the skill itself, but is simply the result of this bargaining process. In this regard, there is really no such thing as an implicitly “fair” salary, only one that is acceptable to both parties.

Reasonableness is the product of the bargain. If one is voluntarily willing to part with a large amount of capital, say one million dollars, to obtain a particular service, then one million dollars is the value of that service. The compensation is thus reasonable. Compensation becomes unreasonable when it is not the product of balanced bargaining. Excessive compensation results when one party to a bargain, due to external pressures, is unable or unwilling to bargain effectively to maximize self-interest. This is the crux of the overcompensation controversy.

In the corporate setting, executive overcompensation results when there is a failure in bargaining between the executive and the corporation. The executive possesses managerial skills that the corporation desires. The corporation possesses capital that the executive desires in exchange for services rendered. How much capital will be given for these services is the result of bargaining. The resulting salary may be problematic where effective bargaining does not take place because one party does not attempt to maximize its own self-interest. An executive salary arrangement is the product of negotiation between the executive and the company’s board of directors, which represents the interests of the company and its owners, the shareholders. If the board is reluctant to bargain effectively with management because, despite its fiduciary obligations, it finds itself more closely aligned with management than with the shareholders, then the product of such a “bargain” may be no bargain at all to the corporation and its owners. Alliances between bargaining parties may result in acquiescence rather than a bargained-for agreement. A salary arrangement resulting from such one-sided, passive bargaining is potentially excessive.

Although today many focus simply on large executive salaries as proof in and of themselves of an overcompensation problem, the real problem involves the process by which those salaries were determined,
not the dollar amount. A high salary does not, on its own, necessarily suggest that the recipient has been overcompensated. As long as the salary was the result of an active, good-faith bargaining process between the board and the executive in question, the compensation cannot be labeled unreasonable. Spirited negotiation by both parties assures proper compensation. That is the very nature of a market-based economy at work.

Compensation amounts do become problematic, however, when a board beholden to a particular executive agrees to a salary package upon demand, in the absence of self-interested bargaining. But under what circumstances would this phenomenon occur? Why would an independent board elected by the shareholders find itself blindly and passively responsive to management in compensation negotiations? The failure to negotiate an executive's compensation request is most likely to occur in those corporations where the outside directors find themselves obligated to no particular shareholder or shareholder block, but gain and maintain their board positions because of executive favor. This situation most commonly exists in large, publicly traded companies that, due to their large size and consequent atomistic shareholding patterns, are controlled by incumbent management and not by one shareholder or group of shareholders.

In such businesses, no one shareholder or shareholding group possesses enough shares to exercise control of the corporation through the election of a majority of the board. Instead, incumbent management, through control of the proxy process, fills the power vacuum and nominates its own candidates for board membership. The board of directors, theoretically composed of representatives of various shareholding groups, is instead peopled by individuals selected by management. The board is thus not representative of any one shareholder or shareholder


11. As of December 31, 1974, management controlled 165 of the 200 largest publicly owned nonfinancial corporations in the United States. Edward S. Herman, Corporate Control. Corporate Power 58 (1981). "[W]ide diffusion of stock does not increase the power of holders of small blocks of stock; it enhances the power of whoever controls the proxy machinery." Id. at 53. "[E]xecutive leadership is becoming more indispensable than ever. Only the executive can mediate among the multitude of constituencies vying to influence every corporation." Thomas A. Stewart, The King Is Dead, Fortune, Jan. 11, 1993, at 35, quoted in Monks & Minow, supra note 3, at 193; see also Mace, supra note 4, at 83—84.

12. In testimony before a United States House subcommittee, Dale Hanson, CEO of California's Public Employee Retirement System, stated that "[n]ominating committees all too often are sham, pure and simple." Monks & Minow, supra note 3, at 193. Monks and Minow note that a 1991 study showed that 82% of board vacancies were filled pursuant to recommendations from the chairman, who in the vast majority of instances also serves as the CEO. Id.
group, but is instead responsive to the leading officers of the corporation. This phenomenon may be described as the "captured board" syndrome.\(^{18}\) The directors on a captured board, responsible for oversight, are generally the officers themselves, individuals performing various professional services for the corporation such as lawyers and investment bankers, and, finally, those with no real professional attachment to the enterprise other than board membership.\(^{14}\) The first two groups, because of their employment or financial relationship to management, may find it difficult to exercise independent oversight. The third group will rarely challenge management prerogative either, although there have been recent exceptions.\(^{18}\) Such board members are usually se-

13. See Eisenberg, supra note 4, at 139–48; see also Stephen M. Bainbridge, Independent Directors and the ALI Corporate Governance Project, 61 Geo. Wash. L. Rev. 1034, 1058, 1058 n.127 (1993) (examining the shirking of the duty to monitor management by "independent" directors who, because of composition and constraints on time and information, simply "rubberstamp" management decisions); Ronald J. Gilson & Reinier Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, 43 Stan. L. Rev. 863, 873–76 (1991) ("All too often . . . outside directors . . . turn out to be more independent of shareholders than they are of management.").

14. The first two groups of directors—the corporate officers and those who perform services for the corporation—are respectively known as "inside" directors and inside "outside" directors. Alternatively, those directors with no connection to the corporation other than board membership are known as "outside" directors. See Avery S. Cohen, The Outside Director—Selection, Responsibilities, and Contribution to the Public Corporation, 34 Wash. & Lee L. Rev. 837, 837 (1977) (classifying directors as "inside directors," "non-independent outside directors," and "independent outside directors"); see also William L. Cary & Melvin A. Eisenberg, Cases and Materials on Corporations 156–57 (concise 6th ed. 1988) (noting that inside directors and outside directors who perform services for the corporation are unable to exercise independent oversight because they have strong professional and economic ties to the corporation and are therefore likely to acquiesce to the decisions of the chief executive); Bainbridge, supra note 13, at 1059 (questioning the independence of outside directors); CEO Pay: How Much Is Enough?, supra note 2, at 130, 131 (comments of Ralph V. Whitworth, proposing that if one wants truly independent directors then the question should be how they obtained their position on the board and not whether they worked for the corporation). But see American Law Institute, Principles of Corporate Governance: Analysis and Recommendations § 1.34 (1994) [hereinafter ALI] (abandoning the use of labels, but stating that a director has a "significant relationship" with a corporation's senior executives when, among other things, he is employed by the corporation, a member of the immediate family of an officer, or affiliated in a professional capacity with a law firm that is the primary legal advisor to the corporation).

15. Recently, outside directors have become emboldened and have challenged management in several notable cases. For example, in October 1992, the outside directors of General Motors ousted their CEO, Robert Stempel, in response to the company's lackluster performance. See Paul Ingrassia, Board Reform Replaces the LBO, Wall St. J., Oct. 30, 1992, at A14. Similarly, James D. Robinson, III, was removed from his position as chief executive of American Express in a move orchestrated by outside directors in January 1993. Chief executives at Westinghouse and IBM met similar fates as a result of director revolts led by outside directors, many of whom were former CEOs. See Julie Amparan Lopez, CEOs Find That Closest Chums on Board Are the Ones Most Likely to Plot a Revolt, Wall St. J., Mar. 26, 1993, at B1; see also Eben Shapiro, Philip Morris CEO Resigns Under Pressure, Wall St. J., June 20, 1994, at A3.
lected either by the chairman or other senior management, and they possess extensive professional and personal ties to the officers that compromise their effectiveness as monitors. These directors are often officers of other public corporations and frequently ask their counter-

(examining the resignation of Philip Morris CEO Michael A. Miles in the wake of the company's loss of more than $30 billion in stock market value in two years and mounting criticism of his leadership from the board and institutional investors); Stewart, supra note 11, at 34 (discussing the recent firings and forced resignations of CEOs at several of the nation's largest corporations).

While these cases demonstrate a board's ability to dispose of an ineffective chief executive, some commentators argue that such board action occurs too infrequently and often only after serious damage to the corporation.

Cases like RJR-Nabisco, General Motors, and American Express, among others, show us that if the situation gets bad enough, directors will do the right thing. However, they also show us that current board structures impose substantial obstacles to doing it sooner and more consistently. For example, the financial press heralded the board of IBM for pushing out CEO John Akers in January 1993. Yet this action took place after the company had lost over $80 billion in market value in just a couple of years. Where was the board during that period?

Nell Minow & Kit Bingham, The Ideal Board, CORP. BOARD, July-Aug. 1993, at 11; see also Martin Lipton & Jay W. Lorsch, A Modest Proposal for Improved Corporate Governance, 48 Bus. Law. 59, 59 (1992) ("Directors eventually may act . . . but their actions often are late, after the shareholders have lost value, employees jobs, and the corporation its competitive market position.").

16. See supra note 4; see also Bok, supra note 2, at 98 (arguing that the selection of new directors is frequently dominated by senior executives); Cary & Eisenberg, supra note 14, at 157; Crystal, supra note 2, at 224-30 (discussing factors that lead to ineffective compensation committees); Herman, supra note 11, at 31 (discussing the "transitory" and "guestlike" nature of an outside directorship); Monks & Minow, supra note 4, at 77-79 (stating that many directors are picked, not for their business acumen, but for their "business or personal relationships" with management); Gilson & Kraakman, supra note 13, at 884 (noting that the way in which outside directors are selected leads to lack of incentive for corporate governance); Minow & Bingham, supra note 15, at 12 (comparing shareholder elections of directors to elections held by the communist party of North Korea in that management selects the candidates and counts the votes).

17. The most common selection for an outside director is the chief executive of another corporation. Jay W. Lorsch & Elizabeth MacIver, Pawns or Potentates: The Realities of America's Corporate Boards 18 (1989) (noting that "63% of all board members are CEOs of other corporations"); J. Spencer Letts, Corporate Governance: A Different Slant, 35 Bus. Law. 1505, 1515 (1980). "For a CEO, the most highly coveted boardmembers are CEOs of other companies. A startling two-thirds of all corporate directors are CEOs." CEO Pay: How Much Is Enough?, supra note 2, at 132 (comments of Ralph V. Whitworth). "One wonders, however, if the person among all who is most likely to be generally supportive of the chief executive isn't another chief executive." Letts, supra, at 1515; see also Barris, supra note 2, at 76 (discussing the lack of impartiality of outside directors). Such directors are deemed to be "outside" directors despite their close personal and professional ties to the executives of the company on whose board they sit. For a definition of "outside directors," see supra note 14. However, Martin Lipton and Jay Lorsch would "not view as independent an executive of another company on the board of which an executive of the company serves." Lipton & Lorsch, supra note 15, at 67-68. Lipton and Lorsch propose that the exclusion of these otherwise "outside" directors would lead to a more independent and active board. See id. at 68 n.32 (citing Kenneth A. Macke, The Board and Management: A New Partnership, DIRECTORSHIP, July-
parts, whom they oversee, to serve as members of their own boards.

Cross-directorships are not uncommon. While such board composition may lead to affable board gatherings, the oversight function may be severely compromised. Board passivity in regard to management monitoring is the result of this compositional structure. Consequently, the outside directors have little incentive other than fiduciary duty (which, for reasons to be discussed, has proven ineffective in creating incentive) to bargain effectively with management over compensation. Passive boards, created by management capture, are ineffective compensation negotiators.

Aug. 1992, at 8 ("The composition of the board is critical to how well it functions. We like to make sure that everything is geared toward making the board as independent and active as possible.").

18. Barris, supra note 2, at 76, 78 n.113. A recent study of 788 of the nation's largest public companies conducted by Directorship, a consulting firm located in Westport, Connecticut, found that in 39 of the companies surveyed, the leaders of those businesses served on one another's boards in a "cross-directorship" phenomenon. The study further detailed that in five of those companies, the cross-directorships involved the board's compensation committees. Alison L. Cowan, Board Room Back-Scratching?, N.Y. TIMES, June 2, 1992, at C1. The five compensation committee cross-directorships were B.F. Goodrich Co. and Kroger Co.; Conagra, Inc. and Valmont Industries, Inc.; Kellogg Co. and Upjohn Co.; Sonoco Products Co. and NationsBank Corp.; and Allergan, Inc. and Beckman Instruments, Inc. Id. In order to be truly independent, The Blue Ribbon Commission on Executive Compensation recommends that compensation committees exclude "any interlocking directorates, particularly among CEOs." Joann S. Lublin, Panel Adopts a Tough Line on CEO Pay, WALL ST. J., Feb. 10, 1993, at B1; see also HERMAN, supra note 11, at 43 (suggesting that the cross-directorships are the result of the directors trusting each other to be truly "outside" directors).


Since 63% of all outside directors on the boards of America's 1000 largest companies are chief executives of other firms, the abdication of the board of directors should be expected. Chief executives who serve as directors for companies other than their own are generous in establishing the salaries of management of those companies because the high salaries can then be used to justify large salaries from their own companies.

Id.

Similarly, Graef Crystal observed that most compensation committees are comprised of directors who serve as chief executives of other companies. CRYSTAL, supra note 2, at 227. Consequently, these executives bring an attendant bias with them to their services on the board that prohibits true arms-length bargaining over compensation. Id. Interestingly, Crystal has noted that a correlation exists between the compensation of chief executives and the compensation of director-CEOs serving on compensation committees. "[T]he higher the pay of the CEOs who sit on the compensation committee, the higher will be the pay of the CEO whose pay the committee regulates." Id.

Ralph V. Whitworth, President of the United Shareholders Association, characterizes the relationship between the CEO and his hand-picked directors as one where "[y]ou dance with who brought you." CEO Pay: How Much Is Enough?, supra note 2, at 131 (comments of Ralph V. Whitworth). Therefore, it is not surprising that "this crowd rarely argues when it comes to approving a CEO's pay." Id. at 132.
Many of the largest American public corporations have shareholding patterns that dispose them to such potential management capture and attendant compensation problems. It is these companies that have traditionally paid their executives the largest salaries and that are currently the target of popular attention. As noted earlier, a large salary is not in and of itself malignant. However, a significant executive compensation package paid by a large public corporation subject to management capture may be indicative, because of its size, of a failure by the directors to bargain effectively. Such compensation may thus be overcompensation. Because of the rapid escalation in executive compensation scales in the United States and in the large number of companies whose boards do not report to a controlling shareholder group, it is clear that a strong potential for overcompensation may exist.

20. See supra note 11. As public corporations developed and grew during the 20th century, ownership was spread "among tens of thousands of individual shareholders, none of whom could cast a meaningful vote in governance of their companies." Stewart, supra note 11, at 35 (citing ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933)). According to Berle and Means, the result of this wide diffusion of ownership was the birth of a class of professional managers who controlled the corporation while owning a de minimis amount of the company's stock. Id; see also BERLE & MEANS, supra, at 6 (discussing the results of separating ownership from management); Elmer W. Johnson, An Insider's Call for Outside Direction, HARV. BUS. REV., Mar. - Apr. 1990, at 46, 46 (stating that capitalism evolved from a "market society dominated by corporations . . . with absentee owners and professional managers"). "The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge and where many of the checks which formerly operated to limit the use of power disappear." Id.

21. See generally MONKS & MINOW, supra note 4, at 166 (explaining that in 1989, the average CEO at the nation's top 200 companies received $2.8 million in salary and bonuses); Arch Patton, Those Million Dollar-A-Year Executives, in EXECUTIVE COMPENSATION: A STRATEGIC GUIDE FOR THE 1990s, at 43, 44 (Fred K. Foulkes ed., 1991) [hereinafter A STRATEGIC GUIDE] (noting that executive pay in the 100 largest publicly owned corporations increased by an average of 13.7% in 1983); Byrne, supra note 2, at 142 (discussing the outcry over executive compensation); Executive Compensation Scoreboard, BUS. WK., May 4, 1992, at 148 - 62 (rating executive compensation among the 500 largest American companies); Carol J. Loomis, King John Wears an Uneasy Crown, FORTUNE, Jan. 11, 1993, at 44 (discussing IBM's difficulties and the potential removal of CEO John Akers); Joann S. Lublin, Higher Profits Fatten CEO Bonuses, WALL ST. J., Apr. 21, 1993, at R1 (discussing executive compensation at America's largest corporations); Joann S. Lublin, Looking Good, WALL ST. J., Apr. 13, 1994, at R1 (examining executive compensation at America's largest corporations); Kevin Maney & Michelle Osborn, Megabucks Amid Layoffs Stoke Outrage, USA TODAY, Mar. 27, 1992, at 1B (examining executive compensation packages in light of continued corporate failures); Stuart Mieher, Westinghouse's Paul E. Lego Resigns as Chief, WALL ST. J., Jan. 28, 1993, at A3 (discussing Lego's resignation in "the midst of financial troubles and pressure from directors and shareholders"); Stewart, supra note 11, at 34 (examining the removal or resignation of 13 Fortune 500 CEOs in 18 months, including chief executives at General Motors, American Express, and Time Warner).

22. In 1991, the average chief executive of a large corporation was paid approximately 104 times the average factory employee's wage. Byrne, supra note 4, at 142. In 1980, the average
therefore not surprising that the popular media have sounded an alarm. Although it is very difficult to look at a specific salary and immediately reach an informed conclusion as to its excessiveness (for how do we know with any precision what one’s services are worth?), given the great potential for ineffective, passive bargaining that the captured board presents, we cannot downplay the significance of the overcompensation controversy. Some sort of reasoned response must be developed.

But what sort of response should be forthcoming? How can we prevent corporations from overpaying their executives? The problem is not high salaries, but excessive salaries. Such is the result of ineffective negotiation between boards and executives. This lack of effective bargaining comes about through board passivity, which is the result of management capture. Passive boards do not negotiate effectively. Eliminate the board passivity created by management capture, and you will solve the compensation crisis. The solution lies not in addressing the malady’s results, overpaid executives, but in facing its root cause, board passivity. The captured, passive boards—not excessive salaries—are the real evil that must be addressed. Executive overcompensation is but a symptom, not the illness.

The core malady afflicting all too many large United States corporations today, board-based passivity, in addition to being problematic in
the compensation area, is extraordinarily detrimental to the well-being of the entire corporate enterprise. It robs the corporation and its owners, the shareholders, of the necessary independent oversight, guidance, and reasoned control vital to the health of the entity. Theoretically, under the traditional legal model, the board is responsible for the overall direction of the enterprise. It should manage the corporation’s business and set general business policy. Management is engaged to carry out that policy and operate the company on a day-to-day basis. The board is expected continually to monitor corporate performance and management effectiveness in maintaining optimal business operation and carrying out board policy. If management performs sub-

25. See CAREY & EISENBERG, supra note 14, at 154–57. The American Law Institute has established general duties for boards of directors:

   (1) Select, regularly evaluate, fix the compensation of, and, where appropriate, replace the principal senior executives;
   (2) Oversee the conduct of the corporation’s business to evaluate whether the business is being properly managed;
   (3) Review and, where appropriate, approve the corporation’s financial objectives and major corporate plans and actions;
   (4) Review and, where appropriate, approve major changes in, the determinations of other major questions of choice respecting, the appropriate auditing and accounting principles and practices to be used in the preparation of the corporation’s financial statements; [and]
   (5) Perform such other functions as are prescribed by law, or assigned to the board under a standard of the corporation.

ALI, supra note 14, at § 3.02(a); see also LORSCH & MACIVER, supra note 17, at 8–12 (examining the historical concept of the burden of proof); MONKS & MINOW, supra note 3, at 182-84 (examining the board of directors’ duties).

However, in reality, the traditional legal model of the corporation serves only as a starting point for the study of corporate structure and governance. “It has become increasingly clear that in practice the board rarely performs either the management or policymaking functions.” CAREY & EISENBERG, supra note 14, at 155. Consequently, most of the power supposedly vested in the board is actually held and exercised by management. Id. at 156.

Discussing this current view of the board’s role, Chancellor William Allen of the Delaware Court of Chancery stated:

   The conventional perception is that boards should select senior management, create incentive compensation schemes and then step back and watch the organization prosper. In addition, board members should be available to act as advisors to the CEO when called upon and they should be prepared to act during a crisis.


26. See CAREY & EISENBERG, supra note 14, at 154–57. “[T]he board of directors is the linchpin of our system of corporate governance, and the foundation for the legitimacy of actions taken by management in the name of the shareholders.” SEC Chairman Richard Breeden, Address at the Town Hall of California (June 1992), in Lipton & Lorsch, supra note 15, at 62. Actively monitoring corporate performance and management in an informed manner is foremost among the responsibilities of the board of directors.

Outside directors should function as active monitors of corporate management, not just in crisis, but continually; they should have an active role in the formulation of
standardly, the board as an effective monitor must either provide executives with new direction or replace them.

The active monitoring role of the board of directors is not only central to the traditional legal model of the corporation, but critical to ensuring the success of the enterprise. Management operates, boards monitor. When the monitoring function of the board becomes compromised for any reason, the corporation may be destined for disaster.27

The long-term strategic, financial, and organizational goals of the corporation and should approve plans to achieve these goals; they should as well engage in the periodic review of short and long-term performance according to plan and be prepared to press for correction when in their judgment there is need.

Allen, supra note 25.

27. The effects of a derelict board of directors are evidenced by the recent fortunes of corporations such as American Express, General Motors, and IBM. For instance, the recent turmoil at General Motors demonstrates the consequences of an inattentive board and the resulting benefits of more activist directors. Throughout its history, the GM Board was typically beholden to GM management, with board meetings being little more than social gatherings in which the CEO's agenda was approved. After a long, steady decline during which GM's share of the American car market dropped from 52% to 35%, the GM Board finally took affirmative steps to improve the company's performance, steps that included firing GM CEO Robert Stempel. See John Greenwald, What Went Wrong?, TIME, Nov. 9, 1992, at 42, 44; see also Kathleen Day, GM's Move Symbolizes Wider Fight, WASH. POST, Oct. 27, 1992, at A1 (noting that "boards typically have been captive to the wishes of the company chairman," but that pressure has been mounting on boards to assume a more proactive stance in the fulfillment of their duties).

In January 1993, IBM CEO John Akers was forced to resign amid sagging profits and lost market share. IBM saw its worldwide market share drop from 30% in 1985 to 19% in 1991, witnessed its stock price lose half its value over a six-month period, was forced to make a 5% cut in its quarterly dividend, and recorded a $4.97 billion loss in 1992. Loomis, supra note 21, at 45, 48; Michael W. Miller & Laurence Hooper, Signing Off: Akers Quits at IBM Under Heavy Pressure; Dividend Is Slashed, WALL ST. J., Jan. 27, 1993, at A1.

Similarly, American Express Board members, dissatisfied with the company's recent financial performance and public relations gaffes, deposed CEO James D. Robinson, III. Bill Saporito, The Toppling of King James III, FORTUNE, Jan. 11, 1993, at 42–43. Robinson, who served as CEO for 16 years, developed American Express into a "financial services super-market." Id. However, the number of American Express cardholders was down worldwide, earnings were lackluster as the result of a $112 million charge at Optima, and the stock price remained depressed. Id. at 43.

The recent allegations of nefarious activity by Orange & Rockland Utilities CEO James F. Smith, however, present perhaps the most egregious example of executive largesse at the hands of an indulgent and derelict board. Joann S. Lublin, Less-Than-Watchful Eyes Didn't Oversee Expenses of Utility Chairman, WALL ST. J., June 15, 1994, at B1. Smith allegedly appropriated nearly $326,000 of company money for his personal use during his 14 years as chief executive. Id. The Orange & Rockland Board was "handpicked" by Smith and contained some personal friends and several directors who owned little stock. Id.; see also ORANGE & ROCKLAND UTILITIES INC., APR. 6, 1994 PROXY STATEMENT 3–5, 9 (1994) (The proxy statement listed board members' stockholdings, including those of directors with relatively few shares: Linda C. Taliferro, Audit Committee, 53 shares; Frank A. McDermott, Jr., Compensation Committee Chairman and Executive Committee, 697 shares; James F. O'Grady, Jr., Compensation and Executive Committees, 600 shares; Michael J. Del Giudice, Audit Committee, 0 shares.). In the words of Kenneth Gribetz, the district attorney prosecuting Smith, the Orange & Rockland
The benefits to be achieved by effective board supervision of management are obvious. Thoughtful, judicious management is encouraged; unnecessarily risky or imprudent behavior is discouraged. The potentially dilatorious impact of the unproductive, foolish, or felonious is lessened by a vigilant board. On the other hand, the pernicious impact of the absence of active board oversight is equally obvious. Without effective board monitoring, the corporation becomes, in effect, a runaway stagecoach likely to do great damage to those within and to its owners who watch in horror from the sidelines.

The primary consequence of board passivity created by management capture is decreased management monitoring. But why does management control over board appointments necessarily create board passivity? Why would nonmanagement, outside directors on such captured

Board "was one big, happy family." Lublin, supra, at B1.

28. The board's preeminent duty is to monitor management and "prevent crisis." Minow & Bingham, supra note 15, at 15. "The board's most important function is to ask tough questions, listen to responses from management, and work together to find the right answers." Id. at 11. If directors perform their monitoring function, "they may prevent a significant portion of the long-term erosion of corporate performance that has plagued many once successful U.S. corporations." Lipton & Lorsch, supra note 15, at 62.

In order to fulfill this monitoring obligation, boards must be comprised of individuals with "the financial and strategic expertise and time to do the job." Robert A.G. Monks, To Change the Company, Change the Board, WALL ST. J., Apr. 27, 1993, at A20. In short, the keystone of a vital public corporation must be a "reformed and revitalized [board] of directors willing to monitor management and capable of mustering the courage and will to conduct themselves with a fiduciary conscience." Johnson, supra note 20, at 55. In effect, to establish an independent board of directors, Elmer Johnson, a former General Motors Board member, has suggested removing retired CEOs from the boards of their former companies, limiting the size of boards to as few as seven directors, requiring directors to own a "significant" number of the company's shares, and compensating management with shares of the corporation's stock. Id. at 54-55. As Johnson puts it, "Patient capital is the foundation on which long-lived, wealth-creating institutions rest. But since patient capital is helpless capital unless it has a voice, its prerequisite is a properly functioning board of directors." Id. at 46; see also Lipton & Lorsch, supra note 15, at 62 (quoting Chancellor Allen, who stated that the board's "most basic responsibility [is] the duty to monitor the performance of senior management in an informed way"); The Working Group on Corporate Governance, A New Compact for Owners and Directors, HARV. BUS. REV., July-Aug. 1991, at 141, 142 (suggesting that "outside" directors should evaluate the performance of the chief executive annually).

Professor Cox notes that empirical evidence demonstrates that outside directors may "help to shield the corporation from managers' self-dealing or overreaching conduct." James D. Cox, The ALI, Institutionalization, and Disclosure: The Quest for the Outside Director's Spine, 61 GEO. WASH. L. REV. 1233, 1234, 1242 (1993). Examining the relationship between board composition and the termination of poorly performing management, Cox points to data that show that the "likelihood that a board will terminate an underperforming executive increases as the board's overall size increases" and continues to increase with the proportion of outside directors. Id. at 1241 (citing Donald L. Helmich, Organizational Growth and Success Patterns, 17 ACAD. MGMT. J. 771, 774 (1974)); Michael S. Weisbach, Outside Directors and CEO Turnover, 20 J. FIN. ECON. 431 (1988); Joann S. Lublin, More Chief Executives are Being Forced Out by Tougher Boards, WALL ST. J., June 6, 1991, at A1.
boards be unwilling to challenge management prerogative and engage
in active oversight? There are three problems with a management-appointed
board that lead to ineffective oversight. First, personal and psychic
ties to the individuals who are responsible for one's appointment
to a board make it difficult to engage in necessary confrontation.
It is always tough to challenge a friend, particularly when the chal-
lengeing party may one day, as an officer of another enterprise, end up
in the same position. Second, conflict with a manager who is also a
member of one's own board may lead to future retribution on one's
own turf, thus reducing the incentive to act. Third, when one owes
one's board position to the largesse of management, any action taken
that is inimical to management may result in a failure to be renomi-
nated to the board, which—given the large fees paid to directors\(^\text{29}\) and
the great reputational advantage to board membership—may function
as an effective club to stifle dissension. Such realities hinder effective
oversight by a corporation's outside directors.

It appears, therefore, that board passivity may be a problem struc-
turally inherent in the management-appointed board. This passivity
chills effective oversight of management activity, including the pre-
sently controversial area of executive compensation. If management
domination of the board appointment process leads to board passivity,
why not simply forbid management involvement in that process?
Would such a prohibition eliminate the passive board?\(^\text{30}\) Although this
sort of rule might create a group of directors more independent of
management, in the realities of the large, modern corporation, it is
both ill-advised and completely unworkable.

First, simply because management proposes an individual for board
membership does not automatically make that individual unworthy of
service. Management, with its knowledge of the company and its in-

\(^{29}\) For example, nonemployee directors receive annual compensation in the amount of
$35,000 at General Electric, $35,000 at Exxon, $55,000 at IBM, and $48,000 at American
Express. Moreover, these nonemployee directors usually receive a fee of between $1000
and $2000 for each meeting attended. In addition, committee chairmen usually receive a supplemental
retainer of between $3000 and $5000 per year. AMERICAN EXPRESS CO., MAR. 14, 1991
PROXY STATEMENT 5 (1991) [hereinafter AMEX PROXY]; INTERNATIONAL BUSINESS
MACHINES CORP., MAR. 16, 1992 PROXY STATEMENT 10 (1992) [hereinafter IBM PROXY];
GENERAL ELECTRIC CO., MAR. 3, 1992 PROXY STATEMENT 13 (1992) [hereinafter GE PROXY];
see Barris, supra note 2, at 78-79, 78 n.114.

\(^{30}\) In fact, many corporations, presumably in an effort to create a more independent
board, have begun to limit management participation in the selection of new directors. Stuart
Proposals to limit the role of CEOs in director selection have been made by a number of com-
mentators, including Jay Lorsch and Elizabeth MacIver. See LORSCH & MACIVER, supra note
17, at 173-76.
dustry and its contacts in the general business community, may be well-suited for finding those whose experience and skill would make them productive board members. To rule out management involvement in the recruitment process might eliminate a whole pool of individuals whose board service could be highly valuable to the business. And, while friendship with management should not be the reason for one's appointment to a board, neither should it act as an automatic disqualifier.

Second, such a prohibition would be unworkable in a very practical sense. Management domination of the board appointment process occurs when a company, due to atomistic shareholding patterns and ineffective communication among shareholders, has no dominant shareholder or shareholding group. Management simply fills the void. If management is forbidden from dominating the process, who will? Prohibiting management involvement will not necessarily create a shareholder's utopia. It was small shareholdings that created the vacuum; there was no economic incentive for a small holder to become actively involved in the process. Removing management from the process will not change this reality and will only lead to chaotic board

31. Because of their relatively small stockholdings, shareholders will become actively involved in running the corporation "only if the expected benefits of doing so outweigh its costs." Bainbridge, supra note 13, at 1055 (citing ROBERT C. CLARK, CORPORATE LAW 390-92 (1986)). Professor Bainbridge notes that the average shareholder is presented with opportunity costs that far outweigh the concomitant benefits of becoming involved. Id. Furthermore, because of atomistic shareholding patterns and divergent interests, it is extremely difficult for shareholders to organize and act as a cohesive unit to produce significant change. Eisenberg, supra note 4, at 159-60, 167; Bainbridge, supra note 13, at 1054-55; Cox, supra note 28, at 1236. "Shareholders are thus rationally apathetic." Bainbridge, supra note 13, at 1055; see Frank H. Easterbrook & Daniel R. Fischel, Voting in Corporate Law, 26 J. L. & ECON. 395, 402 (1983); Martin Lipton, Corporate Governance in the Age of Finance Corporatism, 136 U. PA. L. REV. 1, 66-67 (1987). Management, with its access to information, is able to fill the vacuum left by shareholder apathy to provide uniform and coherent leadership. See Cary & Eisenberg, supra note 14, at 141 (noting that shareholders who own a relatively insignificant amount of the corporation's stock "will normally not want to spend a significant amount of time on the corporation's affairs, and management fills the vacuum"); Mace, supra note 4, at 191 (observing that management controls large public corporations in the absence "of control or influence by the [unorganized] owners of the enterprise"); Monks & Minow, supra note 3, at 98-103 (examining the separation between ownership and control of the corporation). But see Bainbridge, supra note 13, at 1054 n.108 (discussing those commentators who believe that institutional investors can provide an active voice in corporate governance); Cox, supra note 28, at 1258-59 (discussing the role that institutional investors may play in monitoring); infra, note 86 (discussing the role that institutional investors may play in corporate governance). See generally John C. Coffee, Jr., Liquidity Versus Control: The Institutional Investor as Corporate Monitor, 91 COLUM. L. REV. 1277 (1991) (arguing that institutional passivity is a result of insufficient incentives to monitor the corporation rather than a result of overregulation); Gilson & Kraakman, supra note 13, at 863 (proposing a strategy for increased corporate governance by institutional investors).
elections.\textsuperscript{32} This approach would promote corporate uncertainty and instability, certainly no blessing.

If prohibiting management involvement in the board appointment process is not a workable or desirable solution to the passivity problem, what is? How can we stimulate a board, compositionally suited to passivity, to become an active monitor of management? The answer to this question will not only solve the executive overcompensation dilemma, which is but one result of the passivity problem, but will also create much more effective corporate performance. The real problem confronting United States corporate law today is not excessive executive compensation, but the passivity of the management-captured board.

II. BOARD PASSIVITY AND THE DUTY OF CARE

If board passivity is the real problem hindering the effective operation of the large public corporation, what then is the appropriate legal response? What can be done to motivate a board, which is compositionally passive, to become an active management monitor? The problem of board supervisory laxity is not at all new. In fact, it probably dates back to the development of the modern board-managed corporation with its severance of ownership and control. Corporate law traditionally has been highly responsive to this issue. In part to counteract the potentially dilatory effect of director inattentiveness and inactivity, the law created the corporate director's fiduciary duty of care, which was formulated to compel effective oversight. A standard of conduct was developed, violation of which led to personal liability on the part of the offending board member.\textsuperscript{33} The duty of care was an effort

\textsuperscript{32} Bainbridge, supra note 13, at 1054.

\textsuperscript{33} Most commentators have suggested that the duty of care developed from the law of fiduciaries and originated in equity. See Duties and Responsibilities of Outside Directors 20 (Avery S. Cohen & Ronald M. Loeb eds., 1976) ("The classic definition of the duty of care of directors arose from the law of fiduciaries, and it was only through an evolutionary process that there began to be differentiation in form and substance between the duties of corporate directors and the duties of other fiduciaries, such as trustees."); Howard H. Spellman, A Treatise on the Principles of Law Governing Corporate Directors 14-15 (1931) ("Numerous decisions iterate the proposition that the directors bear a fiduciary relationship toward the corporation, its stockholders and creditors."); 2 Seymour D. Thompson & Joseph W. Thompson, Commentaries on the Law of Corporations § 1320 (3d ed. 1927) ("The rule is thoroughly embedded in the general jurisprudence of both America and England that the status of directors is such that they occupy a fiduciary relation toward the corporation and its stockholders, and are treated by courts of equity as trustees."); see also Deborah A. DeMott, Beyond Metaphor: An Analysis of Fiduciary Obligation, 1988 Duke L.J. 879, 880 ("As a legal principle, the [fiduciary] obligation originated in Equity. ... The term 'fiduciary' itself was adopted to apply to situations falling short of 'trusts,' but in which one person was nonetheless obligated to act like a trustee."). But see E. Norman Veasey & William E. Man-
to force desired behavior through a threat of legal liability for noncompliance. It proved to be ineffective, however, as passive boards flourished. In response, the Delaware Supreme Court created a new legal structure designed to strengthen board adherence to the duty in its landmark *Van Gorkom* ruling. Unfortunately, as will be discussed, like most economic regulations designed to create desired behavior through a mandate rather than an incentive, this approach has not proven to be particularly effective. In fact, it has bolstered rather than discouraged board passivity.

The fiduciary duty of care developed as a means to compel oversight by an independent board, which, according to the traditional view, possessed broad power over corporate affairs. Howard Spellman, in a 1931 treatise on corporate directors, described the development of this duty in the following manner:

> [T]he legal situation in which a director finds himself is the product of judicial precaution, motivated by the necessity of safeguarding the interests of the corporation, of its stockholders, and of those who deal with it from overreaching by the members of its managing body for their own advantage. The reason for holding corporate directors to a high degree of accountability is a result of their dominant position, growing out of the complete control accorded to the board in the management of corporate affairs. The courts have consistently upheld the board’s independence. But it is a proper corollary of the grant of extensive powers that their misuse be prevented and their abuse punished. Accordingly, equity subjects the directors of a corporation to the same liability for negligence or misconduct as it does trustees.

SPELLMAN, supra, at 15–16; see also HENRY W. BALLANTINE, BALLANTINE’S MANUAL OF CORPORATION LAW AND PRACTICE § 114, at 359 (1930) (stating that the duty of care requires directors “to exercise an active and vigilant supervision over the officers of the company . . . to be familiar with the requirement of the by-laws of the corporation and enforce them . . . [and] to take the usual methods to inform themselves of the true condition of the affairs of the company”); 4 WILLIAM M. FLETCHER, OF THE LAW OF PRIVATE CORPORATIONS § 2261, at 3510 (1918) (stating that directors occupy a fiduciary relationship with stockholders because they are “agents intrusted with the management of the corporation”); 2 HOWARD L. OLECK, MODERN CORPORATION LAW § 959, at 730 (1959) (arguing that directors act as fiduciaries to shareholders because they are “the central power of management”).

Recent commentators have similarly suggested that the duty of care was developed to compel active oversight of the modern board-managed corporation. See Kenneth E. Scott, Corporation Law and the American Law Institute Corporate Governance Project, 35 STAN. L. REV. 927, 927 (1983) (arguing that the duty of care developed in response to “the freeing of management . . . from effective discipline by stockholders” and the consequent “separation of ownership and control in the modern publicly-held corporation”); see also Alan R. Palmiter, Reshaping the Corporate Fiduciary Model: A Director’s Duty of Independence, 67 TEX. L. REV. 1351, 1353 (1989) (noting that “over the last century,” the duty of care imposed “a set of standards—a regime—for judicial review of corporate decisionmaking”).

34. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). For a complete discussion of the standards that the court in *Van Gorkom* created to bolster director adherence to the duty of care, see infra notes 52–58 and accompanying text.
Under the traditional duty of care, a director was expected to carry out his or her responsibilities "with the care that an ordinary prudent person in a like position would exercise under similar circumstances." Failure to meet this standard would result in the imposition of liability upon the slothful director. This would theoretically compel circumspect and diligent conduct in carrying out the various responsibilities of board membership, including executive salary negotiations. Under the business judgment rule, however, a director would be found to have met this duty of care if in making a specific business decision he or she acted without self-interest, in an informed manner, and with a rational belief that the decision was in the best interests of the corporation. A director who so acted in reaching a business decision was


A director shall discharge his duties as a director, including his duties as a member of a committee:

1. in good faith;
2. with the care an ordinary prudent person in a like position would exercise under similar circumstances; and
3. in a manner he reasonably believes to be in the best interests of the corporation.

Id.

The American Law Institute has defined the duty of care in a similar fashion:

(a) A director or officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinary prudent person would reasonably be expected to exercise in a like position and under similar circumstances.

ALI, supra note 14, § 4.01(a).


36. In Aronson v. Lewis, 473 A.2d 805 (Del. 1984), the Delaware Supreme Court described the business judgment rule as follows:

[A] presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company . . . . Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.

Id. at 812 (citations omitted).

The American Law Institute has defined the rule in the following manner:
then protected from any legal liability to his or her shareholders. Over the years, this standard of care proved not to be very difficult to satisfy, and it was quite unusual for a board to be found to have violated this duty.\textsuperscript{37} Questions then began to arise as to its effectiveness in assuring

(c) A director or officer who makes a business judgment in good faith fulfills the duty under this section if the director or officer:

(1) is not interested in the subject of the business judgment;
(2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
(3) rationally believes that the business judgment is in the best interest of the corporation.

ALI, supra note 14, \S 4.01(c); see Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); see also Teren v. Howard, 322 F.2d 949, 952-53 (9th Cir. 1963); Richardson v. Blue Grass Mining Co., 29 F. Supp. 658, 665 (E.D. Ky. 1939), aff'd, 127 F.2d 291 (6th Cir. 1942); Wall & Beaver Street Corp. v. Munson Line, Inc., 58 F. Supp. 109, 115-16 (D. Md. 1944); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993); Citron v. Fairchild Camera & Instrument Corp. 569 A.2d 53, 64 (Del. 1989); Haber v. Bell, 465 A.2d 353, 357 (Del. Ch. 1983).

Where a director has not made a business decision, such as in the case of an omission, the business judgment rule does not apply, and the director should not be judged under the reasonable care standard. Aronson, 473 A.2d at 812-13.

For a complete discussion of the differences between the ALI's formulation of the business judgment rule and that of the Delaware Supreme Court in Aronson v. Lewis, see Michael P. Dooley, Two Models of Corporate Governance, 47 BUS. L. 461 (1992).

37. Joseph W. Bishop, Jr., Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers, 77 YALE L.J. 1078, 1099 (1968). After extensive research, Professor Bishop discovered only four cases in which a court found that a director violated the duty of care, absent an allegation of self-dealing. Id. at 1099-1100; see New York Credit Men's Adjustment Bureau v. Weiss, 110 N.E.2d 397 (N.Y. 1953); Syracuse Television, Inc. v. Channel 9, Syracuse, 273 N.Y.S.2d 16 (Sup. Ct. 1966); Clayton v. Farish, 73 N.Y.S.2d 727 (Sup. Ct. 1947); Selheimer v. Manganese Corp. of Am., 224 A.2d 634 (Pa. 1966). Even though all of these decisions resulted in director liability, Bishop stated that "none of these cases carries real conviction." Bishop, supra, at 1100.

Several more recent commentators have also taken the view that the duty of care was an easily satisfied standard for directors. They argued that in the few cases where the courts found a breach of the duty of care, elements of director self-interest were present. See William J. Carney, The ALI's Corporate Governance Project: The Death of Property Rights?, 61 GEO. WASH. L. REV. 898, 992 n.126 (1993) ("I am aware of only five cases in the history of American corporate law that have held directors liable for breaches of the duty of care, four of which seem tainted by conflicts of interest."); Cohn, supra note 35, at 591 n.1 ("Research reveals only seven successful shareholder cases not dominated by elements of fraud or self-dealing."); Palmiter, supra note 33, at 1360 ("During their century-long tenure, [care] standards have produced remarkably few cases holding directors liable for unreasonable or careless decisions."); Scott, supra note 33, at 933 ("Very few cases have imposed liability solely on the basis of a violation of the duty of care."). Professor Scott also noted that "[m]any of the 'negligence' cases are tainted by the presence of some elements of conflict of interest or personal gain." Id. at 933 n.23 (citing Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981)); see also Dooley, supra note 36, at 482 (indicating that the lack of decisions holding directors liable for violating the duty of care signifies that "American judges have followed an authority model [designed to preclude judicial review] and have therefore intended that their articulation of the duty of care be mostly hortatory").
diligent board behavior. 38

The American Law Institute (ALI), in connection with its landmark Corporate Governance Project in the early 1980s, consequently decided to reexamine the entire duty-of-care concept and its continuing viability. 39 This reexamination sparked a great deal of controversy among

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38. Professor Bishop was one of the first to question the effectiveness of the duty of care in assuring diligent board behavior. Bishop, supra note 37, at 1078-81. A number of other commentators were similarly critical of the duty's efficacy. See, e.g., Carney, supra note 37, at 923 ("Although courts frequently stated that directors owed their corporations and shareholders a duty of care, courts' failure to enforce that duty in cases of erroneous decisions meant that for practical purposes, the law played no role in enforcing diligence of directors."); George W. Dent, Jr., The Revolution in Corporate Governance, the Monitoring Board, and the Director's Duty of Care, 61 B.U. L. Rev. 623, 654 (1981) ("[T]he duty of care has hitherto been an ineffective tool for requiring directors to perform a meaningful function within the corporation."); Scott, supra note 33, at 932-33 (using a two-fold approach to explain why the duty of care is ineffective).

According to Professor Dent, the duty was ineffective because of judicial reluctance ever to find that a board was in violation of the duty. Dent, supra, at 646-54. Among other reasons for this judicial reticence, Dent explores what are considered the three traditional explanations. First, courts do not feel "that they are competent to review business decisions," as they "possess no special expertise in business affairs." Id. at 648. Second, rigorous enforcement "would pose such a substantial threat of personal liability that the best qualified persons would decline to serve as directors." Id. at 649. Finally, a stringent review "would force directors to become unduly cautious in order to avoid risky ventures that might result in losses to the corporation." Id. at 650.

39. The American Law Institute initiated its Corporate Governance Project in 1978. Roswell B. Perkins, President of the ALI, in discussing the project's origins, may have had the controversy concerning the duty of care in mind when he stated that "[a] commitment to the health and vigor of the free enterprise system requires that the law as to governance of business associations be fully as efficient and effective as, for example, the law of contracts and the law relating to commercial transactions." Melvin A. Eisenberg, An Introduction to the American Law Institute's Corporate Governance Project, 52 Geo. Wash. L. Rev. 495, 495 (1984) (quoting Roswell B. Perkins, The President's Letter, 4 A.L.I. REP. 1 (1982)). Perkins further commented that "there has been a degree of uncertainty and inconsistency in the law which cries out for rational, dispassionate analysis and the development of guiding principles." Id. at 496.

For further commentary concerning the origins and methodology of the Corporate Governance Project, see Eisenberg, supra, at 498-500; Melvin A. Eisenberg, An Overview of the Principles of Corporate Governance, 48 Bus. Law. 1271 (1993); Elliot Goldstein, The Relationship Between the Model Business Corporation Act and the Principles of Corporate Governance: Analysis and Recommendations, 52 Geo. Wash. L. Rev. 501 (1984); Joel Seligman, A Sheep in Wolf's Clothing: The American Law Institute Principles of Corporate Governance Project, 55 Geo. Wash. L. Rev. 325 (1987). Professor Seligman suggested, among other things, that the following governance problems led to the ALI's reconsideration of American corporate governance:

Directors did not establish the basic objectives, corporate strategies, and broad policies in most large and medium-sized companies.... Nor did the board select the corporation's chief executive officer.... Outside directors were not expected to play an adversarial role.... Moreover, few boards met frequently enough to perform a useful role.

Id. at 330-32.

For an alternative perspective on the origins of the Corporate Governance Project, see Jonathan R. Macey, The Transformation of the American Law Institute, 61 Geo. Wash. L
corporate law commentators. A fierce debate ensued, with Professor Scott arguing for the complete abolition of the duty because he believed it to be of minor importance. He suggested:

[Very little if any value would be lost by outright abolition of the legal duty of care and its accompanying threat of a lawsuit. Other incentives for an appropriate degree of care in corporate decision-making would remain, and mechanisms would exist outside the courtroom to correct shortcomings.]

What would be gained by such an abolition? There would be savings in litigation expense, insurance premiums, unnecessary record building, and risk-averse decisionmaking by the board. More important, abolishing duty of care liability could enormously clarify and...

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40. Three different viewpoints emerged in the debate over the duty of care. The first, most notably propounded by Professor Scott, called for the abolition of the duty. Scott, supra note 33, at 936–37. A number of other commentators subscribed to this view. See, e.g., Henry N. Butler & Larry E. Ribstein, Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians, 65 WASH. L. REV. 1, 7, 28–32 (1990) (stating that corporations are contractual in nature and that fiduciary duties should be governed by contract); Jonathan R. Macey, Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes, 1989 DUKE L.J. 173, 174 (advocating the contract theory of corporate governance and suggesting that parties affected by corporate changes are better served by private contracting than by regulatory intervention); Palmiter, supra note 33, at 1436–64 (suggesting the creation of a director's duty of independence); David M. Phillips, Principles of Corporate Governance: A Critique of Part IV, 52 GEO. WASH. L. REV. 653, 704 (1984) (stating that the ALI's current approach to the duty of care will "undermine the utility of corporate doctrine to tackle managerial self-enrichment"); Larry E. Ribstein, The Mandatory Nature of the ALI Code, 61 GEO. WASH. L. REV. 984, 987–98 (1993) (suggesting that corporate governance should arise from contract rather than mandatory rules).

The second approach, typified by arguments by Professor Cox, called for application of a stronger, more rigorous duty of care. James D. Cox, Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures, 52 GEO. WASH. L. REV. 745 (1984). Other commentators suggested a similar approach. See, e.g., Cohn, supra note 35, at 595, 607–27 (proposing a standard of reasonable care so that "the business judgment rule would resume its historical basis as a protection against hindsight evaluation of erroneous decisions, but would shed its protective role as a shield for all director action in the absence of fraud or other illicit behavior").

The third viewpoint on the controversy called for maintenance of the duty of care as it was then currently structured. See John C. Coffee, Jr., Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis, 52 GEO. WASH. L. REV. 789, 828 (1984); see also Victor Brudney, The Role of the Board of Directors: The ALI and Its Critics, 37 U. MIAMI L. REV. 223 (1983) (defending the ALI's formulation of the duty of care); Robert C. Clark, Contracts, Elites, and Traditions in the Making of Corporate Law, 89 COLUM. L. REV. 1703, 1747 (1989) (exploring arguments for and against the duty of care and offering a model provision "in the style of the ALI's Corporate Governance Project"); Melvin A. Eisenberg, The Structure of Corporation Law, 89 COLUM. L. REV. 1461, 1525 (1989) (defending the use of mandatory rules in corporate governance and fiduciary duties).
simplify the legal system in this field.41

Responding to this attack on the duty of care, a number of commentators rushed to its defense, some even calling for a stronger, invigorated, more easily enforceable duty.42 Professor Cox argued:

[T]he law should find violations of the duty of care and impose remedies to compensate shareholders for their losses because of egregious decisionmaking by managers . . . . Derivative suit procedures should be drafted so that violations of the duty of care can be vindicated as efficiently as violations of the duty of loyalty.43

In response, taking what he termed a middle course between the Scott and Cox position—"Steering Between Scylla and Charybdis"44—Professor Coffee also called for the duty’s retention, although he was critical of an “invigorated” duty as one having the potential to “chill the movement towards independent directors or produce excessive risk aversion.”45 Coffee suggested that the duty still had value because of “its socializing and exhortative impact” and that it should be left intact because of its “aspirational” potential.46

In the end, despite the attacks on its viability, the traditional duty of care was more or less retained by the ALI and continued to function as corporate law’s response to the problem of the inattentive board.47

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41. Scott, supra note 33, at 937. Professor Scott believed that pressures and incentives in the free market would compel active board oversight. Id. at 935-36. For instance, “proxy contests, negotiated takeovers, and hostile tender offers” existed to provide protection of shareholder interests without the necessity of due care litigation. Id. at 935. Further, performance-based compensation packages, competition in the market place, and “managerial labor market[s]” also provided incentive for effective board management. Id. Lastly, Professor Scott suggested that board members’ personal reputations and stock portfolios would facilitate active board monitoring. Id. at 936.

42. For those commentators calling for a stronger, more invigorated duty of care, see supra note 40.

43. Cox, supra note 40, at 788.

44. Coffee, supra note 40, at 789.

45. Id. at 799.

46. Id. at 798.

47. For the ALI’s statement of the duty of care, see ALI, supra note 14, § 4.01(a).

Beginning in 1982 and throughout the drafting of § 4.01(a) as part of its Corporate Governance Project—including the final draft adopted in 1992—the ALI continually represented that its formulation of the duty of care did not represent a radical departure from traditional doctrine. See ALI, supra note 14, § 4.01(a) cmt. a; AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(a) cmt. a (Tentative Draft No. 11, 1991); AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(a) cmt. a (Tentative Draft No. 4, 1985); AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(a) cmt. a (Tentative Draft No. 3, 1984); AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 4.01(a) cmt. a (Tentative Draft No. 1, 1982); see also Brudney, supra note 40, at 225 (noting that the duty of care under the ALI is largely “a description of existing legal
Then in mid-1985, the Delaware Supreme Court shocked the corporate and legal communities by dramatically changing the nature of the duty-of-care action through its ruling in Smith v. Van Gorkom.48

As discussed earlier, traditionally it was very rare for a court to rule that a board had violated its duty of care. The courts were very liberal in their application of the protective business judgment rule to challenged board actions. Provided that the directors had no financial interest in the decision they had made, and the decision was not "so removed from the realm of reason" as to appear absolutely irrational (few decisions could ever be so characterized), two of the business judgment rule's three elements had been met.49 The final element, that an informed decision be made, was never really an issue, because the courts seemed to give boards great latitude in their decisionmaking process.80 It was highly unusual for a court to characterize a board

48. 488 A.2d 858 (Del. 1985). For a complete discussion on the Van Gorkom decision, see infra notes 52–84 and accompanying text. The ALI's approach to the duty of care was initially formulated in 1982, prior to Van Gorkom. However, in the final version of its Principles of Corporate Governance, adopted by its membership in 1992, the ALI cited Van Gorkom with seeming approval in its discussion of § 4.01(a). ALI, supra note 14, § 4.01(a) reporter's note 15; see also Macey, supra note 39, at 1220 (noting the ALI's seeming approval of Van Gorkom).

49. ALI, supra note 14, § 4.01(c) cmt. f.

50. To receive business-judgment-rule protection from liability, directors must inform themselves of all reasonably available material prior to making a business decision. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); see Lutz v. Boas, 171 A.2d 381, 395–96 (Del. Ch. 1961) (holding outside directors liable based on their uninformed and uninvolved posture during their tenure as directors); Mitchell v. Highland-Western Glass Co., 167 A. 831, 833 (Del Ch. 1933) ("There was no justification in the evidence for concluding that the defendant's directors acted so far without information that they can be said to have passed an unintelligent and unadvised judgment."); see also Cohn, supra note 35, at 615 (stating that to meet a reasonable
judgment as uninformed and, therefore, undeserving of the business judgment rule shield. This is why the duty of care was never considered to be a particularly difficult standard to meet and why it was

care standard, the following question must be answered affirmatively: "Have the directors sought adequate information?"); Joseph Hinsey, IV, Business Judgment and the American Law Institute's Corporate Governance Project: the Rule, the Doctrine, and the Reality, 52 Geo. WASH. L. REV. 609, 610 (1984) (describing the elements of the business judgment rule and stating its common-law presence in corporate governance law); E. Norman Veasey and Julie M. S. Seitz, The Business Judgment Rule in the Revised Model Act, the Trans Union Case, and the ALI Project—A Strange Porridge, 63 TEX. L. REV. 1483, 1485 (1985) (discussing the origins of the common-law definition of the business judgment rule); cf. Palmier, supra note 33, at 1382–83. Professor Palmier has described "uninformed" director conduct in the following manner: "uninformed" has been understood to mean that directors were grossly negligent or that they engaged in a 'sustained pattern of inattention.' Id. (citations omitted).

Courts, however, have generally given broad discretion to a director's decisionmaking process and thus rarely question whether an informed decision was made. See Warsaw v. Calboun, 221 A.2d 487, 492–93 (Del. 1966) ("In the absence of a showing of bad faith on the part of the directors or of a gross abuse of discretion the business judgment of the directors will not be interfered with by the courts."); Auerbach v. Bennett, 393 N.E.2d 994, 1000 (N.Y. 1979) ("It appears to us that the business judgment doctrine . . . is grounded in the prudent recognition that courts are ill equipped . . . to evaluate what are and must be essentially business judgments."); Kamin v. American Express Co., 383 N.Y.S.2d 807, 812 (N.Y. App. Div. 1976). The court in Kamin stated:

The directors are entitled to exercise their honest business judgment on the information before them, and to act within their corporate powers. That they may be mistaken, that other courses of action might have differing consequences, or that their action might benefit some shareholders more than others presents no basis for the superimposition of judicial judgment.

Id.; see also Cohn, supra note 35, at 594 (stating that the business judgment rule "has come to preclude inquiry into the merits of directors' decisions in the absence of evidence of bad faith, fraud, conflict of interest, or illegality"); Dent, supra note 38, at 648 (suggesting that courts give broad latitude to director's judgment because "[c]ourts sometimes deny that they are competent to review business decisions"); Hinsey, supra, at 612 ("As long ago as 1917, Justice Louis Brandeis recognized the principle that courts leave matters of internal management to the directors' discretion and courts will seldom interfere with this discretion absent misconduct or a breach of the duty of loyalty." (citing United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263 (1917))); Scott, supra note 33, at 933 ("In recognition of the fact that risk taking and uncertainties about future developments characterize most business decisions, courts will not second-guess corporate decisionmakers unless the mistakes in judgment are extreme."); see also Palmier, supra note 33, at 1361–62. Professor Palmier has stated that "the business judgment rule shield[s] board decisions from judicial second-guessing and directors from liability unless a challenger shows that the corporate decision either was tainted by interest . . . or lacked a rational business purpose." Id. at 1361. Referring to the latitude that courts give directors under the business judgment rule, Palmier further argued that "courts accord near-complete deference to corporate decisions untainted by interest." Id. at 1361–62. See generally S. Samuel Arsh, The Business Judgment Rule Revisited, 8 HOFSTRA L. REV. 93 (1979) (discussing the different versions of the business judgment rule and concluding that the business judgment rule is essentially embodied in § 35 of the Model Business Corporation Act); Franklin A. Gevurtz, The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?, 67 S. CAL. L. REV. 287 (1994) (advocating the abolition of the business judgment rule).

For a discussion of judicial reluctance to overturn a board decision concerning executive compensation, see Elson, supra note 1, at 959–63.
considered to be somewhat ineffective in combating the problem of board laxity.\textsuperscript{51}

However, the Delaware court in \textit{Smith v. Van Gorkom}, in a startling change of approach, stiffened substantially the standards that a board must meet to demonstrate that its decisionmaking process was "informed" and therefore merited the protection of the business judgment rule. In that case, after describing in great detail the decision-making process by which the defendant Trans Union Corporation Board (Board) had approved the sale of its company, the court ruled that the Board's decision was uninformed. Although many in the financial community firmly believed that the Board's actions in reaching its decision were perfectly reasonable in the context of events and in no way demonstrated an uninformed judgment (an opinion apparently shared by the court's two dissenting justices),\textsuperscript{52} the majority's detailed

\begin{itemize}
\item There was no indication that the Trans Union directors acted out of self-interest or impropriety, and the directors all possessed substantial business expertise, experience and in-depth knowledge of the affairs of the company;
\item The offered price was substantially above the market value of the company's stock;
\item The directors were aware that previous attempts to sell the firm were unsuccessful; and
\item Trans Union possessed extensive tax credits which could be utilized only through a merger.
\end{itemize}

Carney, supra note 47, at 283-85; Daniel R. Fischel, \textit{The Business Judgment Rule and the Trans Union Case}, 40 Bus. LAW. 1437, 1438 (1985) ("[T]he Delaware Supreme Court erred in holding that the actions of Trans Union's directors were not protected by the business judgment rule."); Macey, supra note 39, at 1221 ("From a business perspective, the directors [of Trans Union] probably thought they had all the information they needed."); Paul H. Zalecki, \textit{The Corporate Governance Roles of the Inside and the Outside Directors}, 24 U. Tol. L. REV. 831, 838 (1993) ("The opinion [in Van Gorkom] surprised many, particularly because Van Gorkom was a large stockholder and was satisfied with the price.").

Consequently, observers in the financial and legal communities felt that the Board's decision was reasonable and informed. In commenting on the Van Gorkom decision, Professor Carney made the following observation:

The result [of Van Gorkom] was that the court upset a decision made by a disinterested board, charged with no fraud or illegality, on the recommendation of a CEO with a substantial ownership interest, because the court did not believe these directors had sufficient information to protect their decision under the business judgment rule. As one dissenting justice pointed out, the five inside directors had 68 years of combined experience, while the five outside directors had 53 years cumulative experience as directors of this company. One outside director was an economist, formerly a Professor of Economics at Yale, Dean of the Graduate School of Business of the University of Chicago, and presently Chancellor of the University of Rochester. The other four were chief executives of major business corporations.

\textsuperscript{51} See supra notes 37–38.

\textsuperscript{52} It has been vigorously argued that the facts in Van Gorkom did not warrant the court's finding of director liability. Critics of Van Gorkom have pointed out, among other facts, the following:

1) There was no indication that the Trans Union directors acted out of self-interest or impropriety, and the directors all possessed substantial business expertise, experience and in-depth knowledge of the affairs of the company;
2) The offered price was substantially above the market value of the company's stock;
3) The directors were aware that previous attempts to sell the firm were unsuccessful; and
4) Trans Union possessed extensive tax credits which could be utilized only through a merger.

Carney, supra note 47, at 283-85; Daniel R. Fischel, \textit{The Business Judgment Rule and the Trans Union Case}, 40 Bus. LAW. 1437, 1438 (1985) ("[T]he Delaware Supreme Court erred in holding that the actions of Trans Union's directors were not protected by the business judgment rule."); Macey, supra note 39, at 1221 ("From a business perspective, the directors [of Trans Union] probably thought they had all the information they needed."); Paul H. Zalecki, \textit{The Corporate Governance Roles of the Inside and the Outside Directors}, 24 U. Tol. L. REV. 831, 838 (1993) ("The opinion [in Van Gorkom] surprised many, particularly because Van Gorkom was a large stockholder and was satisfied with the price.").
description of that decisionmaking process and the problems that they felt were implicit in the defendant Board's actions served to create a number of new and important guideposts to "informed" decisionmaking.53

By detailing where the Trans Union Board's decision was in contravention with what it felt was acceptable behavior, the court created new standards for defining what was and what was seemingly not appropriate conduct for availing oneself of the protection of the business judgment rule. While it never actually mandated any specific requirements in the opinion, the court created its new guidelines for effective decisionmaking by negative implication through its critique of the Trans Union Board's actions. The defendant Board's actions became, in effect, a model for improper conduct, against which other boards' actions would be measured. By criticizing the short amount of time the Board spent deliberating its decision, among other things, the court seemed now to require that a board demonstrate that it had spent some substantial amount of time making a particular judgment in order to demonstrate informed decisionmaking.54 However, the most significant new requirement to emerge from Van Gorkom involved the use of third-party advisors. Although the court's attack on the Trans Union Board's decisionmaking process explicitly stated that investment-bank-rendered fairness opinions were not "required as a matter of law,"55 the fact that the court imposed liability on a board that failed to obtain such an opinion, and indicated that the procurement of such an opinion would have insulated the directors from liability, suggested the imposition of an informal requirement.56 It seemed apparent that, as a


The two dissenting justices in Van Gorkom apparently felt similarly. Justices McNeilly and Christie both argued that the Trans Union directors exercised sound business judgment with full knowledge of the pertinent facts when they approved the merger. Van Gorkom, 488 A.2d at 893–99.


54. Van Gorkom, 488 A.2d at 874 (stating that the Board was grossly negligent when it approved the sale of the company after only two hours of deliberation).

55. Id. at 876.

56. Id. at 876–78; see Lucian A. Bebchuk & Marcel Kahan, Fairness Opinions: How
general proposition, the retention of some independent third-party advisor might assist a board in meeting the "informed" requirement. This was to have tremendous impact on the way boards made decisions in all kinds of circumstances. Prudent corporate counsel now mandate the use of independent third-party counsel in various situations to enable a board to demonstrate that it has made an informed judgment.67

In corporate control transactions, the acquisition of an investment-bank-rendered fairness opinion has become a virtual necessity.68

If few felt that what the Trans Union directors had done was improper, and the court's actions signaled a break with precedent, what then was the reasoning behind this result? Why liability?69 Perhaps the court felt that, despite common practice and acceptance, the Board's actions were lax and inimical to the interests of the shareholders. By seemingly acquiescing to a management-initiated plan to sell

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Fair Are They and What Can Be Done About It?, 1989 DUKE L.J. 27, 28 (1989); Charles M. Elson, Fairness Opinions: Are They Fair or Should We Care?, 53 OHIO ST. L.J. 951, 958 (1992); Robert J. Giumfra, Jr., Investment Bankers' Fairness Opinions in Corporate Control Transactions, 96 YALE L.J. 119, 119-20 (1986); Dennis J. Block & Jonathan M. Hoff, Investment Banker Opinions and Directors' Right to Rely, N.Y. L.J., Nov. 17, 1988, at 5; see also Polk v. Good, 507 A.2d 531, 537 (Del. 1986) (finding that the board's reliance on the advice of an investment banker fulfilled its duty of good faith and reasonable investigation); Citron v. E.I. Du Pont de Nemours & Co., 584 A.2d 490, 512 (Del. Ch. 1990) (holding that the board's reliance on the advice of an investment banker satisfied its fiduciary duty).

57. See Branson, supra note 53, at 103 (stating that to avoid due care violations after Van Gorkom, directors should "make use of independent, outside experts, at least when the transaction is large enough to justify their use"); Fischel, supra note 52, at 1453 ("The most immediate effect of Trans Union will be that no firm considering a fundamental corporate change will do so without obtaining... documentation from outside consultants.").

58. See Branson, supra note 53, at 104; Elson, supra note 56, at 958-59; Giumfra, supra note 56, at 119-20; Macey, supra note 39, at 1221; Macey & Miller, supra note 52, at 139. Professor Fischel, commenting on the Van Gorkom ruling shortly after its announcement, wryly noted that the "outside consultants are the biggest winners after [Van Gorkom]. The decision requires their participation as a type of insurance no matter how worthless their opinion is or how much it will cost." Fischel, supra note 52, at 1453.

59. Commentators have offered varying explanations as to why the Delaware court found the Trans Union directors liable. Professor Carney cited Van Gorkom for the proposition that "Delaware courts have shifted from an assumption of adequate process to an examination of the actual processes." See Carney, supra note 37, at 924. He added that "these cases begin with a presumption of director ignorance and place the burden on directors of demonstrating that sufficient 'evidence' was introduced at the meeting at which the final decision was made, rather than respecting the accumulated experience and knowledge of the directors." Id.; see also Fischel, supra note 52, at 1445, 1447 ("The court in Trans Union was extremely critical of the procedures followed by Van Gorkom and the other directors... Another aspect of the transaction that troubled the court was the failure of Trans Union's directors to conduct an auction."); Macey, supra note 39, at 1220 ("The Van Gorkom court based its opinion on its conclusion that the board of directors making the underlying decision was grossly negligent for recommending the merger to the company's shareholders without having constructed an 'appropriate procedural framework for the decisional process.'" (citing Jonathan R. Macey, Civic Education and Interest Group Formation in the American Law School, 45 STAN. L. REV. 1937 (1993))).
the business without great argument or inquiry, the Board had abdicated its traditional supervisory role and had consequently diminished shareholder value by getting less for the company than might have been received had it taken a more active role in the sale process. By imposing liability on the Trans Union directors, the court was making an example of the group to the rest of the corporate community. This harsh result thus would act both to create guideposts for effective decisionmaking and to compel better behavior through the threat of individual director liability. If boards simply followed the guidelines for good decisionmaking created by implication in the Trans Union Board’s transgressions, the result would be better oversight and enhanced shareholder wealth.

Whatever the motivation of the Van Gorkom court, the result was clear. Through its decision, the Delaware court had signaled that the duty of care, rather than being simply “aspirational,” had now been fitted with a new, sharp set of teeth that would compel effective board behavior. The court’s attempt to force compliance with the duty resulted in the creation of certain procedures that a board must follow to avail itself of the protection of the business judgment rule to avoid liability for a duty-of-care violation. Avoid the pratfalls of the Trans Union Board, and liability will thus be averted. The Delaware court’s response to board passivity was to enhance the duty of care by making it more difficult for a board to avoid its violation by claiming business-judgment-rule protection. Unless it followed certain implied rules of procedure, a board’s actions would be subject to judicial review and potential liability.

Van Gorkom had a profound impact on corporate behavior. In an attempt to avoid liability for loss-producing decisions, corporate boards developed various procedures, based on the missteps of the Trans Union Board, to ensure that their decisions would be labeled informed.

60. The court noted that the Trans Union Board approved the merger recommended by Van Gorkom without extensive questioning. Van Gorkom, 488 A.2d at 875, 877. The court stated: 

[T]he directors were duty bound to make reasonable inquiry of Van Gorkom and [Chief Financial Officer] Romans, and if they had done so, the inadequacy of that upon with they now claim to have relied would have been apparent. . . . No director sought any further information from Romans. No director asked him why he put $55 at the bottom of his range. No director asked Romans for any details as to his study, the reason why it had been undertaken or its depth. . . . [T]he Board accepted without scrutiny Van Gorkom’s representation as to the fairness of the $55 price per share for sale of the company—a subject that the Board had never previously considered. 

Id. at 875, 877.

61. Coffee, supra note 40, at 799.
and therefore subject to the protection of the business judgment rule. Detailed, lengthy discussions regarding the decisions at issue were held, records were made of these debates, numerous documents were presented to each director, and most importantly, third-party “independent” advisors were retained to advise the board on the issues to be resolved. All of these steps were designed to meet the criticism that the Delaware court leveled at the Trans Union directors. Each new step was responsive to some problem with the Trans Union Board’s decisionmaking process as identified by the court. By following the guidelines implicitly laid out in Van Gorkom, it was thought, a board could avoid the disastrous consequence of personal liability.

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62. For a listing of steps that directors should take to ensure a judicial finding of “informed” decisionmaking, see Branson, supra note 53, at 103–09; Manning, supra note 53, at 8–14. See also Carney, supra note 47, at 283–88 (discussing the judicial determination of a properly informed business decision); Macey, supra note 39, at 1219–21 (discussing the steps that directors should take, pursuant to the ALI).

63. Branson, supra note 53, at 103–09 (listing 15 specific guidelines that, if followed, insulate directors from duty-of-care violations); Manning, supra note 53, at 8–14 (listing factors implicit in the Van Gorkom decision that enable directors to avoid liability).

In response to the Van Gorkom decision, a number of state legislatures took action to reduce a director’s risk of personal liability for actions taken while a board member. Delaware was the first state to enact a statute that allowed the placement into a corporation’s certificate of incorporation by shareholder vote of a clause limiting or eliminating director liability for a breach of the duty of care. Dennis J. Block & Jonathan M. Hoff, Protecting Outside Directors: D & O Insurance, N.Y.L.J., Oct. 12, 1989, at 5, 7. The Delaware statute provides that a certificate of incorporation may contain the following:

A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such a provision shall not eliminate or limit the liability of a director: (i) For any breach of the director’s duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or knowing violation of law; (iii) under § 174 of the title; or (iv) for any transaction from which the director derived an improper personal benefit.

Del. Code Ann. tit. 8, § 102(b)(7) (1991). “Within two years” following enactment of the Delaware statute, some 41 states similarly amended their corporations statutes to limit director liability. Roberta Romano, Corporate Governance in the Aftermath of the Insurance Crisis, 39 Emory L.J. 1155, 1160 (1990) [hereinafter Romano, Aftermath of the Insurance Crisis]. Most of these statutes tracked the Delaware approach, but there were some variations. Some states increased the level of culpability necessary to find personal liability. See, e.g., Ind. Code Ann. § 23-1-35-1(e) (Burns Supp. 1994) (requiring “willful misconduct or recklessness”); Ohio Rev. Code Ann. § 1701.59(D) (Anderson 1992) (requiring “deliberate intent” or “reckless disregard”); Wis. Stat. Ann. § 180.0828 (West 1993) (requiring “willful failure to deal fairly,” “violation of criminal law,” “improper personal profit,” or “willful misconduct”). At least one state simply limited the amount of damages for which a director may be liable. See Va. Code Ann. § 13.1-692.1 (Michie 1994) (capping the liability at $100,000 or the amount of compensation received from the corporation within the last 12 months). For further discussion on the different approaches state legislatures used to limit director liability, see Joseph W. Bishop, Law of Corporate Officers and Directors Indemnification and Insurance §§ 6.36–86 (1994); Block & Hoff, supra, at 5, 7; Deborah A. DeMott, Limiting Directors'
Almost ten years have passed since the ruling in Van Gorkom was handed down. Despite numerous attacks on its viability and logic, the decision still stands. In fact, recently the Delaware court explicitly reaffirmed Van Gorkom in Cede & Co. v. Technicolor. In that case, which among other things involved an alleged board duty-of-care violation, the court approvingly cited and applied Van Gorkom to determine whether the defendant Technicolor Board had made an “informed” decision in approving the sale of the company. It found that they had not. And in the most recent Delaware takeover decision, Par-

These statutes, however, have not necessarily eliminated the potential for, or director’s fear of, personal liability. See Leo Hazel et al., Next-to-Last Word on Endangered Directors, HARV. BUS. REV. JAN.-FEB. 1987, at 38, 43 (stating that courts can circumvent the new Delaware statute because “[w]ith only a little effort, courts could find directors liable for disloyalty where before they would have found them liable for negligence”); Romano, Aftermath of the Insurance Crisis, supra, at 1161 (questioning the effectiveness of the legislative response to director liability because “the statutes in most states do not exempt from liability claims for breach of the duty of loyalty, violation of federal securities laws, and breach of the duty of care by directors who are also officers”); Roberta Romano, What Went Wrong with Directors’ and Officers’ Liability Insurance?, 14 DEL. J. CORP. L. 1, 32 (1989) (stating that limited liability statutes are ineffective because “plaintiffs will, in all likelihood, be able to redraft their complaints to continue to bring lawsuits; for example, instead of alleging negligence they will allege reckless behavior”).

In addition to reducing directors’ exposure by limiting personal liability, some states increased director indemnification rights. See, e.g., LA. REV. STAT. ANN. § 12:83E (West Supp. 1994); MO. ANN. STAT. § 351.355(7) (Vernon Supp. 1991); N.Y. BUS. CORP. LAW § 721 (McKinney Supp. 1994); Block & Hoff, supra, at 5, 7; DeMott, supra, at 317–22; Hanks, supra, at 1221–24; Romano, Aftermath of the Insurance Crisis, supra, at 1162–63. This approach, however, has also proved problematic. See Dennis J. Block, Advising Directors on the D & O Insurance Crisis, 14 SEC. REG. L.J. 130, 146–47 (1986); Theodore D. Moskowitz & Walter A. Effross, Turning Back the Tide of Director and Officer Liability, 23 SETON HALL L. REV. 897, 912 (1993); John F. Olson, The D & O Insurance Gap: Strategies for Coping, LEGAL TIMES, Mar. 3, 1986, at 25, 33 (stating that “[indemnification is] only as good as the assets of the corporation”); see also Michael A. Schaeftler, The Liabilities of Office: Indemnification and Insurance of Corporate Officers and Directors 143–44 (1976) (listing several instances where indemnification does not protect directors).

Despite these statutory attempts to limit director personal liability, either through liability limitations or indemnification, director concern with potential liability for improper decision-making still remains. DeMott, supra, at 298 (arguing that directors must continue to be concerned with litigation risks because “[a]s a result of these unfortunate deficiencies [in legislative responses to director liability], the risk exposure of directors and officers to liability is unpredictable”). Therefore, either because of continued fear of personal liability or simply the desire to avoid the embarrassment and inconvenience of a shareholder lawsuit on a particular decision, boards continue to follow the Van Gorkom guidelines for “informed” decisionmaking.

64. For criticisms of the Van Gorkom reasoning, see Carney, supra note 37, at 894; Fischel, supra note 52, at 1438; Macey, supra note 39, at 1219–22.
65. 634 A.2d 345 (Del. 1993).
66. Id. at 366, 367.
amount Communications v. QVC Network,\(^\text{67}\) the court cited to its
decision in Van Gorkom when attacking the defendant Paramount
Board’s decisionmaking process as “uninformed.”\(^\text{68}\) So Van Gorkom
survives. But should it? Has the alteration in board behavior occa-
sioned by the decision really resulted in more “informed” decisionmak-
ing? Have we seen better, more active board oversight and enhanced
shareholder wealth? Despite the best intentions of the Delaware court,
no such good has resulted. Although, theoretically, the new board pro-
cedures that resulted from the heightened attention to the duty of care
occasioned by Van Gorkom should have acted to compel more in-
formed and circumspect decisionmaking, they have not. And, in fact,
some have had the opposite effect and have acted to protect and there-
fore encourage the dangerous board passivity created by management
capture that so perplexed the Van Gorkom court.

One major change in board behavior created by Van Gorkom in-
volves the time that a board spends on a particular decision. The criti-
cism that the court leveled on the Trans Union Board because it de-
voted only two hours to deliberating the sale of the company\(^\text{69}\) has
resulted in boards’ devoting much more time to decisionmaking. Ac-
cordingly, the decisionmaking process now generally runs for a period
of some hours and involves detailed questioning of management by
board members on the proposal before the group. Numerous docu-
ments involving the decision are made available to the directors, and
detailed records are made of the discussions held. While this may cre-
ate the appearance of an “informed” active process, the reality may be
something quite different. It is not unlikely that the proceedings have
been informally, or even formally, scripted in advance by corporate
counsel keenly aware of the Van Gorkom parameters and eager to cre-
ate a protective paper record.\(^\text{70}\) Staged like a good play, such proceed-
ings may evoke a recitation of the required emotions on the part of the

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67. 637 A.2d 34 (Del. 1994).
68. Id. at 50.
70. See Branson, supra note 53, at 110 (“This nearly total emphasis on process may be
criticized as resulting in an excessive amount of play-acting, out-of-pocket costs, inefficiency,
and reliance upon process by both courts and corporations.”); Carney, supra note 37, at 924
(stating that the duty-of-care cases after Van Gorkom “begin with a presumption of director
ignorance and place the burden on directors of demonstrating that sufficient ‘evidence’ was in-
troduced at the meeting at which the final decision was made”); Macey, supra note 39, at 1221
(“The [Van Gorkom] case will increase the use of investment bankers and lawyers in corpo-
rate decision-making. . . . [This] increased ‘papering’ of board decisions will not substantially
raise the level of deliberations.” (quoting Jonathan R. Macey & Geoffrey P. Miller, Trans
Union Reconsidered, 98 YALE L. J. 127, 139 (1988))). For a list of actions that directors should
take to create a protective paper trail, see also Manning, supra note 53, at 8–14.
actors that, in the final analysis, when the stage lights dim, have only been an illusion. Nothing is gained by such a charade. Entertaining, maybe; shareholder value-enhancing, absolutely not.

A requirement that one spend a certain amount of time at a task does little to ensure the proper administration of the job. A requirement to provide one with documents pertaining to a decision does little to assure that they will be read. The key is not dictating the time involved or information provided, but giving the participant some incentive to be both well-versed in the subject and actively engaged when it is discussed. The Van Gorkom requirements do little to accomplish this goal.

The other major change in board behavior occasioned by Van Gorkom has been the active retention of the “independent” third-party advisor to aid boards in their decisionmaking process. As noted earlier, the Van Gorkom court suggested that the use of an independent investment bank by the Trans Union Board to assist it in evaluating the fairness of the price being offered for the company would have aided the Board in precluding liability by helping it to meet the “informed” requirement of the business judgment rule. Since then, the use of the third-party advisor as an aid to informed decisionmaking has grown tremendously. In the corporate control transaction area, the procurement of an investment-bank-rendered fairness opinion has become a virtual necessity because it is considered to be a vital prophylactic measure for ensuing business-judgment-rule protection for buy or sell decisions.

Theoretically, the retention of an independent third-party advisor acts to ensure the probity of a particular decision. If an independent expert suggests that all is well with a particular decision, then it would apparently be hard to quibble with the process by which that decision was made. The key to the effectiveness of this theory is that the advice of the third party be objective and independently rendered. Any ties to the decisionmaker that would act to compromise the independence and objectivity of the advice proffered must be avoided. Otherwise, the advice rendered may not really aid the decisionmaking process, but may simply act to “rubber stamp” the decision that the advisee has already made. This kind of compromised advice does nothing to ensure the probity of the decision reached, but, in fact, is terribly harmful to the entire process. It acts to give legitimacy to a potentially illegitimate decisionmaking process and therefore encourages bad decisions through

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71. See supra notes 55-57 and accompanying text.
72. For a discussion of the necessity of fairness opinions, see supra note 55-58 and accompanying text.
protecting the decisionmaker from liability for the decision. This is why the Van Gorkom-inspired third-party-advisor concept is so problematic. If there is anything in the relationship between the third-party advisor and the board that acts to compromise the objectivity of the advice given, then the presence of that advisor does nothing to ensure the thoughtfulness of the decision to be made. Thus, giving business-judgment-rule protection to such decisions on the basis of the presence of the third party is not only unwise, but potentially harmful to stockholder interests. If, by engaging a “captured” third party, a passive board may completely shield itself from liability for failing carefully and actively to consider a management proposal, there is absolutely no incentive to challenge management on any issue, but a good reason to remain passive. The legal response to board passivity represented by Van Gorkom may thus not only fail to discourage board passivity created by management capture, but may even act to encourage such harmful behavior.

Nowhere is this problem more evident than in the investment-bank-rendered fairness opinion area that was one of the subjects of the Van Gorkom ruling. As discussed, following Van Gorkom, fairness opinions were sought by decisionmaking boards in virtually all corporate control transactions. However, if the fairness opinion is to provide the necessary “back-up” to a board’s decision, the process by which that opinion was formed must necessarily be well-reasoned and honestly and properly performed. Unfortunately, the processes for determining fair value are varied and easily manipulatable, and there exist structural factors implicit in the environment in which investment banks operate that militate against the objective and independent valuation advice necessary for effective board decisionmaking. These structural factors include, among other things, a desire by the opining bank to

73. Elson, supra note 56, at 960–65. The procedures available for determining fair value include discounted cash flow analysis, evaluation of comparable companies, evaluation of comparable acquisitions, and liquidation value. Id. at 961; see, e.g., ROBERT L. KUHN, INVESTMENT BANKING 97–123 (1990) (surveying valuation methods utilized by investment bankers); Givfr, supra note 56, at 137–39 (summarizing the four traditional valuation methods); Michael W. Martin, Note, Fairness Opinions and Negligent Misrepresentation: Defining Investment Bankers’ Duty to Third-Party Shareholders, 60 FORDHAM L. REV. 133, 139–41 (1990) (listing break-up analysis as a fifth method); Arthur H. Rosenbloom & Arthur H. AuFses III, On Understanding Investment Banker Liability, INSIGHTS, Apr. 1990, at 3, 4 (discussing the valuation methods used by investment bankers and their underlying assumptions); Brian H. Safer, Touching All Bases in Setting Merger Prices, MERGERS & ACQUISITIONS, Fall 1984, at 42 (analyzing concisely the strengths and weaknesses of the four traditional valuation techniques).

Although there are arguably merits to each method, it has been suggested that any proper valuation analysis should utilize a combination of some or all of these approaches. Elson, supra note 56, at 960–65.
complete a desired transaction so that it can share in the fees to be generated and the need of that bank to build and maintain an active client base created in part by satisfying management, which is responsible for future employment. As a consequence, we have witnessed the development of a “fairness for hire” regime, where the advice rendered by the retained third-party bank is not the result of a truly independent valuation process, but simply reflects what the board (or actually management in many cases) so desires. The investment banker’s fairness opinion merely “rubber stamps” a previously reached conclusion. Although the retention of such advisors may act to preclude board liability under Van Gorkom, little is accomplished to assure the probity of the board’s decisionmaking process.

In fact, because the procurement of a fairness opinion helps to preclude liability, board passivity may even be encouraged in the management-captured entity. If there is no punishment for passivity, those structural factors promoting board passivity will continue to dominate the directors’ decisionmaking process. Additionally, because the expense of retaining an investment bank to render a fairness opinion is likely to be quite substantial, often running into the millions of dollars, the passivity protected by the fairness opinion is likely to be costly to the shareholder in more ways than one. The fairness opinion requirement, rather than working to protect shareholder wealth, may thus be having the opposite result, something that could not have been the intention of the Van Gorkom court.

A similar phenomenon can be observed in the compensation area. Excessive compensation is the result of a passive bargaining process between boards and executives. Legal protection for a board’s inactivity in this process is available through application of the business judgment rule. Provided that a board has no actual interest in the salary recommendations that it is considering, has spent a significant amount of time discussing the compensation proposals, and has relied on the advice of a third-party advisor as to the appropriateness of a salary package, its compensation decisions will be labeled “informed” and, thus, will be protected under the Van Gorkom rule. The reten-

74. See Elson, supra note 56, at 964—70.
76. See supra notes 29—32 and accompanying text.
77. Elson, supra note 56, at 966-68.
78. See supra Part I.
79. For a discussion of how directors could protect themselves under the Van Gorkom rule, see supra notes 53—63 and accompanying text.
tion of an independent compensation consultant acts to insulate the board from liability.

Theoretically, the use of a third-party advisor helps to ensure director probity in compensation decisionmaking. This, of course, assumes that the consultant acts in an objective and independent manner when advising the directors. Unfortunately, this is rarely the case. There are two fundamental problems in the structure of the consultant-corporation relationship that undercut objectivity. First, these advisors are generally hired by management and frequently perform multiple tasks for the corporation. Thus, there is a powerful disincentive for recommending a salary structure that management would consider to be inadequate. It is difficult to cross the party who has engaged you, particularly if the promise of future dealings with that party or friends of that party lies in the offering. Second, compensation structuring is not a precise art or science. It is based on comparisons with what other businesses are paying. There is tremendous subjectivity involved in deciding with what businesses the client’s compensation structure will be compared. The consultant may look to companies in the same industry, differing types of businesses of similar size, or even companies with a similar profitability picture; the universe is practically infinite, limited only by the number of businesses in existence. Moreover, the relative weight given to each element is completely up to the advisor. The high level of subjectivity inherent in compensation analysis and the reengagement concerns discussed above have left consultants prone to management capture in the same way that investment bankers who render corporate fairness opinions lack independence from the corporations that retain them. As a result, the advice given by a compensation consultant potentially lacks the objectivity and independence necessary to assure that a compensation package is reasonably related to

80. For example, Towers Perrin, one of the nation’s largest compensation consulting firms, also designs employee pension and health plans for companies. CRYSTAL, supra note 2, at 219—20.
81. See id. at 218—19.
82. Id. at 42—50; see Elson, supra note 1, at 974 n.105.
83. See Suein L. Hwang, Ties That Bind, Fired Tambrands CEO Was Unusually Close to a Consulting Firm, WALL ST. J., Aug. 23, 1993, at A1. Immediately following the ouster of Tambrands Chairman and Chief Executive Martin C. Emmett, the corporation terminated all contracts with Personnel Corporation of America (PCA). Id. PCA, a corporation with which Emmett had close personal ties, is a human resources firm that had been retained to advise the board of directors concerning, among other matters, executive compensation. Id. As a result of PCA’s efforts, Emmett received a lucrative benefit package and options to purchase close to 600,000 Tambrands shares. Id. Judith Fischer, publisher of Executive Compensation Reports, says that “it is, or can be, an incestuous relationship” when a chief hires a compensation consultant to advise the board concerning executive compensation. Id.
an executive's professional contributions. This compensation consultant "for hire" phenomenon, particularly when combined with boards partly comprised of outside directors who may be unwilling to challenge management, results in compensation arrangements that are acquiesced to and not bargained for and, thus, that are potentially unreasonable. Unfortunately, these arrangements enjoy legal protection through the operation of the business judgment rule, as modified by the Van Gorkom decision. The idea that a board's retention of a third-party advisor leads to more effective and responsible decisionmaking has proven to be a great disappointment. It has only led to continued—and it may be argued, heightened—board passivity.

The Delaware court's liability-imposing ruling in Van Gorkom was intended to bolster compliance with the duty of care as a means of creating more effective board behavior. As a result of the decision, boards began to follow certain procedures—based on the Trans Union Board's transgressions—that were designed to ensure that each decision made would receive business-judgment-rule protection and thus be in compliance with the duty of care. Theoretically, those procedures should have created more effective decisionmaking. They did not and, in fact, have only resulted in continued board passivity, potentially injurious to shareholder interests. It was a classic triumph of form over function. The duty of care, strengthened by Van Gorkom, has proven to be ineffective in resolving the passivity problem. Thus, another approach must be developed.

III. THE EQUITY-BASED APPROACH

How can we motivate a board, compositionally passive, to become an active management monitor? The traditional approach to this problem, reflected in the duty of care, sought to compel effective board behavior through the threat of personal liability for those boards who abrogated their responsibilities. Despite this duty, harm-producing board passivity created by management capture flourished, and it was rare that courts ever found boards to be in violation. Van Gorkom attempted to bolster compliance with this duty, but as discussed, has proven unsuccessful in reducing board passivity. This malady illus-

84. See CRYSTAL, supra note 2, at 214-40. But see Frederic W. Cook, Executive Pay and the Board, DIRECTORS & BOARDS, Spring 1992, at 43, 45 (observing that the best compensation consultants are not advocates for the CEO, but merely provide independent, objective advice).

85. See supra note 37 and accompanying text.

86. Perhaps recognizing the difficulties inherent in the duty of care, combating the problem of the passive board, and resulting ineffective management, a number of commentators have
trates the difficulty in attempting to induce desired behavior through

recently focused on the potential of institutional shareholder activism in forcing boards to become more active "monitors" of corporate management. The size and financial sophistication of institutional investors, who increasingly constitute the largest shareholders in many of the largest corporations, make them particularly well-suited to an active role in creating more effective shareholder oversight of both boards and managers. As a corporation's largest shareholders, institutions may have the clout to force a board effectively to monitor corporate management. For example, the Teachers Insurance and Annuity Association—College Retirement Equities Fund (TIAA-CREF) recently promulgated a policy statement on corporate governance. In an effort to improve corporate governance policies and procedures, TIAA-CREF advocates a board comprised primarily of independent directors, implementation of a pay-for-performance executive compensation system, annual board review of CEO performance, and board exercise of fiduciary oversight. Teachers Insurance and Annuity Association—College Retirement Equities Fund, Policy Statement on Corporate Governance (1994). Failure to so act could result in a board's ultimate replacement by a coalition of shareholders spearheaded by the agitated institutional investors. The prospect, or even the actual or perceived threat, of such action would be strong enough to convince otherwise passive directors to act more effectively.


It is unquestionable that institutional investors have begun to exercise more power over corporate affairs than they did even a few years ago. In a number of large corporations, they have been active advocates for change in corporate policy and personnel. Most recently, a number of large institutions have played a major role in forcing boards to make changes in manage-

the threat of punishment for noncompliance with accepted practice. Although external force is sometimes useful in creating desired conduct, it may have little impact or even produce an unanticipated harmful result if not effectively applied.

As a well-known parable suggests, it is not the stick that compels acceptable behavior, but the carrot as incentive. The Van Gorkom-enhanced duty of care functions as an ineffective "stick"; we must replace it with a carrot. But how can we incentivize outside directors in the large public corporation to eschew their traditional passivity? We must make it clear that it is in their own self-interest to do so. They must not become active participants in the oversight process because someone is ordering them to so engage, but must act because they feel that it is in their own self-interest.

The board’s failure to monitor management effectively and the consequent overcompensation controversy are the result of unchecked initiative and self-interest on the part of management and passive indifference on the part of the corporation’s directors. Externally based pressure on a board to monitor actively—and to bargain forcefully on compensation matters—has proven to be ineffective. The real solution lies with stimulating effective board oversight from within the boardroom itself. We must create a corporate regime based on board self-motivation. Only then will the board function as the effective monitoring force of general corporate affairs for which it was originally created. But how can we create the kind of self-motivation that will

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ment and policy at such prominent corporations as IBM, Westinghouse, American Express, Phillip Morris, and even General Motors. See supra notes 15, 21, 27.

Despite this activity, it is unclear whether these groups will be able, over the long run, to place the kind of constant and continual pressure on boards that will result in effective oversight. There are several reasons why sole reliance on institutions to resolve the passivity controversy would be a mistake. First, as Professor Coffee has pointed out, a preference for liquidity in their investment portfolios "chills the willingness of institutional investors to participate in the control of major corporations." Coffee, supra, at 1281. Second, because each institution's holdings in the various corporations in which it invests is likely to be quite small proportionally, effective control over the affairs of the target corporation would only be effected through a coalition of institutional investors. Differences over investment goals and strategy may make such coalitions difficult to form and maintain, hindering effective action. Additionally, to act as a group, the varying shareholding institutions must be able to communicate with one another freely. Under present SEC regulations (including the proxy rules), however, such communication may be restricted. There is no doubt that institutions are becoming more restless shareholders and have begun to demand a more active role in corporate governance. But, for the above reasons among others, they may never prove as effective as their proponents suggest in a general corporate monitoring role. This does not mean that efforts to encourage institutional voice should cease, but this voice may not bring as much positive change as earlier envisioned. See Elson, supra note 1, at 970–72; see also Bainbridge, supra note 13, at 1054 n.108 (discussing commentaries that state institutional investors can provide an active voice in corporate governance).
counter the kind of pro-management pressures placed on outside directors due to management capture?

A. Stock Ownership

The outside director must be made to consider management activity from the viewpoint of a company stockholder, to whom the director is legally obligated, instead of from the perspective of one beholden to management. It is the stockholders who stand to lose the most from the lackluster corporate performance created by ineffective board monitoring. Thus, it is crucial that the company's outside directors realign their interests and thinking with those of the shareholders.87 The most

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A business is organized and carried on primarily for the profit of stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.


Professor Berle ascribed to the principle that directors owe a fiduciary duty only to the company's stockholders, stating that "you cannot abandon emphasis on 'the view that business corporations exist for the sole purpose of making profits for their stockholders' until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else." A.A. Berle, Jr., For Whom Corporate Managers Are Trustees: A Note, 45 HARR. L. REV. 1365, 1367 (1932).

However, Professor Merrick Dodd challenged this theory, thereby providing the basis for the contemporary debate concerning to whom the benefits of the director's fiduciary duty should flow. E. Merrick Dodd, Jr., For Whom Are Corporate Managers Trustee?, 45 HARR. L. REV. 1145 (1932) (arguing that directors should represent constituencies other than shareholders). This argument has been coopted and advocated by numerous contemporary scholars. See generally John C. Coffee, Jr., The Uncertain Case for Takeover Reform: An Essay on Stockholders, Shareholders and Bust-Ups, 1988 WIS. L. REV. 435 (1988) (advocating protection of middle managers whose jobs are threatened by bust-up takeovers); Ronald M. Green, Shareholders as Stakeholders: Changing Metaphors of Corporate Governance, 50 WASH. & LEE L. REV. 1409 (1993) (arguing for a shift in the law and a new definition of corporate directors' fiduciary duties); Morey W. McDaniel, Bondholders and Stockholders, 13 J. CORP L. 205, 265-73 (1988) (arguing for protection of bondholders harmed by takeovers); Morey W. McDaniel, Stockholders and Stakeholders, 21 STETSON L. REV. 121 (1991) (arguing why constituency statutes are beneficial and necessary); Marleen A. O'Connor, Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers, 69 N.C. L. REV. 1189 (1991) (arguing that directors should owe employees a fiduciary duty to alleviate employee displacement caused by corporate restructuring); Katherine VanWezel Stone, Employees as Stakeholders Under State Nonshareholder Constituency Statutes, 21 STETSON L. REV. 45 (1991) (advocating the creation of fiduciary duties on behalf of employees); Steven
effective way to create such perspective is to appeal directly to these directors' personal pecuniary interests. The outside directors must not remain mere observers of the corporate enterprise, but must become active equity participants. If a director's personal capital is potentially affected by inept or corrupt management, that director is much less likely to acquiesce passively to such a group. From a personal standpoint, there is much less incentive to stand watch over what one considers to be someone else's property than over what one considers to be one's own. Interestingly enough, this was the whole point behind the creation of the externally imposed director's duty of care.

By becoming equity holders, the outside directors would assume a personal stake in the success or failure of the enterprise. Decisions that had a negative impact upon the business would be collaterally harmful to their own personal financial interests. Thus, director demand for effective management would no longer be the result of compliance with a distant legal requirement (or vaguely understood pressures from outside institutions), but would emanate from within. Directors would have a substantial personal interest in creating an efficient and competitive management structure. To demand any less would be disadvantageous to their own financial well-being.

Equity ownership would act to counter the pressures placed on the outside directors as a result of management capture. It is very hard to resist the demands of individuals to whom you owe your position when your involvement in the venture is limited to the fee you receive for your services and the continuance of that fee is subject to the will of management. Possessing an actual stake in the venture itself alters the nature of this relationship considerably. In addition to considering that the active monitoring of management may lead to replacement, an outside director must also consider that the failure to exercise effective oversight may result in the diminution of his or her personal wealth. Under such an arrangement, it would not be quite so easy simply to acquiesce to the demands of management. This dynamic creates a more


88. See supra note 6. Brown Brothers Harriman's Lawrence Tucker, who served as a director on one particular corporate board that had an average director investment of nearly $1 million, described that group as a "board that pays attention . . . . I've never seen the pocket calculators come out so quickly in my life." Ted Bunker, Editor's Page, INVESTORS' DAILY, July 7, 1993, at 4.

89. As Professor Stobaugh has observed, "A director with little stock ownership but substantial annual compensation would have little financial incentive to 'rock the boat' if that presents any danger of his or her being replaced as a director." Stobaugh, supra note 6, at 3.
balanced relationship between management and equity-holding outside directors and, in turn, encourages the kind of oversight presently lacking in the traditional management-dominated board.  

B. Lengthened Director Terms

Very often, though, outside directors do in fact hold stock in the companies they serve. If equity ownership has any motivational impact or potential, why then are these directors still so susceptible to management capture? It is not that the possession of an equity position in a venture has no impact on director motivation, but the fact that these directors’ stockholdings in their companies are insubstantial compared with the monetary and reputational compensation they receive for board service. In the typical large public corporation, many of the outside directors own relatively small amounts of company stock. Their major stake in the venture is the fee they receive each year for board service. Such fees, particularly in the larger corporations, may well exceed $40,000 per annum—no small reward for a position in-

90. David McLaughlin, a noted management consultant, has stated:

Stock ownership obviously helps to align shareholder and director interests . . . . Some boards have been slow to respond to deteriorating company fortunes (witness the sagas of IBM, General Motors, Westinghouse, and Eastman Kodak). Perhaps if the directors of those companies had significant personal stakes in their enterprises, they would have been quicker to reveal and resolve fundamental issues of strategy and leadership. While compensation has been overrated as a motivator, when six-figure sums are involved, even wealthy individuals pay attention to trends in the stock price.

McLaughlin, supra note 6, at 59.

91. For example, the current and past holdings of a few noted directors at several larger public corporations are as follows:
volving attendance at only a few meetings a year. In addition, the social and reputational advantages for board service are obvious. The more prestigious the company on whose board an individual sits, the more influential one is considered to be in the business community,

<table>
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<tr>
<th>COMPANY</th>
<th>DIRECTOR</th>
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<tr>
<td>Bank of Boston</td>
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<td>Donald Monan</td>
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<td>J. Richard Munro</td>
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<td>Aviana L. Peters</td>
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<td>Disney</td>
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<td>Philip Morris</td>
<td>Rupert Murdoch</td>
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<td>Sears Roebuck</td>
<td>Mandell de Windt</td>
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<td>Norma Pace</td>
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<td>Nancy C. Reynolds</td>
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<td>Ralston Purina</td>
<td>David Banks</td>
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<td>Francis Ferguson</td>
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<td>Benjamin L. Hooks</td>
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<td>Edmund T. Pratt, Jr.</td>
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<td>Louis W. Sullivan</td>
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<td>Westinghouse</td>
<td>Paula Stern</td>
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92. Remuneration for nonemployee directors often exceeds $40,000, including their annual retainer, the fee received for attending meetings, and any additional compensation they may receive for chairing committees. See supra note 29. Often remuneration goes beyond annual compensation and payments for meetings attended. For example, each nonemployee director at Eastman Kodak is covered by group term-life insurance in the amount of $100,000. Nonemployee directors at American Express who have served at least five years are eligible to receive $30,000 per annum upon their retirement from the board; these payments continue for a number of years equal to the time served on the board or until death. AmEx Proxy, supra note 29, at 7. Similarly, General Electric’s nonemployee directors who have served at least five years, are over 65 years of age, and retire directly from the board are eligible to receive either an annual payment for life equal to the amount of the last retainer received or a $450,000 life insurance policy. GE Proxy, supra note 29, at 13; see Bruce Overton, Remuneration of Outside Directors, in A STRATEGIC GUIDE, supra note 21, at 383.
which leads to other opportunities for financial benefit. Outside directors may sometimes supplement their fees with lucrative consulting contracts provided by solicitous management. The most glaring example of this phenomenon occurred during the leadership of F. Ross Johnson, the legendary CEO of RJR/Nabisco, who had placed several outside directors on the company payroll prior to the leveraged buy-out that eventually cost Johnson his job.

Generally, the cumulative annual fees paid to each outside director, particularly when considered over the multi-year terms of typical board membership, involve considerably more money than the usual value of that director's stockholdings in the business. Most business decisions involve a consideration of both the costs and the benefits of the contemplated strategy. When an outside director in a management-controlled enterprise makes a decision that challenges management prerogative, that director risks retribution from the dominant executives, which might involve the failure to be renominated to the board at the next election. Obviously, before making such a decision, the director will, consciously or not, weigh the various benefits that such a decision entails against any attendant costs. Where a director's stockholdings in a given corporation are substantially less than the income that the director receives in fees, the potential loss of such fees may weigh more heavily in that director's mind than any beneficial increase in stock value that might result from the corporate efficiencies created. This would explain management "capture" even in situations where the outside directors have equity positions in their companies. The key, then, is not merely stock ownership, but substantial ownership.

At what threshold do holdings become "substantial"? To have a salutary impact on director behavior, equity ownership by outside directors must be significant enough to affect a director's decisionmaking process. An outside director's shareholding position must be large enough that, in considering a particular course of action, concern about how a decision will positively affect equity value subsumes traditional desires to placate fee-paying management. A director's personal shareholdings must weigh more heavily in that individual's decisionmaking process than fee-maintenance concerns. The value of that individual's equity interest in the business must exceed the amount to be obtained through continued fee income. If a director's personal interest in the

93. See Mace, supra note 4, at 87—91; Overton, supra note 92, at 383.
94. See Bryan Burrough & John Helyar, Barbarians at the Gate: The Fall of RJR Nabisco 97—98 (1991). At the time of the leveraged buyout, RJR Nabisco's outside directors were among the highest paid directors in American industry. Overton, supra note 92, at 388.
company's stock were to exceed the annual compensation and prestige value of board membership, perhaps that individual would be less willing to side continually and complacently with management when such behavior could have a negative impact on the company's market value and, thus, on his or her personal holdings. We must make it in the director's own self-interest to challenge and monitor management. A large equity position in the business would go far toward accomplishing this goal. But how can we create a stake large enough to induce favored behavior?

To create the appropriate equity incentive, the corporation should simply pay the directors their annual fees in company common stock. It seems only natural that each director should be rewarded with an interest in the business itself as compensation for the exercise of oversight as a board member. In addition, the company should make a limited cash payment to each equity-compensated director to cover any income taxes that may be imposed as the result of such stock grants. To prevent the quick liquidation of these stock payments and consequent loss of equity-based incentive, the stock awarded must be restricted as to resale during the individual's directorship. Although some might argue that a stock-option grant to directors may serve the same purpose, and at less cost to the corporation, such an approach would prove less effective than direct equity ownership simply because of the highly tentative nature of an option prior to exercise. Stock ownership provides the director with a tangible stake in the enterprise, not merely some speculative expectancy of a discounted future position.

Although such a compensation system will create substantial stockholdings in the hands of the previously complacent outside directors, a few problems remain. To have any sort of favorable impact on director behavior, the amount of stock that each director holds must be reasonably substantial. The key is to provide each individual with a block large enough to induce active monitoring. Although a director's yearly fee may purchase a large amount of stock, it may not be enough to create the kind of stake that will counterbalance the fear of replacement that management challenge may bring. Therefore, a director's term of office must be expanded significantly. Instead of being elected to a term of one to three years, directors should instead serve five-year terms. In addition to minimizing the immediacy of any management replacement threat, such a term will create in each director both an

95. To alleviate any potential liquidity concerns that a director may have as the result of such restriction, the corporation may allow the individual to pledge the restricted stock as collateral for either a company-sponsored or third-party loan.

96. See Elson, A Board-Based Solution, supra note 2, at A22; Lublin, supra note 6, at R5.
immediate equity stake and, without yearly reelection concerns, the promise of a fixed number of future stock grants. Five years' worth of fees paid in company stock should result in the accumulation of a reasonably substantial equity position for each director.\textsuperscript{97} Moreover, because of the fixed five-year term, the beneficial impact of equity ownership will manifest itself throughout the period of board service. A director will either possess the stock itself or the expectancy of a certain five-year accumulation that will provide similar incentive.

The quinquennial election of directors is not a new proposal. Martin Lipton and Steven Rosenblum, two prominent corporate practitioners, recently advocated such a change in board structure, along with a host of other major governance reforms.\textsuperscript{98} They suggested that the creation of a five-year fixed term of office would create a corporate "long-term view" highly beneficial to corporate "vitality."\textsuperscript{99} The main goal of their proposal, however, involves the creation of a corporate governance model "that will lead managers and stockholders to work cooperatively towards the corporation's long-term business success."\textsuperscript{100} Their arguments advocating term expansion focus primarily on creating a management-shareholder "long-term" cooperation relationship, rather than corporate productivity through active director oversight.\textsuperscript{101} Despite this goal, their call for a longer range perspective on company affairs, an obvious byproduct of five-year director terms, is a laudable and desirable result. Who can really argue when management and boards of directors make decisions with the long-term health of the enterprise in mind? Some of Lipton and Rosenblum's other proposals, especially those promoting the hindrance of changes of corporate control, are more problematic. However, they should not detract from the potential benefits of quinquennial director terms. If five-year terms can be combined with equity grants, an effective incentive for active director monitoring will be created, resulting in greater productivity and responsibility to the equity holders.

\textsuperscript{97} For example, if a director is paid $35,000 per annum, at the conclusion of his term, he should own $175,000 in company stock. If he receives $50,000 per year, he would complete his term with $250,000 worth of stock.

\textsuperscript{98} Lipton & Rosenblum, supra note 7, at 187-253. The quinquennial election of directors is one part of Lipton and Rosenblum's proposal for comprehensive reform of the present corporate governance system. \textit{Id.} Their proposal would also bar nonconsensual changes in control between elections, provide major shareholders with access to corporate proxy materials relating to elections of directors, require a detailed five-year report on the company's performance and a prospective five-year plan, and tie management compensation awards and penalties to the corporation's performance against the plan. \textit{Id.} at 190.

\textsuperscript{99} \textit{Id.} at 216.

\textsuperscript{100} \textit{Id.} at 189.

\textsuperscript{101} \textit{Id.} at 224--52.
There are two potential drawbacks, however, to lengthened director terms. First, such terms may make corporate changes of control much more difficult to accomplish. Second, they could lead to the possible entrenchment of ineffective, or even disloyal, directors. These problems are not as dramatic as they would appear to be at initial glance. First, shareholders always have the right to remove a director for cause, a power that should resolve the problem of the disloyal or inattentive director. Second, provisions could be made to allow shareholder removal of directors without cause, which should ease any potential chilling effect of the proposal on changes of corporate control. However, given the more active director behavior this proposal should entail, changes of control would not appear to be necessary to compel effective management. Moreover, the “long view” perspective that such a lengthened term may provide to the outside directors, no longer subject to the pressures of annual election, also weighs heavily in the proposal’s favor. Directors, now possessing a five-year time horizon, will find it easier to make decisions that offer the promise of strong long-term returns even though they may have a negative impact on short-term profitability. The five-year term thus has great potential.

C. Potential Costs

Of course, as no approach to resolving a particular corporate problem comes without its costs, we must consider the negative impact that an equity-based approach may entail. One difficulty that increased equity ownership may create involves the possible chilling effect of positive risk-taking behavior by the outside directors. A business will only prosper by the amount of risk that management is willing to take. The greater the risk taken, the greater the potential return to the shareholders. It may be argued that outside directors who own large amounts of company stock, particularly those with limited outside assets, will have such a significant portion of their personal wealth tied to company stock that they will have an incentive to demand that management adopt a more conservative risk-taking posture. While such an approach may preserve the value of these individuals’ personal holdings through the steady maintenance of corporate assets, it will concurrently deter the sort of aggressive behavior that brings the potential of

102. See, e.g., Campbell v. Loew’s, Inc., 134 A.2d 852, 859 (Del. Ch. 1957); Auer v. Dressel, 118 N.E.2d 590, 596 (N.Y. 1954). Some state statutes have modified the common-law rule and allow shareholders to remove directors without cause. See e.g., CAL. CORP. CODE § 303(a) (West 1994); N.Y. BUS. CORP. LAW § 706 (McKinney 1986); REV. MODEL BUSINESS CORP. ACT § 8.08 (1984); see also CAREY & EISENBERG, supra note 14, at 153—54.
significant profit and asset growth. Unfortunately, these individuals would have no opportunity to increase their personal tolerance to risk through the portfolio diversification techniques other investors utilize because they would be forced to hold unsalable restricted stock.

This problem, although not insignificant, is not as troubling as it would initially appear to be. It assumes that the commitment of a large portion of one's assets to a single enterprise inevitably leads to conservative behavior. This is not always the case. Many successful entrepreneurs have most of their personal wealth invested in their businesses. This does not discourage, but rather acts to encourage, risk, for the ultimate goal of wealth accumulation that motivates these individuals cannot be met without risk. They achieved success through risk, and their stockholdings encouraged still greater risk because of the potential to share in the larger returns that such risk brings. What about those in business who are not entrepreneurial in spirit but who possess a more restrained, managerial bent? For such individuals, unless they possess significant holdings in other ventures, the commitment of a large portion of their personal wealth to the company on whose board they sit may discourage risk-taking. On the other hand, can it be said that a fee-based compensation program will act conversely—to stimulate risk-taking behavior? Not necessarily. In fact, this is why there has been a shift in recent years to creating compensation programs for corporate management that result in executive equity accumulation rather than simple cash payments. One goal is to encourage risk-taking rather than position preservation.108 Creating equity positions in outside directors may have the same impact.

Although some individuals are risk-averse by nature (and, indeed, the presence of such persons on a board may even be a welcome counterbalance to those with excessive dare), it is not at all clear that the payment of directors' fees in cash encourages risk-positive behavior. In

the typical management-captured corporation, the expectation of continued fee income leads to passive conduct ultimately harmful to corporate productivity. Risk-averse individuals are particularly susceptible to such pressure. Creation of an equity-based incentive as an antidote to director passivity may produce the positive impact on behavior that will far outweigh any potential danger of elevated risk aversion among a few individuals. In fact, the impact may be risk-neutral (for some may be inherently risk-averse) or even risk-positive.

A second disadvantage of equity-based director compensation may be an exclusion from the pool of potential directors of those who would rather be compensated for their activities with cash. It could be argued that by refusing to compensate in cash, a corporation could deprive itself of the services of a large group of talented individuals. No such loss would occur by paying cash fees, for a company could attract the involvement of both those who desire cash and those who would prefer equity, as these individuals could easily convert their cash payments into company stock. This argument misses the point. It was the payment of fees in cash that, in the management-captioned enterprise, created the passivity that led to oversight-driven productivity problems in the first place. A director who would demand only cash and refuse to take an equity position in the enterprise might be just the sort of individual who should not serve as a monitor of management behavior.104 Of course, a director is not giving up the right to compensation by being paid in stock. The form of compensation is simply being varied. Indeed, to decline to serve simply because of a noncash form of payment suggests the sort of purely mercenary mentality that has led to the entire problem of management capture. A board made up of individuals willing to demonstrate a real commitment to the shareholders whom they were elected to serve by taking an equity position in the enterprise is a corporation’s best hope. An equity-based director compensation system will lead to the type of board composition that will maximize management productivity.

104. One commentator states that he will not serve on private company boards unless he can make a substantial cash investment in the company. This large investment allows him to get involved in nearly every facet of the business, which in turn creates a chance to earn a substantial return and decreases the chance of lawsuits from other shareholders. William A. Sahlman, Why Sane People Shouldn’t Serve on Public Boards, HARV. BUS. REV., May–June 1990, at 34. David McLaughlin has argued that stock ownership requirements on the part of corporate directors will not make it more difficult “to recruit first rate directors . . . It is a myth that ‘independent’ non-corporate directors cannot afford to make an investment. Our analysis shows that directors who represent non-profit institutions own about as much stock as the average director.” McLaughlin, supra note 6, at 59.
D. The Empirical Evidence

Central, of course, to the effectiveness of an equity-based solution to the board passivity dilemma is the assumption that stock ownership has a positive impact on director behavior. For this approach to be successful, there must be a link between equity ownership and more motivated director behavior. An empirical examination of the behavior of boards composed of outside directors with substantial stockholdings, as compared with boards whose outside directors do not possess large equity stakes, may act to demonstrate the potentially positive impact of an equity-based approach.

Two businesses researchers, Professor Robert Stobaugh of the Harvard Business School and David McLaughlin, a noted management consultant, recently conducted separate studies examining the linkage between director stock ownership and more effective board oversight and corporate productivity. Both found that substantial outside director equity ownership led to heightened performance. In his study, McLaughlin randomly selected seventy of the largest publicly traded United States companies “with median sales of $9.4 billion, and examined the ownership pattern of the 631 non-management directors who sit on the boards of these companies.” He discovered that “the higher ownership commitment” on the part of the outside directors, the “greater the total shareholder return.” Those companies “whose outside directors have relatively high stock holdings outperform those whose non-management directors have minimal holdings.” Additionally, those businesses with the greatest outside director shareholdings “outperform the bottom half [of the companies surveyed] in both five-year compound earnings-per-share growth and average return on shareholders’ equity.” McLaughlin concluded from his study that, as an aid to performance, boards must establish director-stock-ownership plans and create periodic audits of director shareholdings.

105. McLaughlin, supra note 6, at 55.
106. Id. at 56.
107. Id. at 53. McLaughlin reported that “our study of 70 companies . . . shows that those with the highest director ownership delivered a return of 174% to their shareholders over the five years from 1988 to 1990, while those with the lowest delivered only a 73% return.” Id. at 54.
108. Id. at 56.
109. Id. at 59. McLaughlin argued:

It seems reasonable, however, to require all directors, within three years of election, to hold an amount at least equal in value to the annual retainer. The ownership level should increase over time, to a value of two to three times the annual retainer after four to six years, and three to five times as the director approaches
Professor Stobaugh conducted a similar study, but with a smaller sampling of companies surveyed. He contrasted the director stockholdings of nine companies on the Fortune magazine list of America’s “most admired companies” with nine that were “corporate governance ‘targets’ of varying shareholder rights groups, including the California Public Employees Retirement System and United Shareholders Association.” Stobaugh discovered that the median amount of stock held by the directors of the former group of companies was eight times that of the latter group. He concluded that these results were “consistent with the logic that tying a director’s financial well being to a company’s performance might be important.” On the basis of this survey, he recommended the following:

Stock ownership by corporations should be increased substantially so that directors will be further motivated to take prompt action in addressing corporate problems. In linking a director’s personal financial interest to those of shareholders, shareholder interest will be better served . . . . [I]ncreasing substantially the ownership of stock by directors should improve corporate governance by providing additional incentives for directors to overcome the inertia that sometimes prevents them from making tough decisions.

Expanding on the research conducted by McLaughlin and Stobaugh, I conducted a broader study that yielded similar results. Annually, Fortune magazine conducts a survey to determine America’s most and least admired companies. In 1992, the survey included 311 companies in 32 different industries. The survey polled over 8000

10 years of service. The initial ownership goal can be facilitated for new directors if the company offers to supplement the individual’s own “going in” commitment with an initial grant, or pays a portion of the annual retainer in stock.

Id.

110. Stobaugh, supra note 6, at 2.
111. Id.
112. Id.
113. Id.
114. Id. at 3, 4.

116. The 32 industries included were the following: mining, crude-oil production; petroleum refining; utilities; forest & paper products; pharmaceutical; chemicals; textiles; metals; building materials; rubber & plastics products; metal products; electronics, electrical equipment; computers, office equipment; scientific, photographic & control equipment; publishing, printing; apparel; soaps, cosmetics; retailing; furniture; diversified service; life insurance; diversified financial; commercial banking; savings institutions; food; beverages; tobacco; aerospace; motor vehicles & parts; industrial & farm equipment; transportation; and transportation equipment. Id.
senior executives, outside directors, and financial analysts, asking them to rate the ten largest companies in their own industry on eight attributes of reputation, using a scale of zero (poor) to ten (excellent). The eight reputational attributes polled involved both financial and nonfinancial measures, including such items as value as a long-term investment, use of corporate assets, quality of management, and quality of products or services. These ratings were then combined to create a total reputational score, also on a zero (poor) to ten (excellent) scale, and each company was ranked by the total score received, from the most admired United States corporation (a score of 8.74) to the least admired (a score of 1.99).

Assuming that there is some validity in suggesting that the companies most admired by the corporate and financial communities are more effectively managed and possess better board monitoring than those that are not, this survey provides an excellent starting point for an examination of the link, if any, between good corporate results and outside director stock ownership. Of the 311 companies examined in the Fortune study, I selected for review the 110 companies that were on either extreme of the survey—either receiving the highest or the lowest ratings for overall admiration. Fifty-eight of the companies I examined were “most admired,” receiving a score of 7.0 or higher in the study. The remaining fifty-two I studied were “least admired.”

117. Id. at 53.
118. Id.
119. The eight attributes included were the following: quality of management; financial soundness; quality of products or services; ability to attract, develop, and keep talented people; use of corporate assets; value as long-term investment; innovativeness; and community and environmental responsibility. Id. at 46.
120. Id. at 54–55. Additionally, the opinion research firm of Clark Martire & Bartolomeo, who aided in the survey, explained the relationship between the poll data and actual financial performance of the companies surveyed. Twelve measures of performance, “including profits, assets, and return on shareholders’ equity,” were combined with the survey data into a spreadsheet. A multiple regression was then run to analyze the relationship between financial performance and reputation score. The resulting equation was used to predict a reputational score based solely on financial performance. Id. at 44, 53. Interestingly, financial performance did correlate with the reputational rankings, although there were obviously some exceptions. See id. at 44.
121. The following were the most admired companies: Merck; Rubbermaid; Wal-Mart Stores; 3M; Coca-Cola; Procter & Gamble; Liz Claiborne; J.P. Morgan; Boeing; Kimberly-Clark; Corning; Johnson & Johnson; PepsiCo; Pfizer; General Mills; Motorola; Golden West Financial; American Brands; Cooper Tire & Rubber; Du Pont; BellSouth; Hewlett-Packard; Sara Lee; Shaw Industries; General Electric; Harley-Davidson; Herman Miller; International Flavors & Fragrance; Dow Chemicals; Morgan Stanley Group; Anheuser-Busch; Gillette; Abbott Laboratories; Apple Computers; Reader’s Digest; Illinois Tool Works; AT&T; Springs Industries; Colgate-Palmolive; Eli Lilly; Alcoa; American International Group; Great Western Financial; Bankers Trust N.Y.; Berkshire Hathaway; Southwestern Bell; Philip Morris; Xerox; Amoco; Bell Atlantic; Bristol-Myers Squibb; VF; Bandag; PPG Industries; Exxon; R.R. Don-
receiving a score of 5.5 or lower. I then reviewed the proxy statements of each of the 110 selected corporations to ascertain how much company stock was held by each of the companies' outside directors. Next, I determined how many companies were run by boards in which outside directors with individual holdings valued in excess of $20,000 constituted a majority of the full board and, thus, theoretically controlled that institution. This procedure was then repeated for holdings valued in excess of $50,000, $100,000, $125,000, $150,000, $200,000, and $250,000. Finally, I compared the stockholdings of outside directors serving on the "most admired" companies' boards with the holdings of outside directors serving on the "least admired" companies' boards. This comparison was an attempt to test the hypothesis that outside directors on the boards of companies that were well-regarded and consequently better managed were more likely to have substantial equity holdings in those companies than outside directors on the boards of companies that were least admired and thus poorly run.

122. The following were the least admired companies: Tektronix; W.R. Grace; Dr. Pepper/Seven-Up; Cigna; Whitman; Avondale Industries; Holnam; Collins & Aikman; Northrop; FirstFed Michigan; James River; First Chicago; Seagate Technology; Chase Manhattan; Burlington Industry Cap.; General Motors; USX; Grumman; Borden; Union Carbide; First Interstate Banc.; Inland Steel Industries; USG; Westinghouse Electric; Digital Equipment; Stone Container; Maxxam; Citicorp; Amoskeag; Champion International; West Point-Pepperell; Coast Savings Financial; McDonnell Douglas; Interco; Navistar International; Travelers; Travelers Corp.; USAir Group; Anchor Bancorp; Boise Cascade; Northwest Airlines; Brooke Group; Sears Roebuck; Hartmarx; Bethlehem Steel; Unisys; Crystal; Calfed; Dime; Glenfed; Continental Airlines Holdings; and Wang Laboratories. Id.

123. "Outside directors" was defined as those directors who were not and had not served as officers of the corporation. Furthermore, a family member, such as a widow or spouse, of an officer of the corporation was not considered to be an outside director.

124. The stock prices used to calculate the dollar value of the outside directors' stockholdings reflected the closing market values of the various stocks as of November 10, 1993. WALL ST. J., Nov. 10, 1993, at C3.
TABLE 1

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<th>Size of Director Stockholdings</th>
<th>Most Admired</th>
<th>Percentage of Total Companies in Most Admired Grouping</th>
<th>Least Admired</th>
<th>Percentage of Total Companies in Least Admired Grouping</th>
<th>Deviation Factor</th>
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<td>15.5%</td>
<td>4</td>
<td>7.69%</td>
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The results, presented in Table 1, confirm the initial hypothesis on the relationship between equity holdings and better corporate performance and oversight. The companies in the “most admired” category were much more likely to be run by boards with significant equity investments in the business than those that were considered the “least admired” and thus poor performers. Further, the greater the value of outside director holdings, the more likely it was that the corporation surveyed would fall into the “most admired” category.

In the group of companies that were “least admired,” at the $20,000 director shareholding level, only 61.5% of the companies surveyed had boards numerically dominated by outside directors with at least $20,000 in company shareholdings. At the $100,000 level, the percentage dropped substantially to 26.9%; and at the $150,000 level, the percentage fell to 13.4%. Finally, in the $250,000 category, the highest level surveyed, only 7.69% of the companies in the “least admired” grouping had outside director equity holdings at that level.

The results for those companies in the “most admired” category differed substantially. To be sure, there was—as the dollar criteria grew—a decline in the numbers of companies meeting the holdings standards at each level. However, at each monetary level, the percentage of companies meeting the relevant criteria was always substantially greater than was seen in the “least admired” category, and the lowest percentage of compliance, seen at the highest survey level, $250,000, was significantly greater than the corresponding percentage in the alternative grouping of companies. At the $20,000 level, 82.7% of the
companies surveyed had outside director shareholdings meeting the relevant criteria. At the $100,000 level, the percentage dropped to 37.9%; and at the $150,000 level, the percentage stood at 20.6%. Finally, in the $250,000 category, 15.5% of the companies in the “most admired” grouping had outside director equity holdings at that level.

Two points about these results are particularly worth noting. First, at every examined level of outside director stockholdings, there were proportionally significantly more companies in the “most admired” category than in the “least admired” category. Second, as the level of director holdings increased, the spread between the two groups of companies grew significantly. At the $20,000 level, only 61.5% of the companies in the “least admired” grouping met the equity-holding criteria; at $100,000, just 26.9%; at $150,000, only 13.4%; and finally at $250,000, just 7.69%. This differed substantially from those companies in the “most admired” grouping, where at the $20,000 level, 82.7% met the criteria; at $100,000, 37.9%; at $150,000, 20.6%; and at the $250,000 level, 15.5%. At the $100,000 level, there were almost one and one-half times as many companies in the “most admired” category as in the “least admired”; and at the $250,000 level, the spread between the two grew to exceed more than twice the number.

What, then, do these numbers demonstrate, and how do they relate to an equity-based solution to the passive board problem? The results of my survey, particularly if read in light of the Stobaugh and McLaughlin studies, suggest that the positive impact of outside director stock ownership on corporate performance and, obviously, effective board conduct is notable at all levels of director equity ownership. And, as the value of director holdings increases, the impact of stock ownership is even more notable, as the two groups of companies experience even greater divergence in results. Substantially fewer of the corporations that are considered poor performers, at least by the standards of the Fortune study, are run by boards numerically dominated by outside directors with substantial equity holdings in those businesses. Many more of the companies that are performing in a respected fashion have boards numerically controlled by outside directors with large equity positions. At the $250,000 level, there are more than twice as many companies that are considered good performers as those in the “least admired” category. Although this is not a survey of great scientific precision, it does suggest that there may be some connection between heightened equity ownership and better corporate performance, an important consequence of effective board oversight. The more substantial the holdings become, the greater the appearance of a link between stock ownership and the kind of effective monitoring that leads to desired company performance.
Missing, of course, from an interpretation of the results of the study is any indication of the effect of a five-year board term on director behavior. None of the 110 companies surveyed had such a term structure. What does appear from the results, however, is an indication of the positive impact, not simply of stock ownership, but of substantial stock ownership. The key to more effective board monitoring, then, is to create in each outside director a substantial equity position in the business itself. Payment of director fees in stock, combined with five-year terms of office, will create such holdings. As noted earlier, implementation of this plan will result in outside director stakes in the larger corporations of at least $175,000, or even higher, which, as indicated in the survey, is well above the level at which positive benefit becomes pronounced.

The empirical evidence yielded by this study suggests that companies with boards composed of outside directors with significant shareholdings tend to outperform those without such boards. An alignment of the directors' interests with those of the shareholders, rather than with those of management, through the development of large shareholding positions resulting in more effective oversight, would explain this phenomenon. Thus, an equity-based attack on board passivity may be potentially helpful and warranted.

**E. The Duty of Care, Equity Ownership, and Van Gorkom**

The equity-based approach to resolving the problem of the passive board has great potential and must be strongly encouraged. But what should become of corporate law's traditional response to the inattentive director—the duty of care? Should we abandon this institutionalized legal rule entirely? Not necessarily. The problem with the duty as it is now formulated, post-Van Gorkom, is that it has created a Byzantine pattern of behavior among corporate boards that, as discussed, leads nowhere helpful. We must therefore abandon the Van Gorkom ap-

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125. See supra notes 88–97 and accompanying text.
126. Apparently as a result of the recognition of the beneficial aspects of director stock ownership, within the last year, the number of large United States corporations providing stock grants to outside directors has risen dramatically. According to an analysis of varied 1994 proxy statements by William M. Mercer, Inc., nearly three-fourths of a group of 350 large industrial and service companies reported using stock grants as part of their directors' compensation programs. In Review—Recent Notes & Events: Compensation & Recruitment, CORP. BOARD, July-Aug. 1994, at 28. Despite this trend toward creating stock grant programs for outside directors, it is rather disappointing to note that in its recently promulgated "Board Guidelines," designed to promote effective board behavior, General Motors failed to require or even suggest outside director equity ownership in the company, GENERAL MOTORS CORPORATION, GM BOARD GUIDELINES ON SIGNIFICANT CORPORATE GOVERNANCE ISSUES (1994).
proach to the duty and transform it from a rule of law that attempts to coerce desired behavior through the threat of liability for noncompliance with mandated procedure to one that, as Professor Coffee has suggested, is more "aspirational" in nature. A duty of care that serves more as a guide to desired behavior on the part of corporate directors through its "socializing and exhortative impact," though still available to punish extreme conduct, is, in combination with substantial board equity ownership, much more likely to have a positive impact on board behavior than the present Van Gorkom-styled approach. The real issue that we must confront is motivation. How do we create desired behavior—through coercion or individual-based self-motivation? Self-motivation is always more effective. When it is in an individual's own self-interest to act in an appropriate manner, that individual will so act. Equity ownership creates such motivation and synergistically, in combination with a return to a less rigid approach to the duty of care, will stimulate the effective board oversight that has been so lacking in both the pre- and post-Van Gorkom eras.

This point becomes much clearer through a reexamination of several aspects of Van Gorkom that until now have received scant attention. There are two most interesting facts relating to the compositional nature of the Trans Union Board that, in light of my empirical data, are highly relevant in explaining why the Board's actions might be seen as problematic. First, at the time of its fateful merger decision in late 1980, the Trans Union Board was comprised of ten members—five of whom were officers of the corporation and five of whom were "outside" directors. None of the five outside directors, all of whom apparently supported the proposed merger, could be characterized as "substantial equity holders" in the company. Their rather paltry individual holdings ranged in size from 101 to 599 shares of stock. In fact, four out of the five owned less than 300 shares, which—at a then market price of $37.25 per share—represented total Trans Union holdings for these four directors (all present or former CEOs of very large publicly held corporations) ranging from $3763 to $11,175 in value.

Second, cross-directorships abounded on this Board. Most of the

127. Coffee, supra note 40, at 798.
128. Id.
129. Trans Union's "inside" directors, those who served as directors and officers of the corporation, were Sidney H. Bonser, William B. Browder, Bruce S. Chelberg, Thomas P. O'Boyle, and Jerome W. Van Gorkom. Trans Union's "outside" directors were William B. Johnson, Joseph B. Lanterman, Graham J. Morgan, Robert N. Reneker, and W. Allen Wallis. TRANS UNION CORP., APR. 24, 1980 PROXY STATEMENT 3-6 (1980) [hereinafter TUC PROXY].
130. The stockholdings of Trans Union's "outside" directors were as follows:
outside directors, in addition to Van Gorkom, who was the Trans Union Chairman and CEO, served either on one another's boards or as directors of common corporations. It is no stretch logically to conclude that all of these individuals were probably either financial or social acquaintances of Van Gorkom, with fairly strong ties binding them together. It must also be noted that there appeared to be no one shareholder or group of shareholders holding enough Trans Union shares to exercise control of the company. From the small number of outside directors serving on the Board and the insubstantial stockholdings of each, it is fairly clear that management controlled the enterprise. Additionally, the average yearly fee paid each director, $10,000 plus $700 for each board and board committee meeting attended, adding up to about $18,000 in 1979, well exceeded most of the outside directors' total equity holdings in the company. In sum, given the absence of a dominant shareholder control group at Trans Union, the

<table>
<thead>
<tr>
<th>DIRECTOR</th>
<th>SHARES OWNED</th>
</tr>
</thead>
<tbody>
<tr>
<td>William B. Johnson</td>
<td>101</td>
</tr>
<tr>
<td>Joseph B. Lanterman</td>
<td>200</td>
</tr>
<tr>
<td>Graham J. Morgan</td>
<td>200</td>
</tr>
<tr>
<td>Robert W. Reneker</td>
<td>300</td>
</tr>
<tr>
<td>W. Allen Wallis</td>
<td>599</td>
</tr>
</tbody>
</table>

TUC Proxy, supra note 129, at 4-6.

131. An examination of Trans Union's Board of Directors reveals a network of interlocking directorships and provides one with an excellent case study of the cross-directorship phenomenon. The other directorships held by Trans Union's directors were as follows:

<table>
<thead>
<tr>
<th>COMPANY</th>
<th>DIRECTOR</th>
</tr>
</thead>
<tbody>
<tr>
<td>IC Industries</td>
<td>Johnson (Chairman/CEO, IC Industries)</td>
</tr>
<tr>
<td></td>
<td>Van Gorkom</td>
</tr>
<tr>
<td></td>
<td>Morgan</td>
</tr>
<tr>
<td>U.S. Gypsum</td>
<td>Morgan (Chairman/CEO, U.S. Gypsum)</td>
</tr>
<tr>
<td></td>
<td>Reneker</td>
</tr>
<tr>
<td>Illinois Bell</td>
<td>Lanterman</td>
</tr>
<tr>
<td></td>
<td>Morgan</td>
</tr>
<tr>
<td>Esmark</td>
<td>Reneker (Chairman, Esmark)</td>
</tr>
<tr>
<td></td>
<td>Johnson</td>
</tr>
<tr>
<td>Continental Illinois</td>
<td>Johnson</td>
</tr>
<tr>
<td></td>
<td>Reneker</td>
</tr>
<tr>
<td>International Harvester</td>
<td>Lanterman</td>
</tr>
<tr>
<td></td>
<td>Morgan</td>
</tr>
</tbody>
</table>

TUC Proxy, supra note 129, at 4-6.

132. Trans Union's nonemployee directors received $10,000 annual compensation in 1979 and $700 for each board meeting attended in person. Additionally, directors received $700 for each committee meeting, unless the committee meeting was in communication with a board or other committee meeting, in which case they were paid $350 for attending such committee meeting. TUC Proxy, supra note 129, at 2.
small shareholdings of the outside directors, the numerous cross-directorships, and the fact that the annual board fees exceeded most of the outside directors' total shareholdings, the Trans Union Board had all the markings of a group subject to management-capture or at least serious management domination. This may explain why the Board's rather quick decision to sell the company, following Van Gorkom's brief presentation, appeared to some, including the Delaware court, to be so problematic. There were structural factors inherent in the composition of the Trans Union Board that may have compromised the Board's independent decisionmaking, even with regard to so important a step as the sale of the company.

As discussed, the Delaware court's liability-imposing response to what it considered to be the Trans Union Board's "uninformed" decision in effect rejuvenated the duty of care. The heightened compliance with the duty required by Van Gorkom in its end result did nothing to resolve the problem of board passivity created by management domination, which was perhaps the source of the Trans Union Board's "uninformed" decision. In light of the empirical data collected on the potentially positive effect of equity ownership on board performance, one has to wonder what sort of review process the Trans Union Board might have conducted before making its decision to sell the company. Had each of the outside directors maintained a substantial equity stake in the company. Had the Board held the kind of equity position in Trans Union that might have counterbalanced the potentially compromising impact of management domination, they might have reached a decision on the merger in a very different manner and foreclosed the kind of shareholder and judicial concern that led to the Van Gorkom ruling. The facts of Van Gorkom, then, rather than providing the basis for the creation of a heightened duty of care, may actually lend support to an equity-based approach to the problem of board passivity.

IV. CONCLUSION

The most critical problem confronting United States corporation law today is not the overcompensation of corporate executives, but the flourishing of the passive board created by management capture. Board passivity has resulted in not only the overcompensation controversy, but the lackluster corporate performance that has made our basic industries falter in the international marketplace. Executive overcompensation is but a symptom of the much more serious malady affecting the modern corporation—the presence of management unresponsive to shareholder welfare because unchecked by active board monitoring and oversight. Such self-interested management, either generally unprod...
tive or motivated primarily by personal gain, creates the kind of ineffective corporate enterprise that results in both diminished shareholder profit and lessened overall societal wealth.

The problem of unproductive or self-serving management can be resolved by stimulating effective board oversight. However, the creation of active management monitoring in a board compositionally suited to passivity because of management capture is not an easy task. Traditionally, the corporate law has attempted to compel effective board behavior through the imposition of a legal duty of care, violation of which led to personal liability on the part of an offending director. This approach did little to halt the growth of the passive board. The Delaware court in Van Gorkom attempted to bolster compliance with the duty through the creation of certain guidelines that a board must follow to avoid liability for a duty-of-care violation. Unfortunately, this decision did not lessen, but compounded, the passivity problem. Its approach must therefore be abandoned. This does not mean that we should abrogate the duty of care, but judicial attempts to compel adherence through compliance with rigidly prescribed board procedure are ineffective and must be reconsidered.

The solution then lies, not in compelling, but in somehow encouraging effective board oversight. We must reinvigorate the board from within; each director must function as his or her own motivational force. The most promising solution to the corporate malaise created by poor management and the attendant executive overcompensation problem is to create effective management monitoring based on board self-motivation. Such internal motivation will result from substantial equity ownership on the part of the outside directors. To create the sizable shareholdings that will effect such positive monitoring, corporations should pay directors' annual fees in company stock. To ensure that directors' holdings grow large enough to induce the desired behavior, this equity-compensation proposal must be combined with a quinquennial term of office for each board member. Director stock ownership may not prove to be the comprehensive cure to the passive board, but the costs of this approach are minimal, and it is a good beginning. This proposal will result in more reasoned executive compensation schemes, more effective board oversight, and most importantly, a healthier and more competitive corporation.

ADDENDUM

On August 30, 1994, the Scott Paper Company, the nation's 108th largest public corporation, announced that henceforth all nine outside members of its Board of Directors would be compensated solely in
company stock. Specifically, each director would receive 1000 shares of Scott common stock. The stock ownership plan replaced Scott Paper's existing compensation arrangements, which provided directors with retainers, meeting fees, stock option awards, and retirement benefits. Immediately following the release of the announcement, Scott Paper stock—trading on the New York Stock Exchange—rose three percent, $2.125 a share, to close at a fifty-two week high of $65.875. Scott Paper Chairman and CEO Albert J. Dunlap, in announcing the company's action, stated: "The directors unanimously decided to directly align themselves with our shareholders' interests [in an effort] to increase shareholder value."
A Board-Based Solution to Overpaid CEOs

In many U.S. corporations, executives are paid much more than their performance seems to justify. The problem of overcompensation will not be solved, however, by the Clinton administration's approach to the question.

Arguing on Feb. 11 that "the tax code should no longer subsidize excessive pay of chief executives," President Clinton requested in his budget, and Congress then mandated, that executive compensation over $1 million a year "unrelated to the productivity of the enterprise" no longer be deductible by the offending corporation as a legitimate business expense. The president apparently concluded that all executive salaries above $1 million were somehow inherently suspect. He has missed the point completely.

There is nothing inherently wrong with a large salary. The problem is overcompensation, not high compensation. Many executives who earn well over a million dollars are worth every penny, considering their contributions to corporate profitability. Corporations will gladly pay high-performing executives handsomely, not only to reward their performance but to retain their services in the competitive labor marketplace. High compensation can also be a valuable incentive for future performance. To limit arbitrarily the compensation that all corporations may offer limits the effectiveness of this important incentive.

Furthermore, the Clinton approach to corporate overcompensation fails to address its root cause. Overcompensation is usually the result of a failure in the bargaining process between a corporate board and management over salary.

In many of America's leading corporations, management is supervised by a board largely appointed by management. Excessive compensation results when passible boards beholden to management agree to salary packages on demand, in the absence of spirited negotiation.

An empirical study I recently conducted suggested that bargaining between board and management will be more effective when outside directors have substantial stockholdings in the corporation. Business Week, in conjunction with Standard & Poor's Compustat Services Inc., conducts an annual survey of executive compensation in 500 of the nation's largest publicly traded corporations. Compensation is then compared with executive performance as measured by corporate profitability and total return to the stockholders in stock appreciation and dividends. My own study reviewed the 158 businesses in the Business Week survey that received either the lowest possible rating for compensation in relation to performance or the best.

An intriguing fact emerged from my examination. Those companies with apparently excessive levels of executive compensation tended to have corporate boards controlled by outside directors with insignificant equity holdings in the business. On the other hand, those businesses with levels of executive pay considered in line with services delivered tended to be controlled by boards whose outside directors held substantial equity positions in the companies. There appeared to be a link between substantial stock ownership and more effective compensation oversight by the outside directors. An alignment of directors' interests with those of the shareholders, rather than management, through the possession of large shareholding positions, would explain this phenomenon.

Based on the findings of my study, I believe that some reform in board structure is warranted to create more effective board-level review of executive compensation and to promote more reasonable compensation schemes. Outside directors must be made to consider management compensation proposals not from the perspective of one engaged by and beholden to management, but from the viewpoint of the stockholders to whom they are legally responsible. The best way to create this perspective is to appeal directly to these directors' pecuniary interests. To ensure that they will examine a management initiative in the best interests of the stockholders, we must make them shareholders as well.

Corporations should pay their directors their annual fees in company stock that is restricted as to resale during the director's term in office. In a few years, each outside director will have accumulated a reasonably substantial portfolio and will therefore possess a powerful financial incentive to act more independently of management.

Although some might argue that a stock-option grant to directors may serve the same purpose, such an approach would prove less effective than direct equity ownership, simply because of the highly tentative nature of an option prior to exercise. Stock ownership provides the director with a present tangible stake in an enterprise, not merely some speculative expectancy of a discounted future position.

Additionally, directors' term lengths must be significantly expanded. This would ensure that their equity positions will reach the level necessary to influence their decision making; by stretching out the time between elections, it would also make it harder for management to bully directors with a threat not to renominate them.

Director stock ownership may not prove the comprehensive cure to the overcompensation controversy—but it will have a strong salutary effect and is a much more positive approach than the Clinton administration's taxation-based plan.

Mr. Elson is an associate professor of law, Stetson University, St. Petersburg, Fla., and a fellow at the Heritage Foundation in Washington, D.C.
EXHIBIT "M-16"
Effectiveness of Section 162(m) in controlling executive pay

Mr. Chairman I would like to thank you for inviting me to appear before your Committee today. It is a pleasure to have this opportunity to discuss the effectiveness of Section 162(m). Before I begin I would like to point out that my discussion today revolves around fine tuning section 162(m) to make it more effective, and not illegal activities such as option backdating and deductions that may have been inappropriately taken under section 162(m).

I'd also like to state up front that, based upon my own research, the research of others, and anecdotal reports, that section 162(m) has been at best, only marginally effective in limiting executive pay or in making it more responsive to performance. It is clear that executive compensation has gone up dramatically since the passage of Section 162(m). [Please refer to Table 1 on page 4 at the end of the text] However this increase has not been limited to executives of publicly held corporations, but applies to other highly sought after individuals. For example a fellow by the name of Howard Stern was reported by Forbes magazine to have earned $302 million in 2005.

Why has the tax code failed to restrain the growth in executive compensation?

In an attempt to limit executive compensation, Section 162(m), as well as Section 280(g) which defines excess parachute payments, cap the amount of payments that are deductible, leaving a corporation with three choices.

The first choice would be to cap payments at the threshold set by the code provision. There is very limited evidence that this has occurred. For example in 2005 my research indicates that at least 250 corporations paid one or more executives salary, i.e., non performance-based compensation, in excess of $1 million, 988 paid one or more executives total cash compensation in excess of $1 million, and 1,335 paid one or more executives total compensation in excess of $1 million.

The second choice would be to structure payments to maximize deductions. Corporations may do this by shifting compensation from non performance-based salary to performance-based bonuses and stock options and/or defer compensation to periods in which the deductions would be allowed. In our research, David Ryan and I have found evidence that firms have increased stock option grants in response to section 162(m). Economic theory, as well
as well as extant research, suggests this increase in riskiness of compensation will be accompanied by an increase in expected compensation—counter to the intent of the provision. The shift to more performance-based compensation also accentuates the incentives for executives to manage earnings as missing targets adversely affects bonus compensation and the value of stock options.

The third choice is to forfeit deductions. In research conducted after the passage of section 162(m), David Ryan and I noted that many firms that "qualified" their bonus plans to meet the performance based exception, added verbiage in their proxy statements saying they reserved the right to pay non deductible compensation if they determined it was in the best interest of the firm. In research conducted using data from the mid-1990’s, Jennifer Yin and I found that nearly 40 percent of corporations admitted to forfeiting deductions because of section 162(m). My prediction is that this percentage is much higher today. Especially as corporations shift from stock options to restricted stock in the wake of Statement of Financial Accounting Standards 123R which required the expensing of stock options.

I should note that the choice to forfeit deductions is not limited to section 162(m). From my reading of executive compensation contracts and disclosures, I have found many corporations are willing to not only forgo deductions for excess parachute payments as defined under section 280(g), but are also grossing up the executive’s compensation to pay for the excise taxes levied on the executive.

Recommendations

1. Provide increased disclosure of details in plans submitted for shareholder approval

To qualify as performance based under Section 162(m), corporations have to obtain shareholder approval of their bonus plans. While ostensibly the plans presented to shareholders have to disclose their material terms, in reality they do not. That is, they lack specificity with regard to actual plan parameters, targets, thresholds, etc. (Please see excerpt from Tyco International 2004 Stock and Incentive Plan on page 5). Disclosure of these details would allow shareholders to evaluate if thresholds for performance are adequate. In other words, allow them to determine if pay was not for performance, but for adequate performance. I believe requiring this disclosure will increase the link between pay and performance as directors and executives would be less likely to set low standards. And shareholders, now in possession of the material facts, would be less likely to approve those plans with low performance standards.
2. Require that options be market adjusted, so that the executive only benefits if the firm's share price outperforms the market index.

Under Section 162(m) stock options were de facto assumed to be performance-based, as long as they were not in the money at the time of grant, and a plan was approved by shareholders. In reality stock options are pay for performance with a threshold of 0! That is, any increase in a firm's stock price increases the value of an executive's stock options even if the firm underperforms the market, its industry index, or even risk free investments such as treasury securities. (See example on page 6). Even something as seemingly innocuous as frequent grants ensure that executives benefit from the fluctuating share prices without shareholders seeing any increase in long term value. And this is without even manipulating the system via things like backdating and spring-loading.

3. Require numerical disclosure of actual deductions forfeited and additional taxes paid.

Currently firms discuss forfeiture of deductions in their proxy statements but are exceedingly vague. For example, Wal Mart's most recent proxy statement states "A significant portion of the Company's executive compensation satisfies the requirements for deductibility under Internal Revenue Code Section 162(m)." Other companies, for example Exxon-Mobil and General Motors, while paying their top executive(s) salary far in excess of $1 million dollars, give no indication of whether they forfeit deductions or not.

Disclosure of details would allow shareholders to evaluate if amounts are material and put the onus on directors to justify – which I believe would make them less likely to forfeit deductions.

In closing I would like to thank the committee for the opportunity to testify today and look forward to answering any questions you may have.
Table 1
Average CEO Compensation 1994-2005

<table>
<thead>
<tr>
<th>YEAR</th>
<th>Salary</th>
<th>Cash Compensation</th>
<th>Total Compensation including present value of option grants</th>
<th>Total Compensation including profits from option exercise</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>$516,420</td>
<td>$961,610</td>
<td>$2,165,710</td>
<td>$1,644,190</td>
</tr>
<tr>
<td>1995</td>
<td>$528,130</td>
<td>$1,019,400</td>
<td>$2,255,160</td>
<td>$1,948,280</td>
</tr>
<tr>
<td>1996</td>
<td>$545,860</td>
<td>$1,126,740</td>
<td>$3,085,240</td>
<td>$2,608,580</td>
</tr>
<tr>
<td>1997</td>
<td>$558,570</td>
<td>$1,167,820</td>
<td>$3,739,950</td>
<td>$3,421,990</td>
</tr>
<tr>
<td>1998</td>
<td>$578,710</td>
<td>$1,181,060</td>
<td>$3,886,910</td>
<td>$4,139,530</td>
</tr>
<tr>
<td>1999</td>
<td>$581,250</td>
<td>$1,263,090</td>
<td>$5,433,460</td>
<td>$4,425,240</td>
</tr>
<tr>
<td>2000</td>
<td>$604,360</td>
<td>$1,353,080</td>
<td>$6,798,500</td>
<td>$5,634,030</td>
</tr>
<tr>
<td>2001</td>
<td>$640,840</td>
<td>$1,308,120</td>
<td>$6,363,230</td>
<td>$5,042,440</td>
</tr>
<tr>
<td>2002</td>
<td>$657,880</td>
<td>$1,357,360</td>
<td>$4,958,510</td>
<td>$3,794,220</td>
</tr>
<tr>
<td>2003</td>
<td>$685,180</td>
<td>$1,557,670</td>
<td>$4,625,960</td>
<td>$4,412,310</td>
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<tr>
<td>2004</td>
<td>$707,810</td>
<td>$1,749,060</td>
<td>$5,159,520</td>
<td>$5,911,390</td>
</tr>
<tr>
<td>2005</td>
<td>$745,960</td>
<td>$1,946,380</td>
<td>$5,578,290</td>
<td>$7,127,200</td>
</tr>
</tbody>
</table>
### Table 2

Use of Restricted Stock 1994-2005

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Corporations Granting Restricted Stock</th>
<th>Percentage of Executive Compensation</th>
<th>Dollar amount of restricted Stock Granted</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>436</td>
<td>4%</td>
<td>$648,972,450</td>
</tr>
<tr>
<td>1995</td>
<td>499</td>
<td>5%</td>
<td>$754,126,950</td>
</tr>
<tr>
<td>1996</td>
<td>534</td>
<td>5%</td>
<td>$1,052,007,170</td>
</tr>
<tr>
<td>1997</td>
<td>557</td>
<td>5%</td>
<td>$1,430,845,500</td>
</tr>
<tr>
<td>1998</td>
<td>592</td>
<td>7%</td>
<td>$1,672,348,910</td>
</tr>
<tr>
<td>1999</td>
<td>584</td>
<td>6%</td>
<td>$2,945,467,230</td>
</tr>
<tr>
<td>2000</td>
<td>574</td>
<td>6%</td>
<td>$2,269,551,410</td>
</tr>
<tr>
<td>2001</td>
<td>576</td>
<td>6%</td>
<td>$2,040,594,590</td>
</tr>
<tr>
<td>2002</td>
<td>615</td>
<td>11%</td>
<td>$2,320,166,890</td>
</tr>
<tr>
<td>2003</td>
<td>721</td>
<td>9%</td>
<td>$2,877,404,900</td>
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<tr>
<td>2004</td>
<td>754</td>
<td>12%</td>
<td>$3,570,085,930</td>
</tr>
<tr>
<td>2005</td>
<td>839</td>
<td>14%</td>
<td>$3,698,090,670</td>
</tr>
</tbody>
</table>

(i) Within 90 days after the commencement of a Performance Cycle, the Committee will fix and establish in writing (A) the Performance Measures that will apply to that Performance Cycle; (B) with respect to Performance Units, the Target Amount payable to each Participant; (C) with respect to Restricted Units and Restricted Stock, the Target Vesting Percentage for each Participant; and (D) subject to subsection (d) below, the criteria for computing the amount that will be paid or will vest with respect to each level of attained performance. The Committee will also set forth the minimum level of performance, based on objective factors, that must be attained during the Performance Cycle before any Long Term Performance Award will be paid or vest, and the percentage of Performance Units that will become payable and the percentage of performance-based Restricted Units or Shares of Restricted Stock that will vest upon attainment of various levels of performance that equal or exceed the minimum required level

(ii) The Committee may, in its discretion, select Performance Measures that measure the performance of the Company or one or more business units, divisions or Subsidiaries of the Company. The Committee may select Performance Measures that are absolute or relative to the performance of one or more comparable companies or an index of comparable companies.

(iii) The Committee, in its discretion, may, on a case-by-case basis, reduce, but not increase, the amount of Long Term Performance Awards payable to any Key Employee with respect to any given Performance Cycle, provided, however, that no reduction will result in an increase in the dollar amount or number of Shares payable under any Long Term Performance Award of another Key Employee.
Example 2: How stock options might not be pay for performance

In its proxy statement filed with the Securities and Exchange Commission on March 12, 2001, Apple Computer reported that it had granted its Chief Executive Officer Steven Jobs, 20 million options in January of the previous year, and that if its share price rose at a rate of 5 percent per year, at the end of the options term, those options would be worth $548,317,503. Of course, if its share price increased by five percent per year, Apple stockholders might have preferred purchasing thirty year U. S. Treasury Bonds which offered a 6.34 percent yield risk-free at that point in time.
Form 10-K/A -- Annual report [Section 13 and 15(d), not S-K Item 405] [amend]

Table of submitted documents:

<table>
<thead>
<tr>
<th>Seq</th>
<th>Type</th>
<th>Document</th>
<th>Size</th>
<th>Description</th>
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</thead>
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<td>1</td>
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<td>0000891618-00-001163.txt</td>
<td>50254</td>
<td>FORM 10-K/A</td>
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Filer Information:

BROCADE COMMUNICATIONS SYSTEMS INC (Filer) (0001009626)
IRS No.: 770409517 | State of Incorp.: DE | Fiscal Year End: 1028
Type: 10-K/A | Act: 34 | File No.: 000-25601 | Film No.: 555857
SIC: 7372 Services-Prepackaged Software

Business Address
1901 GUADALUPE PARKWAY
SUITE E
SAN JOSE CA 95131

Mailing Address
1901 GUADALUPE PARKWAY
SAN JOSE CA 95131
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K/A

[ ] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE
ACT OF 1934 FOR THE FISCAL YEAR ENDED OCTOBER 31, 1999

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM ___________ TO ___________

COMMISSION FILE NUMBER: 000-25601
BROCADE COMMUNICATIONS SYSTEMS, INC.
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

------------------------------

<TABLE>
<s>
DELAWARE
Applicable percentage ownership is based on 108,342,098 shares of Common Stock outstanding as of February 24, 2000 together with applicable options for such stockholder. Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission (the "Commission"), and includes voting and investment power with respect to shares. Shares of Common Stock subject to options currently exercisable or exercisable within 60 days after February 24, 2000 are deemed outstanding for computing the percentage ownership of the person holding such options, but are not deemed outstanding for computing the percentage of any other person. Except as noted in the footnotes to this table, and subject to applicable community property laws, the persons named in the table have sole voting and investment power with respect to all shares of the Company's Common Stock shown as beneficially owned by them.

(2) All shares listed are held by The Reyes Family Trust. Includes options to purchase 20,000 shares of Common Stock exercisable within 60 days of February 24, 2000.

(3) All shares listed are held by The Malavalli Revocable Trust. Includes options to purchase 1,736 shares of Common Stock exercisable within 60 days of February 24, 2000.

(4) Includes options to purchase 13,332 shares of Common Stock exercisable within 60 days of February 24, 2000.

(5) All shares are held by Victor Rinkle and Paula Rinkle as community property. Includes options to purchase 160,000 shares of Common Stock exercisable within 60 days of February 24, 2000.

(6) Includes 36,000 shares held by Charles Whitney Smith and Helen Clute Smith Irrevocable Trust for the benefit of Chelsea Marcelle Smith and Alexander Joseph Smith Dated April 30, 1999. Mr. Smith disclaims beneficial ownership in these shares. The balance of the shares are held by Charles Smith and Helen Smith as joint tenants.

(7) Mr. Dempsey is a general partner of Bay Partners SBIC, L.P. and is a director of Brocade. Includes 1,753,968 shares held by Bay Partners SBIC, L.P. Mr. Dempsey disclaims beneficial ownership of shares held by this entity, except to the extent of his proportional interest arising from his partnership interest in Bay Partners SBIC, L.P. Includes 47,748 shares held by The Dempsey Family Limited Partnership.

(8) Includes 106,656 shares held by Leslie Investments, LLC and 332,024 shares held by The Leslie Family Trust.

(9) Mr. Neiman is a partner of Crosspoint Venture Partners and the Chairman of the Board. Includes 315,824 shares held by Crosspoint Venture Partners LS Fund 1997. Mr. Neiman disclaims beneficial ownership of shares held by these entities, except for his proportional interest arising from his partnership interest in Crosspoint Venture Partners.

(10) Includes options to purchase 134,760 shares of Common Stock exercisable within 60 days of February 24, 2000.

* Less than one percent of the outstanding Common Stock.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Since the Company's inception in August 1995, there has not been nor is there currently proposed any transaction or series of similar transactions to
The following descriptive data is supplied in accordance with Rule 304(d) of Regulation S-T.

Brocade Communications Systems, Inc.  
SIC Code Computer Peripheral Equipment Index  
NASDAQ Market Index  
- -----------------

<table>
<thead>
<tr>
<th>Date</th>
<th>Brocade</th>
<th>SIC Code</th>
<th>NASDAQ</th>
</tr>
</thead>
<tbody>
<tr>
<td>5/25/1999</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
</tr>
<tr>
<td>5/28/1999</td>
<td>142.54</td>
<td>100.00</td>
<td>100.00</td>
</tr>
<tr>
<td>6/30/1999</td>
<td>213.12</td>
<td>114.86</td>
<td>108.54</td>
</tr>
<tr>
<td>7/30/1999</td>
<td>261.60</td>
<td>111.05</td>
<td>106.61</td>
</tr>
<tr>
<td>8/31/1999</td>
<td>415.75</td>
<td>121.12</td>
<td>110.27</td>
</tr>
<tr>
<td>9/30/1999</td>
<td>464.09</td>
<td>123.76</td>
<td>110.43</td>
</tr>
<tr>
<td>10/29/1999</td>
<td>594.48</td>
<td>135.09</td>
<td>118.97</td>
</tr>
</tbody>
</table>

(1) The graph assumes that $100 was invested on May 25, 1999 in the Company's Common Stock, the NASDAQ Market Index and the SIC Code Computer Peripheral Equipment Index and that all dividends were reinvested. No dividends have been declared or paid on the Company's Common Stock. Stockholder returns over the indicated period should not be considered indicative of future stockholder returns.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth certain information regarding the beneficial ownership of Common Stock of the Company as of February 24, 2000 as to (i) each person who is known by the Company to own beneficially more than 5% of the outstanding shares of Common Stock, (ii) each director of the Company, (iii) each of the executive officers named in the Summary Compensation Table below and (iv) all directors and executive officers of the Company as a group. Unless otherwise indicated, the address of each listed stockholder is c/o Brocade Communications Systems, Inc., 1901 Guadalupe Parkway, San Jose, California 95131. The share amounts below are adjusted to reflect the Stock Splits.

<table>
<thead>
<tr>
<th>NAME AND ADDRESS OF BENEFICIAL OWNER</th>
<th>NUMBER OF SHARES BENEFICIALLY OWNED</th>
<th>PERCENT OF SHARES BENEFICIALLY OWNED</th>
</tr>
</thead>
<tbody>
<tr>
<td>NAMED EXECUTIVE OFFICERS AND DIRECTORS</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gregory L. Reyes</td>
<td>4,796,440</td>
<td>4.4%</td>
</tr>
<tr>
<td>Kumar Malavalli</td>
<td>2,005,720</td>
<td>1.9</td>
</tr>
<tr>
<td>Peter J. Tarrant</td>
<td>697,988</td>
<td>*</td>
</tr>
<tr>
<td>Victor M. Rinkle</td>
<td>739,660</td>
<td>*</td>
</tr>
<tr>
<td>Charles W. Smith</td>
<td>643,660</td>
<td>*</td>
</tr>
<tr>
<td>Neal Dempsey</td>
<td>1,801,716</td>
<td>1.7</td>
</tr>
<tr>
<td>Mark Leslie</td>
<td>438,680</td>
<td>*</td>
</tr>
<tr>
<td>Seth D. Neiman</td>
<td>344,876</td>
<td>*</td>
</tr>
<tr>
<td>c/o Crosspoint Venture Partners</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2925 Woodside Road</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Woodside, CA 94062</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") requires the Company's executive officers and directors, and persons who own more than ten percent of a registered class of the Company's equity securities to file reports of ownership and changes in ownership with the Securities and Exchange Commission ("Commission") and the National Association of Securities Dealers, Inc. Executive officers, directors and greater than ten percent stockholders are required by Commission regulation to furnish the Company with copies of all Section 16(a) forms they file. Two late reports on Form 4 were filed in January 2000 with respect to distributions made to Neal Dempsey, a director of the Company, by Bay Partners BBIC, L.P. in August 1999 and September 1999. An amended Form 4 was filed in February 2000 with respect to distributions made to Larry W. Sonsini, a director of the Company, by WS Investment Company 98B in August 1999. Based solely on its review of the copies of such forms received by it, or written representations from certain reporting persons, the Company believes that, other than the exceptions described in this paragraph, during fiscal 1999 all executive officers and directors of the Company complied with all applicable filing requirements.

ITEM 11. EXECUTIVE COMPENSATION

EXECUTIVE COMPENSATION

SUMMARY COMPENSATION TABLE

The following Summary Compensation Table sets forth certain information regarding the compensation of the Chief Executive Officer of the Company and the other four most highly compensated executive officers of the Company (the "Named Executive Officers") for services rendered in all capacities to the Company in the fiscal years ended October 31, 1998 and October 31, 1999. The entries under the column heading "Other Compensation" in the table represent the cost of term life insurance for each Named Executive Officer. The share amounts below are adjusted to reflect a two-for-one split of the Company's Common Stock effected as of December 3, 1999 and a two-for-one split of the Company's Common Stock to
Pursuant to the requirements of the Security Exchange Act of 1934, this Amendment to Report on Form 10-K has been signed on behalf of the Registrant by the following persons and in the capabilities and on the dates indicated:

<table>
<thead>
<tr>
<th>SIGNATURE</th>
<th>TITLE</th>
<th>DATE</th>
</tr>
</thead>
<tbody>
<tr>
<td>/s/ Gregory L. Reyes</td>
<td>President, Chief Executive Officer</td>
<td>February 28, 2000</td>
</tr>
<tr>
<td>/s/ Michael J. Byrd</td>
<td>Vice President, Finance and Chief Financial Officer and Assistant Secretary</td>
<td>February 28, 2000</td>
</tr>
<tr>
<td>/s/ Seth D. Neiman</td>
<td>Chairman of the Board</td>
<td>February 28, 2000</td>
</tr>
<tr>
<td>/s/ Neal Dempsey</td>
<td>Director</td>
<td>February 28, 2000</td>
</tr>
<tr>
<td>/s/ Mark Leslie</td>
<td>Director</td>
<td>February 28, 2000</td>
</tr>
<tr>
<td>/s/ Larry W. Sonsini</td>
<td>Director</td>
<td>February 28, 2000</td>
</tr>
<tr>
<td>/s/ Michael J. Byrd</td>
<td>Attorney-in-fact</td>
<td></td>
</tr>
</tbody>
</table>

---END PRIVACY-ENHANCED MESSAGE-----
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K/A

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED OCTOBER 31, 1999

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM __________ TO __________

COMMISSION FILE NUMBER: 000-25601
BROCADE COMMUNICATIONS SYSTEMS, INC.
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

-------END PRIVACY-ENHANCED MESSAGE-------
PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT
SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") requires the Company's executive officers and directors, and persons who own more than ten percent of a registered class of the Company's equity securities to file reports of ownership and changes in ownership with the Securities and Exchange Commission ("Commission") and the National Association of Securities Dealers, Inc. Executive officers, directors and greater than ten percent stockholders are required by Commission regulation to furnish the Company with copies of all Section 16(a) forms they file. Two late reports on Form 4 were filed in January 2000 with respect to distributions made to Neal Dempsey, a director of the Company, by Bay Partners SBIC, L.P. in August 1999 and September 1999. An amended Form 4 was filed in February 2000 with respect to distributions made to Larry W. Sonsini, a director of the Company, by WS Investment Company 98B in August 1999. Based solely on its review of the copies of such forms received by it, or written representations from certain reporting persons, the Company believes that, other than the exceptions described in this paragraph, during fiscal 1999 all executive officers and directors of the Company complied with all applicable filing requirements.

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be effected as of March 14, 2000 (the "Stock Splits").


<table>
<thead>
<tr>
<th>NAME AND PRINCIPAL POSITION</th>
<th>FISCAL YEAR</th>
<th>ANNUAL COMPENSATION</th>
<th>LONG-TERM COMPENSATION AWARDS</th>
<th>SECURITIES UNDERLYING OPTIONS(#)</th>
<th>ALL OTHER COMPENSATION($)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>SALARY($)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gregory L. Reyes</td>
<td>1999</td>
<td>$200,000</td>
<td></td>
<td></td>
<td>$76</td>
</tr>
<tr>
<td>President and Chief Executive Officer</td>
<td>1998</td>
<td>68,606</td>
<td></td>
<td></td>
<td>480</td>
</tr>
<tr>
<td>Kumar Malavalli</td>
<td>1999</td>
<td>167,160</td>
<td>21,071</td>
<td>134,000</td>
<td>475</td>
</tr>
<tr>
<td>Vice President, Technology</td>
<td>1998</td>
<td>162,840</td>
<td>13,027</td>
<td></td>
<td>1,188</td>
</tr>
<tr>
<td>Peter J. Tarrant</td>
<td>1999</td>
<td>143,750</td>
<td>46,250</td>
<td>200,000</td>
<td>432</td>
</tr>
<tr>
<td>Vice President, Marketing and Business Development</td>
<td>1998</td>
<td>109,848</td>
<td>33,021</td>
<td>800,000</td>
<td>870</td>
</tr>
<tr>
<td>Victor M. Rinkle</td>
<td>1999</td>
<td>171,875</td>
<td>20,188</td>
<td>160,000</td>
<td>504</td>
</tr>
<tr>
<td>Vice President, Operations</td>
<td>1998</td>
<td>115,340</td>
<td>39,375</td>
<td>800,000</td>
<td>990</td>
</tr>
<tr>
<td>Charles W. Smith</td>
<td>1999</td>
<td>120,000</td>
<td>62,250</td>
<td>140,000</td>
<td>272,782(1)</td>
</tr>
<tr>
<td>Vice President, Worldwide Sales</td>
<td>1998</td>
<td>118,500</td>
<td></td>
<td>140,000</td>
<td>87,306(1)</td>
</tr>
</tbody>
</table>

(1) Also includes amounts earned by Mr. Smith as commissions.

OPTION GRANTS IN LAST FISCAL YEAR

The following table sets forth certain information for each grant of options to purchase the Company's Common Stock during fiscal 1999 to each of the Named Executive Officers. All of these options granted by the Company were granted under the 1995 Equity Incentive Plan and the 1998 Equity Incentive Plan which, together with the Company's 1998 Executive Equity Incentive Plan, have been combined and continue as the Company's 1999 Stock Plan. All of these options have a term of 10 years, subject to earlier termination in the event the optionee's services to the Company cease. The share amounts and per share prices below are adjusted to reflect the Stock Splits.

<table>
<thead>
<tr>
<th>INDIVIDUAL GRANTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>NAME</td>
</tr>
<tr>
<td>-------------------</td>
</tr>
<tr>
<td>Gregory L. Reyes</td>
</tr>
<tr>
<td>Kumar Malavalli (5)</td>
</tr>
<tr>
<td>Peter J. Tarrant</td>
</tr>
<tr>
<td>Victor M. Rinkle</td>
</tr>
<tr>
<td>Charles W. Smith</td>
</tr>
</tbody>
</table>

(1) Potential realizable values are (i) net of exercise price before taxes, (ii) based on the assumption that the Common Stock of the Company appreciates at the annual rate shown (compounded annually) from the date of grant until the expiration of the ten-year option term and (iii) based on the assumption that the option is exercised at the exercise price and sold on the last day of its term at the appreciated price. These numbers are calculated based on the requirements promulgated by the Commission and do not reflect the Company's estimate of future stock price growth.

(2) All options shown granted to Mr. Malavalli, Mr. Rinkle and Mr. Smith in fiscal 1999 vest with respect to 25% of the shares underlying The option starting one year after the date of grant, with 1/40th of the shares vesting at the end of every month thereafter, with full vesting occurring
on the fourth anniversary of the date of grant. The option granted to Mr. Tarrant is exercisable in two installments: (i) with respect to 80,000 of the shares underlying the option, 1/36 of the shares vest at the end of every month after the date of grant, with full vesting occurring on the third anniversary of the date of grant, and (ii) with respect to 120,000 of the shares underlying the option, the option vests starting three years after the date of grant with 1/12 of the shares vesting at the end of every month thereafter with full vesting occurring on the fourth anniversary of the date of grant. Under the Plans, the Board of Directors retains the discretion to modify the terms, including the price, of outstanding options.

(3) Options were granted at an exercise price equal to the fair market value of the Company's Common Stock, as determined by reference to the closing price reported on the Nasdaq National Market on the date of grant, or as determined by the Board of Directors prior to the Company's securities being traded on the Nasdaq National Market. The Board of Directors based its determination on the Company's financial results and prospects, the share price derived for arms-length transactions and evaluations conducted by valuation experts.

(4) Exercise price and tax withholding obligations may be paid in cash, promissory note, by delivery of already-owned shares subject to certain conditions, or pursuant to a cashless exercise procedure.

(5) Mr. Malavalli's options have been exercised subject to a right of repurchase by the Company at the original exercise price paid per share upon Mr. Malavalli's cessation of service with the Company prior to vesting of the shares. The repurchase right lapses and Mr. Malavalli vests as to 25% of the option shares upon completion of one year of service from the date of grant and the balance in a series of equal monthly installments over the next three years of service.

(6) Mr. Smith's options have been exercised subject to a right of repurchase by the Company at the original exercise price paid per share upon Mr. Smith's cessation of service with the Company prior to vesting of the shares. The repurchase right lapses and Mr. Smith vests as to 25% of the option shares upon completion of one year of service from the date of grant and the balance in a series of equal monthly installments over the next three years of service. In the event of a termination without cause or constructive termination other than for cause at any time during the first year following a change of control, these options will fully vest. Mr. Smith's options have been exercised in conjunction with a promissory note and a stock pledge agreement. See "Certain Relationships and Related Transactions -- Loans to Certain Executive Officers" for descriptions of these exercises.

---

**AGGREGATED OPTION EXERCISES IN LAST FISCAL YEAR AND FISCAL YEAR-END OPTION VALUES**

The following table sets forth information with respect to the Named Executive Officers concerning exercisable and unexercisable options held as of October 31, 1999. The share amounts and per share prices below are adjusted to reflect the Stock Splits.

<table>
<thead>
<tr>
<th>NAME</th>
<th>SHARES ACQUIRED ON EXERCISE(#)</th>
<th>VALUE REALIZED ($)</th>
<th>NUMBER OF SECURITIES UNDERLYING UNEXERCISED OPTIONS AT OCTOBER 31, 1999</th>
<th>VALUE OF UNEXERCISED IN-THE-MONEY OPTIONS AT OCTOBER 31, 1999(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gregory L. Reyes(3)..........</td>
<td>6,142,648</td>
<td>$94,477</td>
<td>Vested: 200,000 Unvested: 134,000</td>
<td>Vested: 200,000 Unvested: 134,000</td>
</tr>
<tr>
<td>Kumar Malavalli(4)...........</td>
<td>134,000</td>
<td>134,000</td>
<td>Vested: 3,110,000 Unvested: 0</td>
<td>Vested: 3,110,000 Unvested: 0</td>
</tr>
<tr>
<td>Peter J. Tarrant............</td>
<td>0</td>
<td>0</td>
<td>Vested: 3,110,000 Unvested: 0</td>
<td>Vested: 3,110,000 Unvested: 0</td>
</tr>
<tr>
<td>Victor M. Rinkle(5)..........</td>
<td>800,000</td>
<td>0</td>
<td>Vested: 160,000 Unvested: 0</td>
<td>Vested: 160,000 Unvested: 0</td>
</tr>
<tr>
<td>Charles W. Smith(6).........</td>
<td>280,000</td>
<td>0</td>
<td>Vested: 10,560,000 Unvested: 0</td>
<td>Vested: 10,560,000 Unvested: 0</td>
</tr>
</tbody>
</table>

<TABLE>
<TABLE>

(1) Market value of the Company's Common Stock at the exercise date minus the exercise price.
(2) Market value of the Company's Common Stock on October 29, 1999 was $67.25 per share (as adjusted for two two-for-one splits of the Company's Common Stock that occurred after the end of fiscal 1999).

(3) Of the exercised shares, 4,223,072 shares are subject to repurchase by the Company upon Mr. Reyes' cessation of service with the Company prior to the vesting of the shares.

(4) Of the exercised shares, 134,000 shares are subject to repurchase by the Company upon Mr. Malavalli's cessation of service with the Company prior to the vesting of the shares.

(5) Of the exercised shares, 450,000 shares are subject to repurchase by the Company upon Mr. Rinkle's cessation of service with the Company prior to the vesting of the shares.

(6) Of the exercised shares, 428,334 shares are subject to repurchase by the Company upon Mr. Smith's cessation of service with the Company prior to the vesting of the shares.

CHANGE OF CONTROL AND SEVERANCE ARRANGEMENTS

Options granted to Mr. Malavalli, Mr. Rinkle and Mr. Smith under the Company's 1999 Stock Plan will vest fully in the event that these individuals are terminated without cause or are constructively terminated at any time during the first year following a change of control of the Company.

Mr. Reyes's option agreement originally under the 1998 Equity Incentive Plan provides that if, during the first year of his employment, he is terminated other than:

- constructively or without cause during the first year following a change of control; or
- for cause,

Mr. Reyes will vest as to 767,832 shares plus a number of shares equal to 127,972 multiplied by the number of full months of his service to the Company. If Mr. Reyes is terminated any time after the first year of his employment, other than:

- constructively or without cause during the first year following a change of control; or
- for cause,

Mr. Reyes will vest as to 767,832 shares in addition to any shares that have vested under the normal four-year vesting schedule contemplated by the agreement. Moreover, upon a change of control, one-half of Mr. Reyes's unvested shares vest in addition to any shares that have vested under the normal four-year vesting schedule contemplated by the agreement, and if Mr. Reyes is constructively terminated or terminated without cause during the first year following the change of control, then all of his unvested shares subject to this option will vest.

Mr. Reyes's option agreement originally under the 1998 Executive Equity Incentive Plan provides that if he is terminated at any time on or after May 13, 2001, other than:

- constructively or without cause during the first year following a change of control; or
- for cause,

then, in addition to any shares that have vested under the normal four-year vesting schedule contemplated by the agreement, 767,832 additional shares will vest, less the number of shares that may vest as a result of his termination pursuant to the option agreement under the former 1998 Equity Incentive Plan as
described above. In addition, upon a change of control, one-half of Mr. Reyes’s unvested shares will vest under the one-year vesting schedule contemplated by the agreement, and if Mr. Reyes is constructively terminated or terminated without cause during the first year following the change of control, then, all of his unvested shares subject to this option will vest. The share amounts set forth above are adjusted to reflect the Stock Splits.

In addition, pursuant to a letter agreement, if Mr. Reyes is constructively terminated or terminated without cause upon a change of control, he will receive a severance payment of one year of his base salary plus his expected bonus for the then current fiscal year under the 1999 Key Employee Incentive Program, as described below.

The Company entered into a Confidential Agreement and General Release of Claims with Jack Bergman, the Company’s former President, Chief Executive Officer and director, effective as of September 23, 1998. This agreement outlines the terms governing Mr. Bergman’s termination of employment, as a member of the Company’s board of directors and as a consultant to the Company. In exchange for and pursuant to the agreement, the Company agreed to provide Mr. Bergman with the following severance benefits for one year following his termination date:

- base salary at his then current rate;
- existing employee health benefits insurance; and
- continued vesting of 64,460 shares per month of Mr. Bergman’s unvested shares of the Company’s Common Stock, until the complete vesting of his 3,094,112 total shares occurred.

The share amounts above are adjusted to reflect the Stock Splits. The agreement also includes a release of claims relating to or arising from Mr. Bergman’s relationship with the Company and the continued obligation of confidentiality with regard to the Company’s proprietary information. All severance benefits under this agreement have been paid or provided by the Company and Mr. Bergman’s stock has fully vested.

1999 KEY EMPLOYEE INCENTIVE PROGRAM

During fiscal 1999 the Company compensated its key employees under the 1999 Key Employee Incentive Program, an executive bonus program pursuant to which selected key employees of the Company were eligible for quarterly and annual cash bonuses based upon achieving specified individual and company-wide objectives, including revenue targets. For Mr. Smith, bonuses were not based on the 1999 Key Employee Incentive Program, but rather on achievement of sales revenue and other specified sales objectives.

DIRECTORS’ COMPENSATION

Directors currently do not receive any cash compensation from the Company for their services as members of the board of directors, although the Company is authorized to pay members for attendance at meetings or a salary in addition to reimbursement for expenses in connection with attendance at meetings. Certain non-employee directors have received grants of options to purchase shares of the Common Stock of the Company, including automatic option grants under the Company’s 1999 Director Option Plan. See "Security Ownership of Certain Beneficial Owners and Management," and "Certain Relationships and Related Transactions--Stock Option Grants and Loan to Certain Directors." Non-employee directors are entitled to participate in the 1999 Director Option Plan. However, Mr. Leslie and Mr. Sonsini will be excluded from receiving option grants under the Director Plan until January 31, 2002. The Director Plan provides for the automatic grant of 10,000 shares (as adjusted to reflect the Stock Splits) of Common Stock to each non-employee director on the date on which such person first becomes a non-employee director. After the first 10,000 share option is granted to the non-employee director, he or she shall automatically be granted an option to purchase 10,000 shares each quarter of each year, provided that he or she shall have served on the board for at least the preceding month. Each option shall have a term of 10 years. Each option granted under the Director Plan will vest 100% and become fully exercisable on the first anniversary of the date of grant. The exercise price of all options shall be 100% of the fair market value per share of the Common Stock, generally determined with reference...
In the event of a merger, or the sale of substantially all of the assets of the Company and if the option is not assumed or substituted, the option will terminate unless exercised. Options granted under the Director Plan must be exercised within three months of the end of the optionee's tenure as a director of the Company, or within 12 months after such director's termination by death or disability, but not later than the expiration of the option's ten-year term.

REPORT OF THE BOARD OF DIRECTORS ON EXECUTIVE COMPENSATION

The following is the report of the Board of Directors with respect to the compensation paid to the Company's executive officers during fiscal 1999. Actual compensation earned during fiscal 1999 by the Named Executive Officers is shown in the Summary Compensation Table.

Compensation Philosophy

The Company operates in the extremely competitive and rapidly changing high technology industry. The Board believes that the compensation programs for the executive officers should be designed to attract, motivate and retain talented executives responsible for the success of the Company and should be determined within a competitive framework and based on the achievement of designated business objectives, individual contribution, customer satisfaction and financial performance. Within this overall philosophy, the Board's objectives are to:

- Provide a competitive total compensation package that takes into consideration the compensation practices of companies with which the Company competes for executive talent.
- Provide variable compensation opportunities that are linked to achievement of financial, organization, management, and individual performance goals.
- Align the financial interests of executive officers with those of stockholders by providing executives with an equity stake in the Company.

Components of Executive Compensation

The compensation program for the Company's executive officers consists of the following components:

- Base Salary
- Quarterly and Annual Cash Incentives
- Long-Term Stock Option Incentives

Base Salary

The Board of Directors reviewed and approved fiscal 1999 salaries for the Chief Executive Officer and other Named Executive Officers at the beginning of the fiscal year. Base salaries were established by the Board based upon competitive compensation data, an executive's job responsibilities, level of experience, individual performance and contribution to the business. In making base salary decisions, the Board exercised its discretion and judgment based upon these factors. No specific formula was applied to determine the weight of each factor. The Board based its determination of Mr. Reyes' salary on both his individual performance and the salaries paid to chief executive officers of peer companies.

Quarterly and Annual Cash Incentives

Quarterly and annual incentive bonuses for executive officers are intended to reflect the Board's belief that a significant portion of the compensation of each executive officer should be contingent upon the performance of the Company, as well as the individual contribution of each executive officer. To carry out this philosophy, the Company has implemented a variable compensation bonus plan, which compensates officers in the form of quarterly and annual cash bonuses. During the fiscal year, the executive officers were eligible for a target
quarterly and annual incentive bonus, calculated by the Committee as a percentage of the officer’s base salary. The target level of bonuses that the executive officers were eligible to receive varied from 10% to 50% of base salaries. The variable compensation bonus plan is intended to motivate and reward executive officers by directly linking the amount of any cash bonus to specific Company-based performance targets and specific individual-based performance targets. The quarterly bonus amounts are tied to specific individual, team and product-based performance targets. The annual bonus amounts are tied to Company-based performance goals such as specific levels of revenue and profit. The Board evaluates the performance of the executive officers and the Company and approves a performance rating based upon the results of its evaluation. In fiscal 1999, Mr. Reyes and the other Named Executive Officers were paid the bonus amounts shown in the Summary Compensation Table as the Company exceeded its corporate performance targets for revenue and profit. Mr. Reyes was eligible for an annual bonus targeted at 50% of his base salary upon achievement of specific milestones. These milestones were related to both individual performance factors and company performance targets.

Long-Term Stock Option Incentives

The Board provides the Company’s executive officers with long-term incentive compensation through grants of options to purchase the Company’s Common Stock. The goal of the long-term stock option

incentive program is to align the interests of executive officers with those of the Company’s stockholders and to provide each executive officer with a significant incentive to manage the Company from the perspective of an owner with an equity stake in the business. It is the belief of the Board that stock options directly motivate an executive to maximize long-term stockholder value. The options also utilize vesting periods that encourage key executives to continue in employ of the Company. The Board considers the grant of each option subjectively, reviewing factors such as the individual performance, the anticipated future contribution toward the attainment of the Company’s long-term strategic performance goals and the number of unvested options held by each individual at the time of the new grant. In fiscal 1999, no options were granted to Mr. Reyes because the Board believed that his current option status was competitive based on market data and his future vesting.

SECTION 162(m)

The Company has considered the potential future effects of Section 162(m) of the Internal Revenue Code on the compensation paid to the Company’s executive officers. Section 162(m) disallows a tax deduction for any publicly held corporation for individual compensation exceeding $1.0 million in any taxable year for any of the Named Executive Officers, unless compensation is performance-based. The Company has adopted a policy that, where reasonably practicable, the Company will seek to qualify the variable compensation paid to its executive officers for an exemption from the deductibility limitations of Section 162(m).

Respectfully submitted by:
Seth D. Neiman
Neal Dempsey
Mark Leslie
Gregory L. Reyes
Larry W. Sonsini

PERFORMANCE GRAPH

Set forth below is a line graph comparing the annual percentage change in the cumulative return to the stockholders of the Company’s Common Stock with the cumulative return of the NASDAQ Market Index and of the SIC Code Computer Peripheral Equipment Index for the period commencing May 25, 1999 and ending on October 31, 1999. Returns for the indices are weighted based on market capitalization at the beginning of each measurement point.
The following descriptive data is supplied in accordance with Rule 304(d) of Regulation S-T.

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Brocade Communications Systems, Inc.
SIC Code Computer Peripheral Equipment Index
NASDAQ Market Index

(1) The graph assumes that $100 was invested on May 25, 1999 in the Company's Common Stock, the NASDAQ Market Index and the SIC Code Computer Peripheral Equipment Index and that all dividends were reinvested. No dividends have been declared or paid on the Company's Common Stock. Stockholder returns over the indicated period should not be considered indicative of future stockholder returns.

The information contained above under the captions "Report of the Board of Directors on Executive Compensation" and "Performance Graph" shall not be deemed to be "soliciting material" or to be "filed" with the Securities and Exchange Commission, nor shall such information be incorporated by reference into any future filing under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, except to the extent that the Company specifically incorporates it by reference into such filing.

COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION

During fiscal 1999, none of the members of the compensation committee was an officer or employee of the Company. Seth D. Neiman served as the Company's President and Chief Executive Officer from August 1995 to June 1996. No member of the compensation committee serves as a member of the board of directors or compensation committee of any entity that has one or more executive officers serving as a member of the Company's board of directors or compensation committee.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth certain information regarding the beneficial ownership of Common Stock of the Company as of February 24, 2000 as to (i) each person who is known by the Company to own beneficially more than 5% of the outstanding shares of Common Stock, (ii) each director of the Company, (iii) each of the executive officers named in the Summary Compensation Table below and (iv) all directors and executive officers of the company as a group. Unless otherwise indicated, the address of each listed stockholder is c/o Brocade Communications Systems, Inc., 1901 Guadalupe Parkway, San Jose, California 95131. The share amounts below are adjusted to reflect the Stock Splits.

<table>
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<tr>
<th>NAME AND ADDRESS OF BENEFICIAL OWNER</th>
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<tr>
<td>Gregory L. Reyes(2)</td>
<td>4,796,440</td>
<td>4.4%</td>
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<tr>
<td>Kumar Malavalli(3)</td>
<td>2,005,720</td>
<td>1.9</td>
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<tr>
<td>Peter J. Tarrant(4)</td>
<td>697,988</td>
<td>*</td>
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<tr>
<td>Victor M. Rinkle(5)</td>
<td>739,660</td>
<td>*</td>
</tr>
<tr>
<td>Charles W. Smith(6)</td>
<td>643,660</td>
<td>*</td>
</tr>
<tr>
<td>Neal Dempsey(7)</td>
<td>1,801,716</td>
<td>1.7</td>
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<tr>
<td>Mark Leslie(8)</td>
<td>438,680</td>
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<tr>
<td>Seth D. Neiman(9)</td>
<td>344,876</td>
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<tr>
<td>c/o Crosspoint Venture Partners</td>
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</table>

2925 Woodside Road
Woodside, CA 94062
ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Since the Company's inception in August 1995, there has not been nor is there currently proposed any transaction or series of similar transactions to
which the Company was or is to be a party in which the amount involved exceeds $60,000 and in which the Company or any member of the immediate family of any of the foregoing persons had or will have a direct or indirect material interest other than (1) compensation agreements and other arrangements, which are described where required in "Change of Control and Severance Agreements" and (2) the transactions described below.

TRANSACTIONS WITH DIRECTORS, EXECUTIVE OFFICERS AND 5% STOCKHOLDERS

LOANS TO CERTAIN EXECUTIVE OFFICERS

On April 11, 1997, the Company loaned $30,000 to Charles W. Smith, the Company's Vice President, Worldwide Sales, secured by a stock pledge agreement, in connection with his purchase of 400,000 shares of the Company's common stock for $0.075 per share. This note accrues interest at the rate of 6.5% per annum, compounded semi-annually, and is due on February 27, 2001. On January 13, 1998, the Company loaned $15,000 to Mr. Smith, secured by a stock pledge agreement, in connection with his purchase of 100,000 shares of the Company's common stock for $0.15 per share. This note accrues interest at the rate of 6.5% per annum, compounded semi-annually, and is due on January 13, 2003. On December 26, 1998, the Company loaned $78,750 to Mr. Smith, secured by a stock pledge agreement, in connection with his purchase of 140,000 shares of the Company's Common Stock for $0.5625 per share. This note accrues interest at the rate of 5% per annum, compounded semi-annually, and is due on January 15, 2003. On January 25, 1999, the Company loaned $78,750 to Mr. Smith, secured by a stock pledge agreement, in connection with his purchase of 140,000 shares of the Company's Common Stock for $0.5625 per share. This note accrues interest at the rate of 5% per annum, compounded semi-annually, and is due on December 31, 2003. The principal amounts and accrued interest on all notes remain outstanding. The share amounts and per share prices above are adjusted to reflect the Stock Splits.

On April 11, 1997, the Company loaned $45,000 to B. Carl Lee, the Company's former Vice President, Finance and Chief Financial Officer, secured by a stock pledge agreement, in connection with his purchase of 600,000 shares of the Company's Common Stock for $0.075 per share. This note accrues interest at the rate of 6.5% per annum, compounded semi-annually, and is due on December 2, 2001. On December 31, 1998, the Company loaned $112,500 to Mr. Lee, secured by a stock pledge agreement, in connection with his purchase of 200,000 shares of the Company's Common Stock for $0.5625 per share. This note accrues interest at the rate of 6.5% per annum, compounded semi-annually, and is due on December 31, 2003. The share amounts and per share prices above are adjusted to reflect the Stock Splits. The entire principal balance and all accrued interest under these notes have been repaid.

On January 26, 1998, the Company loaned $360,000 to Peter J. Tarrant, the Company's Vice President, Marketing and Business Development, secured by a stock pledge agreement, in connection with his purchase of 800,000 shares of the Company's Common Stock for $0.45 per share (as adjusted to reflect the Stock Splits). This note accrues interest at the rate of 6.5% per annum, compounded semi-annually, and is due on January 26, 2003. A principal balance of $180,000 plus accrued interest of $3,413 on this note remain outstanding.

On December 8, 1998, the Company loaned $647,854 to Gregory L. Reyes, the Company's President and Chief Executive Officer, secured by a stock pledge agreement, in connection with his purchase of 1,151,740 shares of the Company's Common Stock for $0.5625 per share. This note accrues interest at the rate of 4.47% per annum, compounded semi-annually, and is due on May 24, 2000. Also on December 8, 1998, the Company loaned $2,807,386 to Mr. Reyes, secured by a stock pledge agreement, in connection with his purchase of 4,990,908 shares of the Company's Common Stock for $0.5625 per share. This note accrues interest at the rate of 4.47% per annum, compounded semi-annually, and is due on May 24, 2000. A principal balance of $3,117,740 and accrued interest in the amount of $185,765 remain outstanding on both notes. The share amounts and per share prices above are adjusted to reflect the Stock Splits.

On December 24, 1998, the Company loaned $450,000 to Victor M. Rinkle, the Company's Vice President, Operations, secured by a stock pledge agreement, in connection with his purchase of 800,000 shares of the Company's Common Stock for $0.5625 per share (as adjusted to reflect the Stock Splits). This note accrues interest at the rate of 8.5% per annum, compounded semi-annually, and is due on December 24, 2004. A principal balance of $369,000 and accrued interest in the amount of $20,454 remain outstanding on this note.
On April 20, 1999, the Company loaned $100,000 to Paul R. Bonderson, Jr., the Company's Vice President, Engineering. The loan was secured by a stock pledge agreement. This note accrued interest at the rate of 5.21% per annum, compounded semi-annually, and is due on April 21, 2004. The entire principal balance and all accrued interest under this note has been repaid.

On May 17, 1999 the Company loaned $312,562 to Jean Zorzy, the Company's Vice President of Program Management, secured by a stock pledge agreement, in connection with her purchase of 145,000 shares of the Company's Common Stock for $0.5625 per share and 132,000 shares of the Company's Common Stock for $1.75 per share (as adjusted to reflect the Stock Splits). This note accrues interest at the rate of 6.5% per annum, compounded semi-annually, and is due on May 17, 2004. A principal balance of $305,531 and accrued interest in the amount of $9,047 remain outstanding on this note.

STOCK OPTION GRANTS AND LOAN TO CERTAIN DIRECTORS

On January 6, 1999, the Company granted to Mark Leslie, a director of Brocade, a fully vested stock option under the 1999 Stock Plan to purchase 487,424 shares of the Company's common stock at $0.5625 per share. On January 28, 1999, the Company loaned $274,176 to Mr. Leslie, secured by a stock pledge agreement, in connection with his purchase of 487,424 shares of the Company's Common Stock at $0.5625 per share. The share amounts and per share prices above are adjusted to reflect the Stock Splits. The entire principal balance was repaid before any interest accrued under this note.

On January 29, 1999, the Company granted to Larry W. Sonsini, a director of Brocade, a fully vested stock option under the 1999 Stock Plan to purchase 487,424 shares of the Company's Common Stock at $1.25 per share (as adjusted to reflect the Stock Splits). Mr. Sonsini is also a partner of Wilson Sonsini Goodrich & Rosati, P.C., a law firm, to whom we have paid legal fees in connection with this solicitation.

INDEMNIFICATION

The Company has entered into indemnification agreements with each of its directors and officers. Such indemnification agreements require the Company to indemnify its directors and officers to the fullest extent permitted by Delaware law.

CONFLICT OF INTEREST POLICY

The Company believes that all transactions with affiliates described above were made on terms no less favorable to The Company than could have been obtained from unaffiliated third parties. The Company's policy is to require that a majority of the independent and disinterested outside directors on the Board approve all future transactions between Brocade and its officers, directors, principal stockholders and their affiliates. Such transactions will continue to be on terms no less favorable to the Company's than it could obtain from unaffiliated third parties.

All future transactions, including loans, between the Company and its officers, directors, principal stockholders and their affiliates will be approved by a majority of the Board, including a majority of the independent and disinterested outside directors, and will continue to be on terms no less favorable to the Company than could be obtained from unaffiliated third parties.
Pursuant to the requirements of the Security Exchange Act of 1934, this Amendment to Report on Form 10-K has been signed on behalf of the Registrant by the following persons and in the capabilities and on the dates indicated:

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<tr>
<td>Gregory L. Reyes</td>
<td>President, Chief Executive Officer and Director</td>
<td>February 28, 2000</td>
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<tr>
<td>Michael J. Byrd</td>
<td>Vice President, Finance and Chief Financial Officer and Assistant Secretary</td>
<td>February 28, 2000</td>
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<td>Seth D. Neiman</td>
<td>Chairman of the Board</td>
<td>February 28, 2000</td>
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<td>Neal Dempsey</td>
<td>Director</td>
<td>February 28, 2000</td>
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<td>Mark Leslie</td>
<td>Director</td>
<td>February 28, 2000</td>
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<tr>
<td>Larry W. Sonsini</td>
<td>Director</td>
<td>February 28, 2000</td>
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* /s/ MICHAEL J. BYRD

Michael J. Byrd
Attorney-in-fact
Form PRE 14A -- Other preliminary proxy statements

SEC Accession No.
Period of Report: 2001-04-04
Documents: 1
Filing date: 2001-02-15
Accepted: 2001-02-15 00:00:00

Table of submitted documents:

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Filer Information:

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Type: PRE 14A | Act: 34 | File No.: 000-25601 | Film No.: 1547320
SIC: 7372 Services-Prepackaged Software

Business Address
1745 TECHNOLOGY DRIVE
SAN JOSE CA 95110
4084878000

Mailing Address
1745 TECHNOLOGY DRIVE
SAN JOSE CA 95110
SCHEDULE 14A
(RULE 14A-101)

INFORMATION REQUIRED IN PROXY STATEMENT

SCHEDULE 14A INFORMATION
PROXY STATEMENT PURSUANT TO SECTION 14(A) OF THE SECURITIES
EXCHANGE ACT OF 1934 (AMENDMENT NO.   )

Filed by the Registrant [x]

Filed by a Party other than the Registrant [ ]

Check the appropriate box:

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(Brocade Communications Systems, Inc.)

(Brocade Communications Systems, Inc.)

Payment of Filing Fee (Check the appropriate box):

[x] No fee required.

[ ] Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.

(1) Title of each class of securities to which transaction applies:

(2) Aggregate number of securities to which transaction applies:

(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

(4) Proposed maximum aggregate value of transaction:

(5) Total fee paid:

[ ] Fee paid previously with preliminary materials:

[ ] Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:
NOTICE OF ANNUAL MEETING OF STOCKHOLDERS

TO THE STOCKHOLDERS:

NOTICE IS HEREBY GIVEN that the Annual Meeting of Stockholders (the "Annual Meeting") of BROCADE COMMUNICATIONS SYSTEMS, INC., a Delaware corporation (the "Company"), will be held on Wednesday, April 4, 2001, at 11:00 a.m. local time, at the Silicon Valley Conference Center located at 2161 N. First Street, San Jose, California for the following purposes:

1. To elect two (2) directors to serve until the 2004 Annual Meeting of Stockholders or until their successors are duly elected and qualified;

2. To ratify the appointment of Arthur Andersen, LLP as independent auditors of the Company for the fiscal year ending October 27, 2001;

3. To amend the Company's Certificate of Incorporation to increase the authorized number of shares of Common Stock from 400,000,000 shares to 800,000,000 shares; and

4. To transact such other business as may properly come before the Annual Meeting or before any adjournments thereof, including any motion to adjourn to a later date to permit further solicitation of proxies if necessary.

The foregoing items of business are more fully described in the Proxy Statement accompanying this notice. Only stockholders of record at the close of business on February 19, 2001 are entitled to notice of and to vote at the Annual Meeting.

All stockholders are cordially invited to attend the Annual Meeting in person. However, to assure your representation at the meeting, you are urged to mark, sign, date and return the enclosed Proxy Card as promptly as possible in the postage-paid envelope enclosed for that purpose or you may vote by telephone or using the Internet as instructed on the enclosed Proxy Card. Any stockholder attending the Annual Meeting may vote in person even if he or she has returned a proxy.

Sincerely,

Michael J. Byrd
Vice President and Chief Financial Officer
and Assistant Secretary

San Jose, California
March 5, 2000

YOUR VOTE IS IMPORTANT.

WHETHER OR NOT YOU PLAN TO ATTEND THE MEETING, PLEASE COMPLETE, SIGN, DATE AND RETURN THE ACCOMPANYING PROXY CARD IN THE ENCLOSED POSTAGE-PAID ENVELOPE OR VOTE BY TELEPHONE OR USING THE INTERNET AS INSTRUCTED ON THE ENCLOSED PROXY CARD.

PAGE 3

BROCADE COMMUNICATIONS SYSTEMS, INC.

PROXY STATEMENT FOR 2001
ANNUAL MEETING OF STOCKHOLDERS

INFORMATION CONCERNING SOLICITATION AND VOTING

GENERAL

The enclosed Proxy is solicited on behalf of the Board of Directors (the "Board") of BROCADE COMMUNICATIONS SYSTEMS, INC., a Delaware corporation (the "Company" or "Brocade"), for use at the Annual Meeting of Stockholders (the "Annual Meeting") to be held Wednesday, April 4, 2001 at 11:00 a.m. local time, or at any adjournment thereof, for the purposes set forth herein and in the accompanying Notice of Annual Meeting of Stockholders. The Annual Meeting will be held at the Silicon Valley Conference Center located at 2161 N. First Street, San Jose, California. The Company's principal executive offices are located at 1745 Technology Drive, San Jose, California 95110, and its telephone number at that location is (408) 487-8000.

These proxy solicitation materials and the Annual Report on Form 10-K for
the year ended October 28, 2000, including financial statements, were first mailed on or about January 2001. Copies of this proxy solicitation materials and financial statements were mailed on or about February 15, 2001.

THE COMPANY SHALL PROVIDE WITHOUT CHARGE TO EACH STOCKHOLDER SOLICITED BY THESE PROXY SOLICITATION MATERIALS A COPY OF THE ANNUAL REPORT ON FORM 10-K TOGETHER WITH THE FINANCIAL STATEMENTS AND FINANCIAL STATEMENT SCHEDULES REQUIRED TO BE FILED WITH THE ANNUAL REPORT UPON REQUEST OF THE STOCKHOLDER MADE IN WRITING TO BROCADE COMMUNICATION SYSTEMS, INC., 1745 TECHNOLOGY DRIVE, SAN JOSE, CALIFORNIA 95110, ATTN: MICHAEL J. BYRD, VICE PRESIDENT AND CHIEF FINANCIAL OFFICER AND ASSISTANT SECRETARY.

RECORD DATE; OUTSTANDING SHARES

Stockholders of record at the close of business on February 19, 2001 (the "Record Date") are entitled to notice of and to vote at the meeting. The Company has one series of shares outstanding, designated Common Stock, $0.001 par value per share. As of the Record Date, shares of the Company's Common Stock were issued and outstanding and held of record by approximately stockholders. As of the Record Date, no shares of the Company's Preferred Stock were outstanding.

REVOCABILITY OF PROXIES

Any proxy given pursuant to this solicitation may be revoked by the person giving it at any time before its use by (a) delivering to the Company (Attention: Michael J. Byrd, Vice President and Chief Financial Officer and Assistant Secretary) a written notice of revocation or a duly executed proxy bearing a later date or (b) attending the meeting and voting in person.

VOTING

Each stockholder is entitled to one vote for each share held.

SOLICITATION OF PROXIES

This solicitation of proxies is made by the Company, and all related costs will be borne by the Company. In addition, the Company may reimburse brokerage firms and other persons representing beneficial owners of shares for their expenses in forwarding solicitation material to such beneficial owners. Proxies may also be solicited by certain of the Company's directors, officers and regular employees, without additional compensation, in person or by telephone or facsimile.

QUORUM; ABSTENTIONS; BROKER NON-VOTES

Voters cast by proxy or in person at the Annual Meeting will be tabulated by the Inspector of Elections (the "Inspector") who will be an employee of the Company's transfer agent. The Inspector will also determine whether or not a quorum is present. Except in certain specific circumstances, the affirmative vote of a majority of shares present in person or represented by proxy at a duly held meeting at which a quorum is present is required under Delaware law and the Company's Bylaws for approval of proposals presented to stockholders. In general, Delaware law also provides that a quorum consists of a majority of shares entitled to vote and present or represented by proxy at the meeting.

When proxies are properly dated, executed and returned, the shares represented by such proxies will be voted at the Annual Meeting in accordance with the instructions of the stockholder. If no specific instructions are given, the shares will be voted for (i) the election of the nominees for directors set forth herein; (ii) the ratification of Arthur Andersen, LLP as independent auditors of the Company for the fiscal year ending October 27, 2001; (iii) the approval of an amendment to the Company's Certificate of Incorporation to increase the authorized number of shares of Common Stock from 400,000,000 shares to 800,000,000 shares; and (iv) upon such other business as may properly come before the Annual Meeting or any adjournment thereof.

Pursuant to Delaware law, the Inspector will treat shares that are voted "WITHHELD" or "ABSTAIN" as being present and entitled to vote for purposes of determining the presence of a quorum and as entitled to vote (the "Votes Cast") on the subject matter at the Annual Meeting with respect to such matter. With respect to broker non-votes, in a 1988 Delaware case, Berlin v. Esmarin, Partners, the Delaware Supreme Court held that, although broker non-votes may be counted for purposes of determining the presence or absence of a quorum for the transaction of business, broker non-votes should not be counted for purposes of determining the number of Votes Cast with respect to the particular proposal on which the broker has expressly not voted. Broker non-votes with respect to
proposals set forth in this Proxy Statement will therefore not be considered.

"Votes Cast" and "Votes Abstained" reflect the determination of the

DEADLINE FOR RECEIPT OF STOCKHOLDER PROPOSALS

Stockholders are entitled to present proposals for action at a forthcoming

meeting if they comply with the requirements of the proxy rules established by

the Securities and Exchange Commission. Proposals of stockholders of the Company

that are intended to be presented by such stockholders at the Company's 2002

Annual Meeting of Stockholders must be received by the Company no later than

November 5, 2001 in order that they may be considered for inclusion in the Proxy

Statement and form of Proxy relating to that meeting.

The attached Proxy Card grants the proxy holders discretionary authority to

vote on any matter raised at the Annual Meeting. If a stockholder intends to

submit a proposal at the Company's 2002 Annual Meeting of Stockholders which is

not eligible for inclusion in the Proxy Statement relating to the meeting, and

the stockholder fails to give the Company notice in accordance with the

requirements set forth in the Securities Exchange Act of 1934, as amended, no

later than January 19, 2002, then the proxy holders will be allowed to use their

discretionary authority when and if the proposal is raised at the Company's

Annual Meeting in 2002.

SECURITY OWNERSHIP OF CERTAIN

BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth certain information regarding the beneficial

ownership of Common Stock of the Company as of January 31, 2001 as to (i) each

of the executive officers named in the Summary Compensation Table below, (ii)

each director and nominee for director of the Company, (iii) each person who is

known by the Company to own beneficially more than 5% of the outstanding shares

of Common Stock and (iv) all directors and executive officers of the Company as

a group. Unless otherwise indicated, the address of each listed stockholder is

c/o Brocade Communications Systems, Inc., 1745 Technology Drive, San Jose,

California 95110.

<table>
<thead>
<tr>
<th>NAME AND ADDRESS OF BENEFICIAL OWNER</th>
<th>NUMBER OF SHARES BENEFICIALLY OWNED(1)</th>
<th>PERCENT OF SHARES BENEFICIALLY OWNED(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>NAMED EXECUTIVE OFFICERS AND DIRECTORS</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gregory L. Reyes(3)</td>
<td>4,882,640</td>
<td>2.2%</td>
</tr>
<tr>
<td>Charles W. Smith</td>
<td>564,030</td>
<td>*</td>
</tr>
<tr>
<td>Jack Cuthbert(4)</td>
<td>108,666</td>
<td>*</td>
</tr>
<tr>
<td>Michael J. Byrd</td>
<td>1,548,462</td>
<td>*</td>
</tr>
<tr>
<td>Paul R. Bonderson, Jr.(5)</td>
<td>3,370,333</td>
<td>1.5%</td>
</tr>
<tr>
<td>Neal Dempsey(6)</td>
<td>73,820</td>
<td>*</td>
</tr>
<tr>
<td>Mark Leslie(7)</td>
<td>509,492</td>
<td>*</td>
</tr>
<tr>
<td>Seth D. Neiman</td>
<td>20,000</td>
<td>*</td>
</tr>
<tr>
<td>c/o Crosspoint Venture Partners</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2925 Woodside Road</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Woodside, CA 94062</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Larry W. Sonsini</td>
<td>89,232</td>
<td>*</td>
</tr>
<tr>
<td>c/o Wilson Sonsini Goodrich &amp; Rosati</td>
<td></td>
<td></td>
</tr>
<tr>
<td>650 Page Mill Road</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Palo Alto, CA 94304</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5% STOCKHOLDERS</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FMR Corp.(8)</td>
<td>24,151,020</td>
<td>10.7%</td>
</tr>
<tr>
<td>82 Devonshire St</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Boston, MA 02109</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Morgan Stanley Dean Witter &amp; Co.(9)</td>
<td>12,836,960</td>
<td>5.7%</td>
</tr>
<tr>
<td>1585 Broadway</td>
<td></td>
<td></td>
</tr>
<tr>
<td>New York, NY 10036</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Oak Associates, Ltd.(10)</td>
<td>11,805,000</td>
<td>5.2%</td>
</tr>
<tr>
<td>3875 Embassy Parkway</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Akron, OH 44333</td>
<td></td>
<td></td>
</tr>
<tr>
<td>All Executive Officers and Directors as a Group (12</td>
<td>11,924,117</td>
<td>5.3%</td>
</tr>
<tr>
<td>persons)(11)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

</TABLE>
(1) Except as indicated in the footnotes to this table and pursuant to applicable community property laws, the persons named in the table have sole voting and investment power with respect to all shares of Common Stock. The number of shares beneficially owned includes Common Stock of which such individual has the right to acquire beneficial ownership either currently or within 60 days after January 31, 2001, including, but not limited to, upon the exercise of an option.

(2) Percentage of beneficial ownership is based upon 225,484,682 shares of Common Stock outstanding as of January 31, 2001. For each named person, this percentage includes Common Stock of which such person has the right to acquire beneficial ownership either currently or within 60 days of January 31, 2001, including, but not limited to, upon the exercise of an option; however, such Common Stock shall not be deemed outstanding for the purpose of computing the percentage owned by any other person.


(3) All shares listed are held by The Reyes Family Trust.

(4) Includes options to purchase 54,332 shares of Common Stock exercisable within 60 days of February 19, 2001.

(5) Includes 3,066,528 shares held by The Bonderson Family Living Trust. Also includes 6,416 shares held by Mr. Bonderson, Jr.'s daughter and 6,416 shares held by Mr. Bonderson, Jr.'s son, as to which he disclaims beneficial ownership. Includes options to purchase 33,333 shares of Common Stock exercisable within 60 days of February 19, 2001.

(6) Includes 52,000 shares held by the Dempsey Family Limited Partnership and 1,820 shares held by the Dempsey Revocable Trust.

(7) Includes 95,324 shares held by Leslie Investments, LLC and 514,168 shares held by The Leslie Family Trust.

(8) Information based on Schedule 13G/A dated February 13, 2001, as filed by FMR Corp. with the Securities and Exchange Commission.

(9) Information based on Schedule 13G dated February 12, 2001, as filed by Morgan Stanley Dean Witter & Co. with the Securities and Exchange Commission.

(10) Information based on Schedule 13G dated February 13, 2001, as filed by Oak Associates, Ltd. with the Securities and Exchange Commission.

(11) Includes options to purchase 140,999 shares of Common Stock exercisable by all directors and executive officers within 60 days of February 19, 2001.

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PROPOSAL ONE

ELECTION OF DIRECTORS

NOMINEES

The Company has a classified Board of Directors currently consisting of two Class I directors, Seth D. Neiman and Mark Leslie, two Class II directors, Neal Dempsey and Larry W. Sonsini, and one Class III director, Gregory L. Reyes, who will serve until the annual meetings of stockholders to be held in 2003, 2001, and 2002, respectively, or until their respective successors are duly elected and qualified. At each annual meeting of stockholders, directors are elected for a term of three years to succeed those directors whose terms expire on the annual meeting dates.

The nominees for election at the Annual Meeting to Class II of the Board of Directors are Neal Dempsey and Larry W. Sonsini. If elected, Mr. Dempsey and Mr. Sonsini will each serve as a director until the annual meeting in 2004, or until their respective successors are elected and qualified or until their earlier
resignation or removal. The proxy holders may not vote the proxies for a greater number of persons than are named as nominees in this proxy statement. If the proxy holders are instructed, the proxy holders will vote the proxies received by them for the Company's two nominees. In the event that any nominee of the Company is unable or declines to serve as a director at the time of the Annual Meeting, the proxies will be voted for any nominee who shall be designated by the present Board of Directors to fill the vacancy. The Company is not aware of any nominee who will be unable or will decline to serve as a director. In the event that additional persons are nominated for election as directors, the proxy holders intend to vote all proxies received by them in such a manner as will assure the election of as many of the nominees listed below as possible, and, in such event, the specific nominees to be voted for will be determined by the proxy holders.

**VOTE REQUIRED**

If a quorum is present and voting, the two nominees receiving the highest number of votes will be elected to the Board. Abstentions and "broker non-votes" are not counted in the election of directors.

**DIRECTORS AND NOMINEES**

The following table sets forth certain information regarding the Company's directors and nominees as of February 19, 2001:

<table>
<thead>
<tr>
<th></th>
<th>NAME</th>
<th>AGE</th>
<th>POSITION</th>
<th>DIRECTOR SINCE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Class II nominees</td>
<td>Neal Dempsey</td>
<td>59</td>
<td>Director</td>
<td>1996</td>
</tr>
<tr>
<td></td>
<td>Larry W. Sonsini</td>
<td>60</td>
<td>Director</td>
<td>1999</td>
</tr>
<tr>
<td>Class III director</td>
<td>Gregory L. Reyes</td>
<td>38</td>
<td>President, Chief Executive Officer and Director</td>
<td>1998</td>
</tr>
<tr>
<td></td>
<td>Seth D. Neiman</td>
<td>46</td>
<td>Chairman of the Board</td>
<td>1995</td>
</tr>
<tr>
<td></td>
<td>Mark Leslie</td>
<td>55</td>
<td>Director</td>
<td>1999</td>
</tr>
</tbody>
</table>

(1) Member of Compensation Committee.

(2) Member of Audit Committee.

There is no family relationship between any director or executive officer of the Company.

Seth D. Neiman has served as Chairman of the Board of Directors of Brocade since August 1995. Mr. Neiman formerly served as the Company's Chief Executive Officer from August 1995 to June 1996. Since August 1994, Mr. Neiman has held various positions at Crosspoint Venture Partners, a venture capital firm. Mr. Neiman has been a general partner of Crosspoint since January 1996, and a managing partner since December 1999. From September 1991 to July 1994, Mr. Neiman was Vice President of Engineering at Coactive Networks, a local area networks company. Mr. Neiman serves on the Board of Directors of Avanex Corporation, an optical networking company, and Foundry Networks, Inc., an Internet switching and routing company. Mr. Neiman also serves on the Boards of Directors and compensation committees of numerous private companies. Mr. Neiman received a B.A. in Philosophy from Ohio State University.

Mark Leslie has served as a director of Brocade since January 1999. Mr. Leslie currently serves as the Chairman of the Board of Directors of VERITAS Software Corporation, a storage management software company. From February 1990 to November 2000, Mr. Leslie served as Chief Executive Officer and a member of the Board of Directors of VERITAS Software Corporation. Mr. Leslie also serves on the Board of Directors and audit and compensation committees of Keynote.
Neal Dempsey has served as a director of Brocade since December 1996. Since May 1989, Mr. Dempsey has been a General Partner of Bay Partners, a venture capital firm. Mr. Dempsey also serves on the Boards of Directors and compensation committees of numerous private companies. Mr. Dempsey received a B.A. in Business from the University of Washington.

Larry W. Sonsini has served as a director of Brocade since January 1999. Mr. Sonsini has been a partner of the law firm of Wilson Sonsini Goodrich & Rosati, P.C., since 1973 and is currently the Chairman and Chief Executive Officer of the firm. Mr. Sonsini serves on the Boards of Directors of Commerce One, Inc., Echelon Corporation, Lattice Semiconductor Corporation, LSI Logic, Inc., Novell, Inc., Pixar, and Tibco Software, Inc. as well as on the Boards of Directors of several private companies. Mr. Sonsini received an A.B. from the University of California, Berkeley and an L.L.B. from Boalt Hall School of Law, University of California, Berkeley.

Gregory L. Reyes has served as the President and Chief Executive Officer and a member of the Board of Directors of Brocade since July 1998. Before joining Brocade, from January 1995 to June 1998, Mr. Reyes was President and Chief Executive Officer of Wireless Access, Inc., a wireless data communications products company. From January 1995 to November 1997, Mr. Reyes served as Chairman of the Board of Directors of Wireless Access. From January 1991 to January 1995, Mr. Reyes served as Divisional Vice President and general manager of Norand Data Systems, a developer of wireless data networks and hand-held terminals. Mr. Reyes also serves on the Board of Directors and compensation committees of several private companies. Mr. Reyes received a B.S. in Business Administration from Saint Mary’s College in Moraga, California.

BOARD MEETINGS AND COMMITTEES

The Board held a total of four meetings during fiscal 2000. No director who presently serves on the Board attended fewer than 75% of the meetings of the Board and committees thereof held during fiscal 2000, if any, upon which such director served.

The Company’s Board currently has two committees: an audit committee and a compensation committee. The audit committee consists of Mr. Neiman and Mr. Dempsey, each of whom is independent as defined under the National Association of Securities Dealers listing standards. The audit committee held a total of four meetings during fiscal 2000. The audit committee makes recommendations to the Company’s Board of Directors regarding the selection of independent auditors, reviews the results and scope of audit and other services provided by the Company’s independent auditors and reviews the accounting principles and auditing practices and procedures to be used for the Company’s financial statements. A copy of the audit committee charter is attached to this Proxy Statement as Appendix A.

The compensation committee consists of Mr. Leslie and Mr. Dempsey. The compensation committee held a total of two meetings during fiscal 2000. The compensation committee approves stock compensation of the Company’s executive officers and makes recommendations to the Board of Directors regarding stock plans and the compensation of officers and other managerial employees. The Board has no nominating committee or any committee performing such functions.

COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION

The compensation committee currently consists of Mr. Dempsey and Mr. Leslie. During fiscal 2000, none of the members of the compensation committee was an officer or employee of the Company. Mr. Leslie served as the Chief Executive Officer and a member of the Board of Directors of VERITAS Software Corporation, a storage management software company, from February 1990 to November 2000. Except as set forth above, during fiscal 2000, no member of the compensation committee or executive officer of the Company served as a member of the Board of Directors or compensation committee of any entity that has one or more executive officers serving as a member of the Company’s Board of Directors or compensation committee.
The Board of Directors has selected Arthur Andersen, LLP, independent auditors, to audit the financial statements of the Company for the fiscal year ending October 27, 2001, and recommends that stockholders vote for ratification of such appointment. Although action by stockholders is not required by law, the Board of Directors has determined that it is desirable to request approval of this selection by the stockholders. Notwithstanding the selection, the Board of Directors, in its discretion, may direct the appointment of new independent auditors at any time during the year, if the Board of Directors feels that such a change would be in the best interest of the Company and its stockholders. In the event of a negative vote on ratification, the Board of Directors will reconsider its selection.

Arthur Andersen, LLP has audited the Company's financial statements annually since October 1997. Representatives of Arthur Andersen, LLP are expected to be present at the meeting with the opportunity to make a statement if they desire to do so and are expected to be available to respond to appropriate questions.

FEES BILLED TO COMPANY BY ARTHUR ANDERSEN, LLP DURING FISCAL 2000

AUDIT FEES

Audit fees billed to the Company by Arthur Andersen, LLP during the Company's 2000 fiscal year for the audit of the Company's annual financial statements included on Form 10-K and review of those financial statements included in the Company's quarterly reports on Form 10-Q totaled $195,000.

FINANCIAL INFORMATION SYSTEMS DESIGN AND IMPLEMENTATION FEES

The Company did not engage Arthur Andersen, LLP to provide advice to the Company regarding financial information systems design and implementation during the fiscal year ended October 28, 2000.

ALL OTHER FEES

Fees billed to the Company by Arthur Andersen, LLP during the Company's 2000 fiscal year for all other non-audit services rendered to the Company, including accounting advice services totaled $20,000. The audit committee of the Board of Directors has determined that the accounting advice services provided by Arthur Andersen, LLP are compatible with maintaining Arthur Andersen, LLP's independence.


PROPOSAL THREE

INCREASE IN THE AUTHORIZED NUMBER OF SHARES OF COMMON STOCK

GENERAL

The Company's Certificate of Incorporation currently authorizes the issuance of 400,000,000 shares of Common Stock and 5,000,000 shares of Preferred Stock. In February 2001, the Board of Directors adopted a resolution approving an amendment to the Certificate of Incorporation to increase the authorized number of shares of Common Stock to 800,000,000 shares, subject to stockholder approval of the amendment. No change is being proposed to the authorized number of shares of Preferred Stock.

CURRENT USE OF SHARES

As of January 31, 2001, the Company had approximately 275,584,682 shares of Common Stock outstanding and approximately 63,239,084 shares of Common Stock reserved for future issuance under the Company's incentive stock plans, of which approximately 54,777,995 shares are covered by outstanding options and approximately 8,461,089 shares are available for future grant or purchase. Based upon the foregoing number of outstanding and reserved shares of Common Stock, the Company has approximately 111,276,234 shares remaining available for other purposes.
The Board of Directors has adopted resolutions setting forth the proposed amendment to the first sentence of Article 4 of the Company's Certificate of Incorporation (the "Amendment"), the advisability of the Amendment, and a call for submission of the Amendment for approval by the Company's stockholders at the Annual Meeting. The following is the text of Article 4 of the Certificate of Incorporation of the Company, as proposed to be amended:

The Company is authorized to issue two classes of shares of stock to be designated, respectively, Common Stock, $0.001 par value, and Preferred Stock, $0.001 par value. The total number of shares that the Company is authorized to issue is 805,000,000 shares. The number of shares of Common Stock authorized is 800,000,000. The number of shares of Preferred Stock authorized is 5,000,000.

PURPOSE AND EFFECT OF THE PROPOSED AMENDMENT

Since going public, the Company has effected three two-for-one stock splits. The Board of Directors believes that it is in the Company's best interest to increase the number of shares of Common Stock that it is authorized to issue in order to enable the Company to effect additional stock splits in the future if the Board of Directors determined that it were in the Company's best interest to do so.

The Board of Directors also believes that the availability of additional authorized but unissued shares will provide it with the flexibility to issue Common Stock for other proper corporate purposes that may be identified in the future, such as to raise equity capital, to make acquisitions through the use of stock, to establish strategic relationships with other companies, to adopt additional employee benefit plans or reserve additional shares for issuance under such plans. The Board of Directors has no immediate plans, understandings, agreements or commitments to issue additional Common Stock for any such purposes.

The Board of Directors believes that the proposed increase in the authorized shares of Common Stock will make available sufficient shares to effect a stock split in the future and should the Company decide to use its shares for one or more of such previously mentioned purposes or otherwise. No additional action or authorization by the Company's stockholders would be necessary prior to the issuance of such additional shares, unless required by applicable law or the rules of any stock exchange or national securities association trading system on which the Common Stock is then listed or quoted. The Company reserves the right to seek a further increase in authorized shares from time to time in the future as considered appropriate by the Board of Directors.

Under the Company's Certificate of Incorporation, the Company's stockholders do not have preemptive rights with respect to Common Stock. Thus, should the Board of Directors elect to issue additional shares of Common Stock, existing stockholders would not have any preferential rights to purchase such shares. In addition, if the Board of Directors elects to issue additional shares of Common Stock, such issuance could have a dilutive effect on earnings per share, voting power, and shareholdings of current stockholders.

The proposed amendment to increase the authorized number of shares of Common Stock could, under certain circumstances, have an anti-takeover effect, although this is not the intention of this proposal. For example, in the event of a hostile attempt to take over control of the Company, it may be possible for the Company to endeavor to impede the attempt by issuing shares of Common Stock, thereby diluting the voting power of the other outstanding shares and increasing the potential cost to acquire control of the Company. The Amendment therefore may have the effect of discouraging unsolicited takeover attempts. By potentially discouraging initiation of any such unsolicited takeover attempt, the proposed Amendment may limit the opportunity for the Company's stockholders to dispose of their shares at the higher price generally available in takeover attempts or that may be available under a merger proposal. The proposed amendment may have the effect of permitting the Company's current management, including the current Board of Directors, to retain its position, and place it in a better position to resist changes that stockholders may wish to make if they are dissatisfied with the conduct of the Company's business. However, the Board of Directors is not aware of any attempt to take control of the Company and the Board of Directors has not presented this proposal with the intent that it be utilized as a type of anti-takeover device.
THE BOARD OF DIRECTORS RECOMMENDS THAT THE STOCKHOLDERS VOTE "FOR" THE PROPOSAL TO AMEND THE COMPANY'S CERTIFICATE OF INCORPORATION TO INCREASE THE AUTHORIZED NUMBER OF SHARES OF COMMON STOCK FROM 400,000,000 SHARES TO 800,000,000 SHARES.

EXECUTIVE COMPENSATION AND OTHER MATTERS

EXECUTIVE COMPENSATION

SUMMARY COMPENSATION TABLE

The following Summary Compensation Table sets forth certain information regarding the compensation of the Chief Executive Officer of the Company and the next four most highly compensated executive officers of the Company (the "Named Executive Officers") for services rendered in all capacities to the Company for the last three fiscal years.

<table>
<thead>
<tr>
<th>NAME AND PRINCIPAL POSITION</th>
<th>FISCAL YEAR</th>
<th>ANNUAL COMPENSATION</th>
<th>SECURITY UNDERLYING OPTIONS</th>
<th>ALL OTHER COMPENSATION</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>SALARY($)</td>
<td>BONUS($)</td>
<td>(#)</td>
</tr>
<tr>
<td>Gregory L. Reyes............</td>
<td>2000</td>
<td>$360,000</td>
<td>$1,615,800</td>
<td>1,040,000</td>
</tr>
<tr>
<td>President and Chief Executive Officer</td>
<td>1999</td>
<td>200,000</td>
<td>150,000</td>
<td>--</td>
</tr>
<tr>
<td>Charles W. Smith...........</td>
<td>2000</td>
<td>160,000</td>
<td>358,250</td>
<td>543,328</td>
</tr>
<tr>
<td>Vice President, OEM Sales</td>
<td>1999</td>
<td>120,000</td>
<td>62,250</td>
<td>280,000</td>
</tr>
<tr>
<td>Jack Cuthbert..............</td>
<td>2000</td>
<td>120,000</td>
<td>278,750</td>
<td>340,000</td>
</tr>
<tr>
<td>Vice President, Worldwide Sales, Marketing and Support</td>
<td>1999</td>
<td>114,000</td>
<td>20,000</td>
<td>102,448(6)</td>
</tr>
<tr>
<td>Michael J. Byrd............</td>
<td>2000</td>
<td>250,000</td>
<td>413,900</td>
<td>85,000</td>
</tr>
<tr>
<td>Vice President and Chief Financial Officer</td>
<td>1999</td>
<td>100,000</td>
<td>--</td>
<td>420,000</td>
</tr>
<tr>
<td>Paul R. Bonderson, Jr......</td>
<td>2000</td>
<td>220,000</td>
<td>396,567</td>
<td>532,000</td>
</tr>
<tr>
<td>Vice President, Engineering</td>
<td>1999</td>
<td>165,000</td>
<td>9,901</td>
<td>268,000</td>
</tr>
<tr>
<td></td>
<td>1998</td>
<td>165,000</td>
<td>12,375</td>
<td>--</td>
</tr>
</tbody>
</table>

(1) Other compensation represents group term life insurance premiums and 401(k) matching payments.
(2) Also includes $640,085 earned as commissions.
(3) Also includes $272,436 earned as commissions.
(4) Also includes $86,965 earned as commissions.
(5) Also includes $427,057 earned as commissions.
(6) Also includes $102,120 earned as commissions.
(7) Also includes $19,576 earned as commissions.

OPTION GRANTS IN LAST FISCAL YEAR

The following table sets forth certain information for each grant of options to purchase the Company's Common Stock during Fiscal 2000 to each of the Named Executive Officers. All of these options granted by the Company were granted under the Company's 1999 Stock Plan and have a term of 10 years subject...
INDIVIDUAL GRANTS

<table>
<thead>
<tr>
<th>NAME</th>
<th>NUMBER OF OPTIONS GRANTED TO EMPLOYEES</th>
<th>PERCENT OF TOTAL OPTIONS</th>
<th>EXERCISE PRICE ($)</th>
<th>EXPIRATION DATE</th>
<th>POTENTIAL REALIZABLE VALUE AT ASSUMED ANNUAL RATES OF STOCK PRICE APPRECIATION FOR OPTION TERM(1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gregory L. Reyes(5).........</td>
<td>1,040,000</td>
<td>3.40%</td>
<td>$32.13</td>
<td>11/19/09</td>
<td>$21,014,640 $53,255,223</td>
</tr>
<tr>
<td>Charles W. Smith(6).........</td>
<td>288,328</td>
<td>0.94%</td>
<td>32.13</td>
<td>11/19/09</td>
<td>5,826,066 $14,764,396</td>
</tr>
<tr>
<td>Jack Cuthbert(7)</td>
<td>143,328</td>
<td>0.47%</td>
<td>32.13</td>
<td>11/19/09</td>
<td>2,896,141 $7,339,389</td>
</tr>
<tr>
<td>Michael J. Byrd(8).........</td>
<td>85,000</td>
<td>0.28%</td>
<td>40.50</td>
<td>01/31/10</td>
<td>10,188,093 $25,818,628</td>
</tr>
<tr>
<td>Paul R. Bonderson, Jr.(9)..</td>
<td>532,000</td>
<td>1.74%</td>
<td>32.13</td>
<td>11/19/09</td>
<td>10,749,796 $27,242,095</td>
</tr>
</tbody>
</table>

(1) Potential realizable values are (i) net of exercise price before taxes, (ii) based on the assumption that the Common Stock of the Company appreciates at the annual rate shown (compounded annually) from the date of grant until the expiration of the ten-year option term and (iii) based on the assumption that the option is exercised at the exercise price and sold on the last day of its term at the appreciated price. These numbers are calculated based on the requirements promulgated by the Commission and do not reflect the Company’s estimate of future stock price growth.


(3) Options were granted at an exercise price equal to the fair market value of the Company’s Common Stock, as determined by reference to the closing price reported on the Nasdaq National Market on the date of grant.

(4) Exercise price and tax withholding obligations may be paid in cash, promissory note, by delivery of already-owned shares subject to certain conditions, or pursuant to a cashless exercise procedure.

(5) The option granted to Mr. Reyes in fiscal 2000 vests as follows: (i) with respect to 40,000 of the shares underlying the option, the option vests on the date of grant, and (ii) with respect to 1,000,000 of the shares underlying the option, the option vests starting November 1, 2002, with 1/12 of the shares vesting on the first day of every month thereafter, with full vesting occurring on November 1, 2003.

(6) The option granted to Mr. Smith in fiscal 2000 vests as follows: (i) with respect to 80,000 of the shares underlying the option, the option vests starting November 1, 2001, with 1/12 of the shares vesting on the first day of every month thereafter, and (ii) with respect to 208,328 of the shares underlying the option, the option vests starting November 1, 2002, with 1/12 of the shares vesting on the first day of every month thereafter, with full vesting occurring on November 1, 2003.

(7) The option granted to Mr. Cuthbert in fiscal 2000 to purchase 143,328 shares vests as follows: (i) with respect to 26,664 of the shares underlying the option, the option vests starting June 29, 2001, with 1/12 of the shares vesting on the 29th day of every month thereafter, and (ii) with respect to 116,664 of the shares underlying the option, the option vests starting June 29, 2002, with 1/12 of the shares vesting on the 29th day of every month thereafter, with full vesting occurring on June 29, 2003.

The option granted to Mr. Cuthbert in fiscal 2000 to purchase 400,000 shares vests starting January 31, 2000, with 1/48 of the shares underlying the option vesting on the last day of every month thereafter, with full vesting occurring on January 31, 2004.

(8) The option granted to Mr. Byrd in fiscal 2000 vests starting November 1, 2002, with 1/12 of the shares underlying the option vesting on the
(9) The option granted to Mr. Bonderson, Jr. in fiscal 2000 vests as follows: (i) with respect to 88,336 of the shares underlying the option, the option vests starting November 1, 1999, with 1/12 of the shares vesting on the first day of every month thereafter, and (ii) with respect to 266,000 of the shares underlying the option, the option vests starting December 1, 2000, with 1/24 of the shares vesting on the first day of every month thereafter, and (iii) with respect to 177,664 of the shares underlying the option, the option vests starting December 1, 2002, with 1/12 of the shares vesting on the first day of every month thereafter, with full vesting occurring on December 1, 2003.

AGGREGATED OPTION EXERCISES IN LAST FISCAL YEAR
AND FISCAL YEAR-END OPTION VALUES

The following table sets forth information with respect to the Named Executive Officers concerning exercised and unexercised options held as of October 28, 2000.

<table>
<thead>
<tr>
<th>NAME</th>
<th>SHARES ACQUIRED ON EXERCISE(#)</th>
<th>VALUE REALIZED ($)</th>
<th>NUMBER OF SECURITIES UNDERLYING UNEXERCISED OPTIONS AT OCTOBER 28, 2000</th>
<th>VALUE OF UNEXERCISED IN-THE-MONEY OPTIONS AT OCTOBER 28, 2000($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gregory L. Reyes(3)</td>
<td>40,000</td>
<td>$2,995,600</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Charles W. Smith(4)</td>
<td>--</td>
<td>--</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jack Cuthbert</td>
<td>338,776</td>
<td>22,629,764</td>
<td>18,832</td>
<td>23,389,167</td>
</tr>
<tr>
<td>Michael J. Byrd(5)</td>
<td>--</td>
<td>--</td>
<td>1,071,330</td>
<td>95,714,860</td>
</tr>
<tr>
<td>Paul R. Bonderson, Jr.</td>
<td>--</td>
<td>192,640</td>
<td>607,360</td>
<td>54,193,564</td>
</tr>
</tbody>
</table>

(1) Market value of the Company's Common Stock at the exercise date minus the exercise price.

(2) Market value of the Company's Common Stock at fiscal year-end minus the exercise price. The market value of the Company's Common Stock on October 28, 2000 was $113.25 per share.

(3) Prior to fiscal 2000, Mr. Reyes acquired, on exercise of stock options, 12,285,296 shares of the Company's Common Stock. Of this amount, 5,374,816 shares are subject to repurchase by the Company upon Mr. Reyes' cessation of service with the Company prior to the vesting of the shares.

(4) Prior to fiscal 2000, Mr. Smith acquired, on exercise of stock options, 1,560,000 shares of the Company's common stock. Of this amount, 408,334 shares are subject to repurchase by the Company upon Mr. Smith's cessation of service with the Company prior to the vesting of the shares.

(5) Prior to fiscal 2000, Mr. Byrd acquired, on exercise of stock options, 2,640,000 shares of the Company's common stock. Of this amount, 1,650,000 shares are subject to repurchase by the Company upon Mr. Byrd's cessation of service with the Company prior to the vesting of the shares.

CHANGE OF CONTROL AND SEVERANCE ARRANGEMENTS

Mr. Reyes' option agreement originally under the 1998 Equity Incentive Plan provides that if Mr. Reyes is terminated any time after the first year of his employment, other than (1) constructively or without cause during the first year following a change of control, or (2) for cause, Mr. Reyes will vest as to 1,535,664 shares in addition to any shares that have vested under the normal four-year vesting schedule contemplated by the agreement. Moreover, upon a change of control, one-half of Mr. Reyes' unvested shares vest in addition to any shares that have vested under the normal four-year vesting schedule contemplated by the agreement, and if Mr. Reyes is constructively terminated or terminated without cause during the first year following the change of control, then all of his unvested shares subject to this option will vest.

Mr. Reyes' option agreement originally under the 1998 Executive Equity Incentive Plan provides that if he is terminated at any time on or after May 13, 2001, other than (1) constructively or without cause during
the first year following a change of control, or (2) for cause, then in addition
to any shares that have vested under the normal four-year vesting schedule
contemplated by the agreement, 1,535,664 additional shares will vest, less the
number of shares that may vest as a result of his termination under the 1998
Equity Incentive Plan as described above. In addition, upon a change of control,
one-half of Mr. Reyes’s unvested shares vest in addition to any shares that have
vested under the normal four-year vesting schedule contemplated by the
agreement, and if Mr. Reyes is constructively terminated or terminated without
cause during the first year following the change of control, then, all of his
unvested shares subject to this option will vest.

In addition, pursuant to a letter agreement, if Mr. Reyes is constructively
terminated or terminated without cause upon a change of control, he will receive
a severance payment of one year of his base salary plus his expected bonus for
the then current fiscal year.

Mr. Byrd’s employment agreement provides that Mr. Byrd will receive three
years’ vesting acceleration if his employment is terminated at any time without
cause prior to April 2, 2001, and one year’s vesting acceleration if his
employment is terminated after April 2, 2001. In addition, one-half of Mr.
Byrd’s unvested options will vest upon a change of control of the Company.
Following a change of control, the same number of unvested shares will become
vested shares each month as before the change of control. Mr. Byrd’s options
will vest fully if he is constructively terminated at any time during the first
year following a change of control. If Mr. Byrd’s employment is terminated
without cause and if no change of control has occurred, he will continue to
receive his base salary for a period of twelve months following the date of
termination. If Mr. Byrd’s employment is terminated without cause or if he is
constructively terminated after a change of control, then the Company will pay
him a lump sum equal to 130 percent of his annual base salary calculated at the
rate in effect at the time of termination of employment or the rate in effect
immediately before the change of control event, whichever is greater.

Options granted to Mr. Smith and Mr. Bonderson, Jr. originally under the
1998 Equity Incentive Plan will vest fully in the event that these individuals
are terminated without cause or are constructively terminated at any time during
the first year following a change of control of the Company.

In addition, options granted to Mr. Smith originally under the 1995 Equity
Incentive Plan will vest fully in the event that he is terminated without cause
or is constructively terminated at any time during the first year following a
change of control of the Company.

DIRECTORS’ COMPENSATION

Directors currently do not receive any cash compensation from the Company
for their services as members of the Board of Directors, although the Company is
authorized to pay members for attendance at meetings or a salary in addition to
reimbursement for expenses in connection with attendance at meetings. Certain
non-employee directors have received grants of options to purchase shares of the
Common Stock of the Company, including automatic option grants under the
Company’s 1999 Director Option Plan. See “Certain Relationships and Related
Transactions -- Stock Option Grants to Certain Directors.” Non-employee
directors are entitled to participate in the 1999 Director Option Plan. However,
Mr. Leslie and Mr. Sonsini will be excluded from receiving option grants under
the Director Plan until January 31, 2002. The Director Plan provides for the
automatic grant of 20,000 shares of Common Stock to each non-employee director
on the date on which such person first becomes a non-employee director. After
the first 20,000 share option is granted to the non-employee director, he or she
shall automatically be granted an option to purchase 20,000 shares each quarter
of each year, provided that he or she shall have served on the Board for at
least the preceding month. Each option shall have a term of 10 years. Each
option granted under the Director Plan will vest 100% and become fully
exercisable on the first anniversary of the date of grant. The exercise price of
all options shall be 100% of the fair market value per share of the Common
Stock, generally determined with reference to the closing price of the Common
Stock as reported on the Nasdaq National Market on the date of grant.

In the event of a merger, or the sale of substantially all of the assets of
the Company and if the option is not assumed or substituted, the option will
terminate unless exercised. Options granted under the Director Plan must be
exercised within three months of the end of the optionee’s tenure as a director
of the Company.
or within 12 months after such director's termination by death or disability, but not later than the expiration of the option's ten-year term.

REPORT OF THE COMPENSATION COMMITTEE OF THE BOARD OF DIRECTORS

The following is the report of the Board of Directors with respect to the compensation paid to the Company's executive officers during fiscal 2000. Actual compensation earned during fiscal 2000 by the Named Executive Officers is shown in the Summary Compensation Table.

Compensation Philosophy

The Company operates in the extremely competitive and rapidly changing high technology industry. The Committee believes that the compensation programs for the executive officers should be designed to attract, motivate and retain talented executives responsible for the success of the Company and should be determined within a competitive framework and based on the achievement of designated business objectives, individual contribution, customer satisfaction and financial performance. Within this overall philosophy, the Committee's objectives are to:

- Provide a competitive total compensation package that takes into consideration the compensation practices of companies with which the Company competes for executive talent.
- Provide variable compensation opportunities that are linked to achievement of financial, organization, management, and individual performance goals.
- Align the financial interests of executive officers with those of stockholders by providing executives with an equity stake in the Company.

Components of Executive Compensation

The compensation program for the Company's executive officers consists of the following components:

- Base Salary
- Quarterly and Annual Cash Incentives
- Long-Term Stock Option Incentives

Base Salary

The Board of Directors reviewed and approved fiscal 2000 salaries for the Chief Executive Officer and other Named Executive Officers at the beginning of the fiscal year. Base salaries were established by the Board based upon competitive compensation data, an executive's job responsibilities, level of experience, individual performance and contribution to the business. In making base salary decisions, the Board exercised its discretion and judgment based upon these factors. No specific formula was applied to determine the weight of each factor. The Board's decision with regard to Mr. Reyes' base salary was based on both his personal performance of his duties and the salary levels paid to chief executive officers of peer companies. Again there was no specific formula applied to determine the weight of each factor.

Quarterly and Annual Cash Incentives

Quarterly incentive bonuses for executive officers are intended to reflect the Board's belief that a significant portion of the compensation of each executive officer should be contingent upon the performance of the Company, as well as the individual contribution of each executive officer. To carry out this philosophy, the Company has implemented a variable compensation bonus plan, which compensates officers in the form of quarterly cash bonuses. During the fiscal year, the executive officers were eligible for a target quarterly incentive bonus. The quarterly incentive bonus was calculated by the Committee as a percentage of the officers' base salary. At the beginning of fiscal 2000, the Board established target bonuses for each executive officer as a percentage of the officer's base salary. The annual target level of the quarterly bonuses that the executive officers were eligible to receive varied from 40% to 60% of base
salaries. The variable compensation bonus plan is intended to motivate and reward executive officers based on their performance. This bonus plan allows for specific company-based performance targets and specific individual-based performance targets. The quarterly bonus amounts are tied to specific individual, team and product based performance targets. They are also tied to company-based performance goals such as specific levels of revenue and operating margin. The Board evaluates the performance of the executive officers and the Company and approves a performance rating based upon the results of its evaluation. In fiscal 2000, Mr. Reyes and the other Named Executive Officers were paid the bonus amounts shown in the Summary Compensation Table as the Company exceeded its corporate performance targets for revenue and profit. In addition to the quarterly incentive bonuses noted above, Mr. Reyes and certain other executive officers were eligible for additional annual bonuses based upon achievement of specific milestones. These milestones were related to both individual performance factors and company performance targets. These additional bonuses are also included in the bonus amounts shown in the Summary Compensation Table.

Long-Term Stock Option Incentives

The Board provides the Company's executive officers with long-term incentive compensation through grants of options to purchase the Company's Common Stock. The goal of the long-term stock option incentive program is to align the interests of executive officers with those of the Company's stockholders and to provide each executive officer with a significant incentive to manage the Company from the perspective of an owner with an equity stake in the business. It is the belief of the Board that stock options directly motivate an executive to maximize long-term stockholder value. The options also utilize vesting periods that encourage key executives to continue in employ of the Company. The Board considers the grant of each option subjectively, reviewing factors such as the individual performance, the anticipated future contribution toward the attainment of the Company's long-term strategic performance goals and the number of unvested options held by each individual at the time of the new grant. In fiscal 2000, 1,040,000 options to purchase shares of the Company's Common Stock were granted to Mr. Reyes.

Section 162(m)

The Company has considered the potential future effects of Section 162(m) of the Internal Revenue Code on the compensation paid to the Company's executive officers. Section 162(m) disallows a tax deduction for any publicly held corporation for individual compensation exceeding $1.0 million in any taxable year for any of the Named Executive Officers, unless compensation is performance-based. The Company has adopted a policy that, where reasonably practicable, the Company will seek to qualify the variable compensation paid to its executive officers for an exemption from the deductibility limitations of Section 162(m).

Respectfully submitted by:
Neal Dempsey
Mark Leslie

REPORT OF THE AUDIT COMMITTEE OF THE BOARD OF DIRECTORS

The following is the report of the audit committee of the Board of Directors. The audit committee has reviewed and discussed the audited financial statements of the Company for the fiscal year ended October 28, 2000 with management. In addition, the audit committee has discussed with Arthur Andersen, LLP, the Company's independent auditors, the matters required to be discussed by Statement on Auditing Standards No. 61 (Communications with Audit Committee). The audit committee also has received the written disclosures and the letter from Arthur Andersen, LLP as required by the Independence Standards Board Standard No. 1 (Independence Discussions with Audit Committees) and the audit committee has discussed the independence of Arthur Andersen, LLP with that firm.

Based on the audit committee's review of the matters noted above and its discussions with the Company's independent auditors and the Company's management, the audit committee recommended to the Board of Directors that the financial statements be included in the Company's Annual Report on Form 10-K. This report has been provided by Neal Dempsey and Seth D. Neiman, the members of the Audit Committee.

Respectfully Submitted by:
Set forth below is a line graph comparing the annual percentage change in the cumulative return to the stockholders of the Company's Common Stock with the cumulative return of the NASDAQ Market Index and of the SIC Code Computer Peripheral Equipment Index for the period commencing May 25, 1999 and ending on October 28, 2000. Returns for the indices are weighted based on market capitalization at the beginning of each measurement point.

CUMULATIVE TOTAL RETURN

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Brocade Communications Systems, Inc.</td>
<td>100.00</td>
<td>261.60</td>
<td>594.47</td>
<td>716.02</td>
<td>1,096.12</td>
<td>1,578.99</td>
<td>2,002.19</td>
</tr>
<tr>
<td>SIC Code Computer Peripheral Equipment Index</td>
<td>100.00</td>
<td>111.05</td>
<td>133.97</td>
<td>191.45</td>
<td>235.62</td>
<td>225.72</td>
<td>204.99</td>
</tr>
<tr>
<td>NASDAQ Market Index</td>
<td>100.00</td>
<td>106.61</td>
<td>118.78</td>
<td>158.00</td>
<td>156.29</td>
<td>152.52</td>
<td>118.97</td>
</tr>
</tbody>
</table>

(1) The graph assumes that $100 was invested on May 25, 1999 in the Company's Common Stock, in the NASDAQ Market Index and in the SIC Code Computer Peripheral Equipment Index and that all dividends were reinvested. No dividends have been declared or paid on the Company's Common Stock. Stockholder returns over the indicated period should not be considered indicative of future stockholder returns.

The information contained above under the captions "Report of the Compensation Committee of the Board of Directors", "Report of the Audit Committee of the Board of Directors" and "Performance Graph" shall not be deemed to be "soliciting material" or to be "filed" with the Securities and Exchange Commission, nor shall such information be incorporated by reference into any future filing under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, except to the extent that the Company specifically incorporates it by reference into such filing.

SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") requires the Company's executive officers and directors, and persons who own more than ten percent of a registered class of the Company's equity securities to file reports of ownership and changes in ownership with the Securities and Exchange Commission ("Commission"). Executive officers, directors and greater than ten percent stockholders are required by Commission regulation to furnish the Company with copies of all Section 16(a) forms they file. Based solely on its review of the copies of such forms received by it, or written representations from certain reporting persons, the Company believes that during fiscal 2000 all executive officers and directors of the Company complied with all applicable filing requirements.

CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

There was not during fiscal 2000, nor is there currently proposed, any transaction or series of similar transactions to which the Company was or is to be a party in which the amount involved exceeds $60,000 and in which any director, executive officer, holder of more than 5% of the Common Stock of the
TRANSACTIONS WITH DIRECTORS, EXECUTIVE OFFICERS AND 5% STOCKHOLDERS

LOANS TO CERTAIN EXECUTIVE OFFICERS

On April 11, 1997, the Company loaned $30,000 to Charles W. Smith, the Company’s Vice President, OEM Sales, secured by a stock pledge agreement, in connection with his purchase of 800,000 shares of the Company’s Common Stock for $0.04 per share. This note accrued interest at the rate of 6.5% per annum, compounded semi-annually, and was to be due on February 27, 2001. On January 13, 1998, the company loaned $15,000 to Mr. Smith, secured by a stock pledge agreement, in connection with his purchase of 200,000 shares of the Company’s Common Stock for $0.08 per share. This note accrued interest at the rate of 6.5% per annum, compounded semi-annually, and was to be due on January 13, 2003. On December 26, 1998, the Company loaned $78,750 to Mr. Smith, secured by a stock pledge agreement, in connection with his purchase of 280,000 shares of the Company’s Common Stock for $0.28 per share. This note accrued interest at the rate of 5% per annum, compounded semi-annually, and was to be due on January 15, 2003. On January 25, 1999, the Company loaned $78,750 to Mr. Smith, secured by a stock pledge agreement, in connection with his purchase of 280,000 shares of the Company’s Common Stock for $0.28 per share. This note accrued interest at the rate of 5% per annum, compounded semi-annually, and was to be due on December 31, 2003. The entire principal balances and all accrued interest under these notes have been repaid.

On January 26, 1998, the Company loaned $360,000 to Peter J. Tarrant, the Company’s Vice President, Strategic Marketing, secured by a stock pledge agreement, in connection with his purchase of 1,600,000 shares of the Company’s Common Stock for $0.23 per share. This note accrued interest at the rate of 6.5% per annum, compounded semi-annually, and was to be due on January 26, 2003. The entire principal balance and all accrued interest under this note has been repaid.

On December 8, 1998, the Company loaned $647,854 to Gregory L. Reyes, the Company’s President and Chief Executive Officer, secured by a stock pledge agreement, in connection with his purchase of 2,303,480 shares of the Company’s Common Stock for $0.28 per share. This note accrued interest at the rate of 4.47% per annum, compounded semi-annually, and was due on May 24, 2000. Also on December 8, 1998, the Company loaned $2,807,386 to Mr. Reyes, secured by a stock pledge agreement, in connection with his purchase of 9,981,816 shares of the Company’s Common Stock for $0.28 per share. This note accrued interest at the rate of 4.47% per annum, compounded semi-annually, and was due on May 24, 2000. The entire principal balances and all accrued interest under these notes have been repaid.

On December 24, 1998, the Company loaned $450,000 to Victor M. Rinkle, the Company’s Vice President, Operations, secured by a stock pledge agreement, in connection with his purchase of 1,600,000 shares of the Company’s Common Stock for $0.28 per share. This note accrued interest at the rate of 6.5% per annum, compounded semi-annually, and was due on December 24, 2004. The entire principal balance and all accrued interest under this note has been repaid.

On April 1, 1999, the Company loaned $1,650,000 to Michael J. Byrd, the Company’s Vice President and Chief Financial Officer, secured by a stock pledge agreement, in connection with his purchase of 2,640,000 shares of the Company’s Common Stock pursuant to a nonqualified stock option for $0.63 per share. The note accrued interest at the rate of 5.21% per annum, compounded semi-annually, and was to be due on May 24, 2006. The entire principal balance and all accrued interest under this note has been repaid.

On May 17, 1999, the Company loaned $312,562 to Jean Zorzy, the Company’s Vice President, Program Management, secured by a stock pledge agreement, in connection with her purchase of 290,000 shares of the Company’s Common Stock for $0.28 per share and 264,000 shares of the Company’s Common Stock for $0.88 per share. This note accrued interest at the rate of 6.5% per annum, compounded semi-annually, and was due on May 17, 2004. The entire principal balance and all accrued interest under this note has been repaid.
On April 27, 2000, the Company loaned $1,000,000 to David A. Smith, the Company’s Vice President, Research and Development, in connection with his relocation to the San Francisco Bay Area. The loan is interest free and will be forgiven on a pro-rata basis over four years, commencing on April 27, 2000. If for any reason, Mr. Smith ceases employment with the Company before April 27, 2004, the principal balance at the time of termination shall become due and payable (on a pro-rata basis) on the first day of each calendar quarter, commencing with the first calendar quarter following the date of termination and ending on July 1, 2004. At October 28, 2000, the outstanding principal balance on this note was $875,000.

STOCK OPTION GRANTS TO CERTAIN DIRECTORS

During fiscal 2000, the Company granted to Mr. Neiman and Mr. Dempsey options to purchase shares of the Company’s Common Stock in accordance with the provisions of the 1999 Director Option Plan set forth under the heading “Executive Compensation and Other Matters -- Directors’ Compensation.” At the beginning of the first, second, third, and fourth quarters of fiscal 2000, Mr. Neiman and Mr. Dempsey were each granted options to purchase 20,000 shares of the Company’s Common Stock at $33.63, $40.00, $62.00, and $81.97 per share, respectively.

DEMNIFICATION

The Company has entered into indemnification agreements with each of its directors and officers. Such indemnification agreements require the Company to indemnify its directors and officers to the fullest extent permitted by Delaware law.

CONFLICT OF INTEREST POLICY

The Company believes that all transactions with affiliates described above were made on terms no less favorable to the Company than could have been obtained from unaffiliated third parties. The Company’s policy is to require that a majority of the independent and disinterested outside directors on the Board approve all future transactions between Brocade and its officers, directors, principal stockholders and their affiliates. Such transactions will continue to be on terms no less favorable to the Company’s than it could obtain from unaffiliated third parties.

All future transactions, including loans, between the Company and its officers, directors, principal stockholders and their affiliates will be approved by a majority of the Board, including a majority of the independent and disinterested outside directors, and will continue to be on terms no less favorable to the Company than could be obtained from unaffiliated third parties.

INCORPORATION BY REFERENCE

The following information is incorporated by reference from the Form 10-K filed by the Company on January 26, 2001:

- Item 6. Selected Financial Data
- Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations
- Item 7A. Quantitative and Qualitative Disclosure About Market Risk
- Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

OTHER MATTERS

The Company knows of no other matters to be submitted at the meeting. If any other matters properly come before the meeting, it is the intention of the persons named in the enclosed form of Proxy to vote the shares they represent as the Board may recommend.

BY ORDER OF THE BOARD OF DIRECTORS
DIRECTIONS TO SILICON VALLEY CONFERENCE CENTER MAP

SILICON VALLEY CONFERENCE CENTER
2161 N. FIRST ST.
SAN JOSE, CA

FROM SAN FRANCISCO -- HIGHWAY 101
- South on Highway 101 and take the Brokaw/North First Street exit.
- At the stoplight turn left onto Brokaw, go one block, turn left onto North First Street.
- Go 2 blocks, make a U-turn at Guadalupe Parkway/Charcot.
- Turn right into the first driveway and the Conference Center is to your left.

FROM SAN JOSE -- HIGHWAY 101
- North on Highway 101 North and take the Brokaw exit.
- At the stoplight turn left onto Brokaw, go one block, and turn right onto North First Street.
- Go 2 blocks, make a U turn at Guadalupe Parkway.
- Turn right into the first driveway and the Conference Center is to your left.

APPENDIX A

CHARTER FOR THE AUDIT COMMITTEE
OF THE BOARD OF DIRECTORS
OF BROCADE COMMUNICATIONS SYSTEMS, INC.

PURPOSE:
The purpose of the Audit Committee of the Board of Directors of Brocade Communications Systems, Inc. ("the "Company") shall be:
- to provide oversight and monitoring of Company management and the independent auditors and their activities with respect to the Company's financial reporting process;
- to provide the Company's Board of Directors with the results of its monitoring and recommendations derived therefrom;
- to nominate to the Board of Directors independent auditors to audit the Company's financial statements and oversee the activities and independence of the auditors; and
- to provide to the Board of Directors such additional information and materials as it may deem necessary to make the Board of Directors aware of significant financial matters that require the attention of the Board of Directors.

The Audit Committee will undertake those specific duties and responsibilities listed below and such other duties as the Board of Directors may from time to time prescribe.

MEMBERSHIP:
The Audit Committee members will be appointed by, and will serve at the discretion of, the Board of Directors and will consist of a least three members
of the Board of Directors. On or before June 14, 2001, the members will meet the following criteria:

1. Each member will be an independent director, in accordance with the Nasdaq National Market Audit Committee requirements;

2. Each member will be able to read and understand fundamental financial statements, in accordance with the Nasdaq National Market Audit Committee requirements; and

3. At least one member will have past employment experience in finance or accounting, requisite professional certification in accounting, or other comparable experience or background, including a current or past position as a chief executive or financial officer or other senior officer with financial oversight responsibilities.

RESPONSIBILITIES:

The responsibilities of the Audit Committee shall include:

- Providing oversight and monitoring of Company management and the independent auditors and their activities with respect to the Company’s financial reporting process;

- Recommending the selection and, where appropriate, replacement of the independent auditors to the Board of Directors;

- Reviewing the performance of the independent auditors, who shall be accountable to the Board of Directors and the Audit Committee;

- Requesting from the independent auditors of a formal written statement delineating all relationships between the auditor and the Company, consistent with Independent Standards Board Standard No. 1, and engaging in a dialogue with the auditors with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditors;

- Directing the Company’s independent auditors to review before filing with the SEC the Company’s interim financial statements included in Quarterly Reports on Form 10-Q, using professional standards and procedures for conducting such reviews;

- Discussing with the Company’s independent auditors the matters required to be discussed by Statement on Accounting Standards No. 61, as it may be modified or supplemented;

- Reviewing with management, before release, the audited financial statements and Management’s Discussion and Analysis in the Company’s Annual Report on Form 10-K;

- Providing a report in the Company’s proxy statement in accordance with the requirements of Item 306 of Regulation S-K and Item 7(e)(3) of Schedule 14A;

- Reviewing the Audit Committee’s own structure, processes and membership requirements; and

- Performing such other duties as may be requested by the Board of Directors.

MEETINGS:

The Audit Committee will meet at least quarterly. The Audit Committee may establish its own schedule, which it will provide to the Board of Directors in advance.

The Audit Committee will meet separately with the independent auditors as well as members of the Company’s management as it deems appropriate in order to review the financial controls of the Company.

MINUTES:

The Audit Committee will maintain written minutes of its meetings, which minutes will be filed with the minutes of the meetings of the Board of
Apart from the report prepared pursuant to Item 306 of Regulation S-K and Item 7(e)(3) of Schedule 14A, the Audit Committee will summarize its examinations and recommendations to the Board from time to time as may be appropriate, consistent with the Committee’s charter.

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PROXY
BROCADE COMMUNICATIONS SYSTEMS, INC.
2001 ANNUAL MEETING OF STOCKHOLDERS
APRIL 4, 2001

THIS PROXY IS SOLICITED ON BEHALF OF THE BOARD OF DIRECTORS

The undersigned stockholder of BROCADE COMMUNICATIONS SYSTEMS, INC., a Delaware corporation, hereby acknowledges receipt of the Notice of Annual Meeting of Stockholders and Proxy Statement, each dated MARCH 5, 2001, and hereby appoints Gregory L. Reyes and Michael J. Byrd each as proxy and attorney-in-fact, with full power of substitution, on behalf and in the name of the undersigned, to represent the undersigned at the 2001 Annual Meeting of Stockholders of BROCADE COMMUNICATIONS SYSTEMS, INC. to be held on Wednesday, April 4, 2001 at 11:00 a.m. local time, at the Silicon Valley Conference Center, 2161 N. First Street, San Jose, California and at any adjournment or adjournments thereof, and to vote all shares of common stock which the undersigned would be entitled to vote if then and there personally present, on the matters set forth on the reverse side (Continued, and to be signed on the other side)

There are three ways to vote your Proxy

Your telephone or Internet vote authorizes the Named Proxies to vote your shares in the same manner as if you marked, signed and returned your Proxy Card.

VOTE BY PHONE -- TOLL FREE -- 1-800-240-6326 -- QUICK *** EASY *** IMMEDIATE

-- Use any touch-tone telephone to vote your proxy 24 hours a day, 7 days a week, until 12 p.m. (noon) (ET) on April 3, 2001.

-- You will be prompted to enter your 3-digit Company Number and your 7-digit Control Number which are located above.

-- Follow the simple instructions the Voice provides you.

VOTE BY INTERNET -- http://www.eproxy.com/brcd/ -- QUICK *** EASY *** IMMEDIATE

-- Use the Internet to vote your proxy 24 hours a day, 7 days a week, until 12 p.m. (noon) (CT) on April 3, 2001.

-- You will be prompted to enter your 3-digit Company Number and your 7-digit Control Number which are located above to obtain your records and create an electronic ballot.

VOTE BY MAIL

Mark, sign and date your Proxy Card and return it in the postage-paid envelope we've provided or return it to Brocade Communications Systems, Inc., c/o Shareowner Services, P.O. Box 64873, St. Paul, MN 55164-0873.

If you vote by Phone or Internet, please do not mail your Proxy Card.

Please detach here

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1. ELECTION OF DIRECTORS: WITHHOLD FOR FOR ALL
   NOMINEES: (except as marked)
   01 - Neal Dempsey, [ ] [ ]
   02 - Larry W. Sonsini. [ ] [ ]

   INSTRUCTION: To withhold authority to vote for any individual nominee, write that nominee’s number in the space provided below;

2. Ratification of Arthur Andersen, LLP as independent auditors of Brocade Communications Systems, Inc. for the fiscal year ending October 27, 2001;
3. Approval of an amendment to the Company's Certificate of Incorporation to increase the maximum number of shares of Common Stock from 400,000,000 shares to 800,000,000 shares; and, in their discretion, upon such other matter or matters which may properly come before the meeting or any adjournment or adjournments thereof. THIS PROXY WILL BE VOTED AS DIRECTED OR, IF NO CONTRARY DIRECTION IS INDICATED, WILL BE VOTED FOR THE COMPANY'S NOMINEES FOR ELECTION TO THE BOARD OF DIRECTORS, THE RATIFICATION OF ARTHUR ANDERSEN, LLP AND THE APPROVAL OF THE AMENDMENT TO THE COMPANY'S CERTIFICATE OF INCORPORATION, OR AS SAID PROXIES DEEM ADVISABLE ON SUCH OTHER MATTERS AS MAY PROPERLY COME BEFORE THE MEETING, INCLUDING, AMONG OTHER THINGS, CONSIDERATION OF ANY MOTION MADE FOR ADJOURNMENT OF THE MEETING.

Address change? Mark Box Indicate Changes below: [ ]

This proxy should be marked, dated and signed by the stockholder(s) exactly as his or her name appears hereon, and returned promptly in the enclosed envelope or vote by telephone or electronically via the Internet. Persons signing in a fiduciary capacity should so indicate. If shares are held by joint tenants or as community property, both should sign.

Signature(s)__________________________________________

Dated__________________________________________, 2001
EXHIBIT "O"
21. SECURITIES ACT

Analysis

Instruction

21.0 Securities Act—Preliminary Instruction.
21.1 Securities—Misrepresentation—Elements and Burden of Proof (15 U.S.C. § 78j(b)).
21.2 Securities—Misrepresentations or Omissions and Materiality—Definitions (15 U.S.C. §§ 78j(b) and 77k).
21.3 Securities—Scienter—Knowledge—Definition (15 U.S.C. § 78j(b)).
21.9 Securities Act—Affirmative Defense of Broker or Dealer (Rule 10b–5).
21.0 SECURITIES ACT—PRELIMINARY INSTRUCTION

The plaintiff claims to have suffered a loss caused by the defendant's violation of the securities laws. To help you understand the evidence while it is being presented, I will now explain some of the terms and concepts that may be referred to during this trial.

A security is an investment in an enterprise with the expectation of profit from the efforts of other people. Some common types of securities are [stocks,] [bonds,] [debentures,] [warrants,] [and] [investment contracts].

A broker buys and sells securities for clients for a commission.

A dealer buys securities and resells them to clients. An individual or a corporation can be a broker, a dealer, or both.

The buying and selling of securities is controlled by the securities laws. One who violates the securities laws is liable for damages caused by the violation. In particular, the securities laws prohibit [misrepresentation of material facts] [omission of material facts] [and] [false registration] in connection with the purchase and sale of securities.

[A representative of a broker or dealer may also buy and sell securities for or to clients. If a representative violates the securities laws, the broker or dealer may also be liable as a controlling person. A controlling person is one who possesses the power to direct or cause the direction of the management or policies of another.]

[A controlling person may be excused from liability by proving that [he] [she] [it] acted in good faith and did not induce the act that violated the securities laws.]
21.1 SECURITIES—MISREPRESENTATION—ELEMENTS AND BURDEN OF PROOF

(15 U.S.C. § 78j(B))

[On the plaintiff’s claim _________] the plaintiff has the burden of proving each of the following elements by a preponderance of the evidence:

1. the defendant [made an untrue statement of a material fact] [or] [omitted a material fact necessary under the circumstances to keep the statements that were made from being misleading] in connection with the trading of securities;

2. the defendant acted knowingly;

3. the defendant [used] [or] [caused the use of] an [instrumentality of interstate commerce] [mail] [telephone] [or] [_______] in connection with the trading of securities [whether or not the [instrumentality of interstate commerce] [mail] [telephone] [or] [_______] was used to make an untrue statement or a material omission;]

4. the plaintiff reasonably relied on [defendant's untrue statement of a material fact] [defendant's failure to state a necessary material fact] in [buying] [or] [selling] [or] [not selling] securities; and

5. the plaintiff suffered damages as a result of the defendant's [conduct] [misrepresentation] [omission].

If you find that each of the elements on which the plaintiff has the burden of proof has been proved, your verdict should be for the plaintiff. If, on the other hand, the plaintiff has failed to prove any of these elements, your verdict should be for the defendant.

Comment

See 15 U.S.C. § 78j(b) (unlawful to use deceptive device in connection with purchase or sale of a security) and 17 C.F.R. § 240.10b–5 (unlawful to use a device to defraud, to make an untrue statement of material fact, or to engage in a fraudulent act in connection with the purchase and sale of a security). See Instruction 21.3 (Securities—Scienter Knowledge—Definition) for definition of knowledge.

In Gray v. Winthrop Corp., 82 F.3d 877, 884 (9th Cir.1996), the court confirmed the showing required, as outlined above, for the establishment of a 10b–5 claim. See McGonigle v. Combs, 968 F.2d 810, 817 (9th Cir.) cert. dismissed, 506 U.S. 948 (1992).

A presumption of reliance is said to arise when the fraud involves material omissions, Affiliated Ute Citizens v. United States, 406 U.S. 128, 153–54 (1972), or when a theory of fraud on the market is involved, Basic, Inc. v. Levinson, 485 U.S. 224, 247 (1988). In a "mixed case of misstatements and omissions," the presumption will only apply if the case primarily alleges omissions. Binder v. Gillespie, 184 F.3d 1059, 1063–64 (9th Cir.1999) (case resolved on summary judgment) cert. denied, 528 U.S. 1154 (2000). Accordingly, at trial, the court will have to resolve whether the presumption is applicable in light of the evidence. Additional instructions may be needed when this presumption could arise. See, e.g., In re Convergent Technologies Sec.Litig., 948 F.2d 507, 512 n. 2 (9th Cir.1991) (in fraud on the market case, plaintiff need not show actual reliance on any misrepresentation or omission; instead
the plaintiff must show reliance on the integrity of the price established by the market which was in turn influenced by the misleading information or the omission of information); In re Apple Computer Sec. Litig., 886 F.2d 1109, 1115 (9th Cir. 1989) (defendant may rebut evidence giving rise to the presumption of reliance), cert. denied, 496 U.S. 943 (1990).
21.2 SECURITIES—MISREPRESENTATIONS OR OMISSIONS AND MATERIALITY—DEFINITIONS (15 U.S.C. §§ 78j(b), 77k)

A fact stated or omitted is material if there is a substantial likelihood a reasonable buyer or seller of securities would consider the fact important in deciding whether or not to buy or sell a particular security.

Whether a fact stated or omitted is material depends on the facts as they existed at the time of the statement or omission.

Comment

The standard for materiality developed in *TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (whether a reasonable shareholder would "consider it important" or whether the fact would have "assumed actual significance") was explicitly adopted as the standard of materiality for actions under § 78j(b). *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988).


The Ninth Circuit adopted various formulations from *TSC Indus.*, and *Basic Inc.* Compare *Kaplan v. Rose*, 49 F.3d 1363, 1371 (9th Cir.1994) (omission or misrepresentation would have misled a reasonable investor about the nature of his or her investment), cert. denied, 516 U.S. 810 (1995), and *In re VeriFone Sec. Litig.*, 11 F.3d 865, 869 (9th Cir.1993), with *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1413 n. 2 (9th Cir.1994) (substantial likelihood omitted fact would have been viewed by reasonable investor as having significantly altered the "total mix" of information; reasonable investor would have felt the fact "important" in deciding whether to invest), cert. denied, 516 U.S. 868 (1995), and compare *In re Stac Electronics Sec. Litig.*, 89 F.3d 1399, 1408 (9th Cir.1996) (same), cert. denied, 520 U.S. 1103 (1997), with *McGonigle v. Combs*, 968 F.2d 810, 817 (9th Cir.) (substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in deliberations of the reasonable shareholder), cert. dismissed, 506 U.S. 948 (1992).

This instruction should be adjusted for cases involving statements which imply rather than state factual assertions, such as statements of reasons, opinions or beliefs. *See Kaplan v. Rose*, 49 F.3d 1363, 1375 (9th Cir.1994) (projection or statement of belief is a "factual" misstatement if it (1) is not actually believed, or (2) there is no reasonable basis for the belief, or (3) the speaker is aware of undisclosed facts tending to seriously undermine the statement's accuracy), cert. denied, *Payne v. Kaplan*, 516 U.S. 810 (1995). *See also In re Wells Fargo Sec. Litig.*, 12 F.3d 922, 930 (9th Cir.1993), cert. denied, 513 U.S. 917 (1994); *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1113 (9th Cir.1989), cert. denied, 496 U.S. 943 (1990).

In appropriate cases under 15 U.S.C. § 78j(b), the "safe harbor" provisions of 15 U.S.C. § 78u–5 should be examined. Even if material, when the alleged fraud concerns certain forward-looking statements the jury may be compelled to examine whether the statement falls within the safe harbor and therefore does not qualify as a fraudulent statement under the Act. *See 15 U.S.C. § 78u–5(c).*

A defendant acts knowingly when [the defendant makes an untrue statement [with the knowledge that the statement was false] [or] [with reckless disregard for whether the statement was true]] [or] [the defendant omits necessary information [with the knowledge that the omission would make the statement false or misleading] [or] [with reckless disregard for whether the omission would make the statement false or misleading]].

[Reckless means highly unreasonable conduct that is an extreme departure from ordinary care, presenting a danger of misleading investors, which is either known to the defendant or is so obvious that the defendant must have been aware of it.]

Comment

See 15 U.S.C. § 78j(b) (unlawful to use deceptive device in connection with purchase or sale of a security); SEC Rule 10b–5, 17 C.F.R. § 240.10b–5 (1991) (unlawful to use a device to defraud, to make an untrue statement of material fact, or to engage in a fraudulent act in connection with the purchase and sale of a security).

The element of scienter was developed in Ernst & Ernst v. Hochfelder, 425 U.S. 185, reh'g denied, 425 U.S. 986 (1976). In Nelson v. Serwold, 576 F.2d 1332, 1337 (9th Cir.), cert. denied, 439 U.S. 970 (1978), the court interpreted the Ernst & Ernst decision as only eliminating negligence as a basis for liability. The court found that Congress intended Section 10(b) to reach both knowing and reckless conduct. Id. at 1337.

"Recklessness," in the context of Section 10(b) and Rule 10b–5, was defined by the Ninth Circuit in Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir.1990) (en banc), cert. denied, 499 U.S. 976 (1991), and In re Software Toolworks, Inc., 50 F.3d 615, 626 (9th Cir.1994), cert. denied, 516 U.S. 907 (1995). See Comment to Instructions 21.4 (Securities Act—Excessive Trading (Churning)—Elements and Burden of Proof) and 21.6 (Securities Act—Excessive Trading (Churning)—Intent to Defraud—Reckless—Definition).

In a securities action where the plaintiff's recovery of money damages requires proof that the defendant acted with a particular state of mind, the Private Securities Litigation Reform Act provides a defendant the right to require the court to submit an interrogatory to the jury regarding the defendant's state of mind at the time of the alleged violation.
21.4 SECURITIES ACT—EXCESSIVE TRADING (CHURNING)—ELEMENTS AND BURDEN OF PROOF (15 U.S.C. § 78j(B), RULE 10B-5)

[On the plaintiff’s ______ claim,] the plaintiff has the burden of proving each of the following elements by a preponderance of the evidence:

1. the trading in the plaintiff’s brokerage account was excessive in light of the plaintiff’s investment objectives;

2. the defendant exercised control over the trading in the account;

3. the defendant acted [with intent to defraud] [or] [with reckless disregard of the plaintiff’s investment objectives];

4. the defendant [used] [or] [caused the use of] an [instrumentality of interstate commerce] [mail] [telephone] [or] [_______] in connection with the trading in the plaintiff’s account; and

5. the defendant’s conduct caused damage to the plaintiff.

If you find that each of the elements on which the plaintiff has the burden of proof has been proved, your verdict should be for the plaintiff. If, on the other hand, the plaintiff has failed to prove any of these elements, your verdict should be for the defendant.

Comment

See 15 U.S.C. § 78j(b) (unlawful to use deceptive device in connection with purchase or sale of a security) and 17 C.F.R. § 240.10b–5 (unlawful to use a device to defraud, to make an untrue statement of material fact, or to engage in a fraudulent act in connection with the purchase and sale of a security). See also Nesbit v. McNeil, 896 F.2d 380, 382–83 (9th Cir.1990) (elements of "churning" under 10b–5; no single factor or test identifies excessive trading); Mihara v. Dean Witter Co., 619 F.2d 814, 821 (9th Cir.1980).

While the phrase "willful and reckless" was used in Mihara and Nesbit, the committee believes that the Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir.1990) (en banc), cert. denied, 499 U.S. 976 (1991) definition of "recklessness" accurately sets forth the standard and definition for liability in the Rule 10b–5 context for both misrepresentation and churning cases. See Comments to Instruction 21.3 (Securities—Science—Knowledge—Definition).

See the Comment to Instruction 21.14 (Securities Act—Damages) regarding special instructions on "churning" damages.
21.5 SECURITIES ACT—EXCESSIVE TRADING
(CHURNING)—CONTROL—DEFINITION (15 U.S.C. § 78j(b), RULE 10B–5)

A broker exercises control over trading in an account when [the client has authorized the broker to trade without first consulting the client] [or] [the client has not authorized the broker to trade and the broker trades] [or] [the client, without exercising independent judgment, routinely follows the broker’s recommendations].

Comment

See Follansbee v. Davis, Skaggs & Co., 681 F.2d 673, 677 (9th Cir. 1982) (when evaluating whether nonprofessional investor is in control of investor's account, the "touchstone is whether or not the customer has sufficient intelligence and understanding to evaluate the broker's recommendations and to reject one when he thinks it unsuitable"); Mihara v. Dean Witter & Co., 619 F.2d 814, 821 (9th Cir. 1980) (account need not be discretionary; "the requisite degree of control is met when the client routinely follows the recommendations of the broker").
21.6 SECURITIES ACT—EXCESSIVE TRADING (CHURNING)—INTENT TO DEFRAUD—RECKLESS—DEFINITION (15 U.S.C. § 78J(B), RULE 10B–5)

[Intent to defraud is an intent to deceive or cheat.]

[Reckless means highly unreasonable conduct that is an extreme departure from ordinary care.]

Comment

See Comments to Instructions 21.3 (Securities—Scicenter—Knowledge—Definition) and 21.4 (Securities Act—Excessive Trading (Churning—Elements and Burden of Proof).

21.7 SECURITIES ACT—AGENT AND PRINCIPAL (15 U.S.C. § 78J(B), RULE 10B-5)

Comment

Use Instructions 6.4 (Agent and Principal—Definition), 6.5 (Agent—Scope of Authority Defined), and 6.6 (Act of Agent is Act of Principal—Scope of Authority Not in Issue) if there are no issues regarding the principal-agent relationship.

If there is an issue regarding the existence of the relationship or scope of authority, use Instruction 6.9 (Both Principal and Agent Sued—Agency or Authority Denied), Instruction 6.10 (Principal Sued, But Not Agent—Agency or Authority Denied), and Instruction 21.8 (Securities Act—Liability of Controlling Person—Elements and Burden of Proof).

Note, however, that the relationship between a controlling person and a controlled person is not necessarily a principal-agent relationship. See Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1574 (9th Cir.1990) (en banc) (no authority exists in the statutory scheme to restrict definition of controlling person to exclude independent contractors; court refused to distinguish between registered representatives who are employees or agents and those who might be independent contractors in determining who was a "controlling person"), cert. denied, 499 U.S. 976 (1991).
21.8 SECURITIES ACT—LIABILITY OF CONTROLLING PERSON—ELEMENTS AND
BURDEN OF PROOF (15 U.S.C. § 78j(b), RULE 10B-5)

The plaintiff claims that the defendant is a controlling person and is therefore liable under
securities laws. On this claim, the plaintiff has the burden of proving by a preponderance of the evidence
that the defendant [controlling person] possessed, directly or indirectly, the power to direct or cause the
direction of the management and policies of [controlled person].

Comment

See 15 U.S.C. § 78t(a) (liability of controlling persons); 17 C.F.R. § 230.405 (definition of
"control"); Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1578 (9th Cir.1990) (en banc) (broker-dealer
is "controlling person" within meaning of Securities Act), cert. denied, 499 U.S. 976 (1991).

For good faith defense, see Instruction 21.9 (Securities Act—Affirmative Defense of
Broker or Dealer).

This instruction may need to be supplemented with instructions regarding respondent
superior liability. See Instructions 6.4 (Agent and Principal—Definition); 6.5 (Agent—Scope of Authority
Defined); 6.6 (Act of Agent Is Act of Principal—Scope of Authority Not an Issue); 6.7 (Both Principal and
Agent Sued—No Issue as to Agency or Authority); 6.8 (Principal Sued but Not Agent—No Issue as to
Agency or Authority); 6.9 (Both Principal and Agent Sued—Agency or Authority Denied); and/or 6.10
(Principal Sued, but Not Agent—Agency or Authority Denied).

Use this instruction with instructions on Rule 10b-5 misrepresentation and excessive
trading.
21.9 SECURITIES ACT—AFFIRMATIVE DEFENSE OF BROKER OR DEALER (RULE 10B-5)

If you find that the defendant [insert name of broker or dealer] is a controlling person, you must consider whether the defendant induced a violation and acted in good faith. The defendant has the burden of proving both of the following elements by a preponderance of the evidence:

1. the defendant did not directly or indirectly induce the violation; and

2. the defendant acted in good faith. Good faith can be established only by proving that the defendant maintained and enforced a reasonable and proper system of supervision and internal control.

If you find that each of the elements on which the plaintiff has the burden of proof has been proved, your verdict should be for the plaintiff, unless you also find that the defendant has proved this affirmative defense, in which event your verdict should be for the defendant.

Comment

This instruction is to be used for a controlling person who is a broker or dealer.

See 15 U.S.C. § 78t(a) (Section 20(a) of the 1934 Act (Liability of Controlling Persons)); Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1575–76 (9th Cir.1990) (en banc), cert. denied, 499 U.S. 976 (1991). The defendant has the burden of establishing its good faith. Hollinger, 914 F.2d at 1575–76. Hollinger also holds that Section 20(a) does not supplant respondent superior liability under the common law. Id. at 1578.
21.10 SECURITIES ACT—FALSE OR MISLEADING REGISTRATION STATEMENT—ELEMENTS AND BURDEN OF PROOF
(15 U.S.C. § 77E, SECTION 11)

[On the plaintiff's ______ claim,] the plaintiff has the burden of proving each of the following elements by a preponderance of the evidence:

1. [the registration statement misrepresented a material fact] [or] [the registration statement omitted material facts making it misleading];

2. the defendant [insert appropriate language from 15 U.S.C. § 77k(a)]; and

3. the defendant's conduct caused damage to the plaintiff.

If you find that each of the elements on which the plaintiff has the burden of proof has been proved, your verdict should be for the plaintiff. If, on the other hand, the plaintiff has failed to prove any of these elements, your verdict should be for the defendant.

Comment


For materiality definition, see Instruction 21.2 (Securities—Misrepresentations or Omissions and Materiality—Definitions).
21.11 SECURITIES ACT—AFFIRMATIVE DEFENSE OF WAIVER—ELEMENTS AND BURDEN OF PROOF

The defendant contends that the plaintiff waived the right to complain of the defendant's conduct.

The defendant has the burden of proving by a preponderance of the evidence that, at the time, the plaintiff knew the plaintiff had a right to complain of defendant's conduct and voluntarily or intentionally gave up that right.

If you find that each of the elements on which the plaintiff has the burden of proof has been proved, your verdict should be for the plaintiff, unless you also find that the defendant has proved this affirmative defense, in which event your verdict should be for the defendant.

Comment

See Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1208 (9th Cir.1970) (waiver is the voluntary or intentional relinquishment of a known right); Royal Air Properties v. Smith, 312 F.2d 210, 213–14 (9th Cir.1962) (common law defenses applicable to judicially-created private right of action under 10(b)), appeal after remand, 333 F.2d 568, 570–72 (9th Cir.1964).

21.12 SECURITIES ACT—AFFIRMATIVE DEFENSE OF ESTOPPEL—ELEMENTS AND BURDEN OF PROOF

The defendant contends the plaintiff is [barred] [estopped] from complaining of the defendant's conduct. The defendant has the burden of proving each of the following elements by a preponderance of the evidence:

1. the plaintiff knew [describe facts that constitute basis for claim];

2. the defendant did not know the plaintiff had objections to [describe facts that constitute basis for claim];

3. [the plaintiff intended that the defendant act upon the plaintiff's [acts] [omissions]] [or] [the defendant had a right to believe the plaintiff's [acts] [omissions] were to be acted upon]; and

4. the defendant relied upon the plaintiff's [acts] [omissions] to the defendant's injury.

If you find that each of the elements on which the plaintiff has the burden of proof has been proved, your verdict should be for the plaintiff, unless you also find that the defendant has proved this affirmative defense, in which event your verdict should be for the defendant.

Comment

See TRW, Inc. v. FTC, 647 F.2d 942, 950–51 (9th Cir.1981) (four requirements of estoppel under federal law). See also Stewart v. Ragland, 934 F.2d 1033, 1041 (9th Cir.1991) (four elements of estoppel claim applying California common law).
21.13 SECURITIES ACT—AFFIRMATIVE DEFENSE OF RATIFICATION—ELEMENTS AND BURDEN OF PROOF

The defendant contends the plaintiff ratified the defendant's conduct. The defendant has the burden of proving, by a preponderance of the evidence, that the plaintiff communicated to the defendant, by words or actions, that the plaintiff accepted and approved of the conduct.

If you find that each of the elements on which the plaintiff has the burden of proof has been proved, your verdict should be for the plaintiff, unless you also find that the defendant has proved this affirmative defense, in which event your verdict should be for the defendant.

Comment

See Royal Air Properties v. Smith, 312 F.2d 210, 213–14 (9th Cir. 1962) (common law defenses applicable to judicially-created private right of action under 10(b)), appeal after remand, 333 F.2d 568, 570–72 (9th Cir. 1964).

Comment

See Instruction 7.1 (Damages–Proof) for format. The measure and type of damages should be drafted to fit the facts and law in each particular securities case.

See also Instructions 7.2 (Measures of Types of Damages); 7.3 (Damages–Mitigation); 7.4 (Damages Arising in the Future–Discount to Present Cash Value).

There are two different types of damages in churning cases. A plaintiff may recover excessive commissions, that is, the difference between commissions paid and commissions that would have been reasonable on transactions during the pertinent time period. Nesbit v. McNeil, 896 F.2d 380, 387 (9th Cir.1990). A plaintiff may also recover for portfolio losses. Hatrock v. Edward D. Jones, 750 F.2d 767, 773–73 (9th Cir.1984). Dividend income may be used to offset portfolio losses. Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 651 F.2d 615, 621 (9th Cir.1981). However, excessive commissions should not be offset by portfolio gains made on the investments. Nesbit, 896 F.2d at 385.
EXHIBIT "P"
IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF CALIFORNIA

In re CLARENT CORPORATION
SECURITIES LITIGATION

IT IS SO ORDERED.
Dated: February 11, 2005

CHARLES R. BREYER
UNITED STATES DISTRICT JUDGE
DUTY OF JURY TO FIND FACTS AND FOLLOW LAW

Members of the jury, now that you have heard all the evidence and the arguments of attorneys, it is my duty to instruct you on the law which applies to this case.

It is your duty to find the facts from all the evidence in the case. To those facts you will apply the law as I give it to you. You must follow the law as I give it to you whether you agree with it or not. And you must not be influenced by any personal likes or dislikes, opinions, prejudices, or sympathy. That means that you must decide the case solely on the evidence before you. You will recall that you took an oath promising to do so at the beginning of the case.

In following my instructions, you must follow all of them and not single out some and ignore others; they are all equally important. And you must not read into these instructions or into anything the court may have said or done any suggestion as to what verdict you should return—that is a matter entirely up to you.
WHAT IS EVIDENCE

The evidence from which you are to decide what the facts are consists of:

(1) the sworn testimony of any witness;

(2) the exhibits which have been received into evidence; and

(3) any facts to which the lawyers have agreed or stipulated.
WHAT IS NOT EVIDENCE

In reaching your verdict you may consider only the testimony and exhibits received into evidence. Certain things are not evidence and you may not consider them in deciding what the facts are. I will list them for you:

1. Arguments and statements by lawyers are not evidence. The lawyers are not witnesses. What they have said in their opening statements, closing arguments and at other times is intended to help you interpret the evidence, but it is not evidence. If the facts as you remember them differ from the way the lawyers have stated them, your memory of them controls.

2. Questions and objections by lawyers are not evidence. Attorneys have a duty to their clients to object when they believe a question is improper under the rules of evidence. You should not be influenced by the objection or by the court's ruling on it.

3. Testimony that has been excluded or stricken, or that you have been instructed to disregard, is not evidence and must not be considered. In addition some testimony and exhibits have been received only for a limited purpose; where I have given a limiting instruction, you must follow it.

4. Anything you may have seen or heard when the court was not in session is not evidence. You are to decide the case solely on the evidence received at the trial.
DIRECT AND CIRCUMSTANTIAL EVIDENCE

Evidence may be direct or circumstantial. Direct evidence is direct proof of a fact, such as testimony by a witness about what the witness personally saw or heard or did. Circumstantial evidence is proof of one or more facts from which you could find another fact. You should consider both kinds of evidence. The law makes no distinction between the weight to be given to either direct or circumstantial evidence. It is for you to decide how much weight to give to any evidence.
CREDIBILITY OF WITNESSES

In deciding the facts in this case, you may have to decide which testimony to believe and which testimony not to believe. You may believe everything a witness says, or part of it, or none of it.

In considering the testimony of any witness, you may take into account:

1. the opportunity and ability of the witness to see or hear or know the things testified to;
2. the witness’s memory;
3. the witness’s manner while testifying;
4. the witness’s interest in the outcome of the case and any bias or prejudice;
5. whether other evidence contradicted the witness’s testimony;
6. the reasonableness of the witness’ testimony in light of all the evidence; and
7. any other factors that bear on believability.

The weight of the evidence as to a fact does not necessarily depend on the number of witnesses who testify.
OPINION EVIDENCE, EXPERT WITNESS

You have heard testimony from persons who, because of education or experience, are permitted to state opinions and the reasons for their opinions.

Opinion testimony should be judged just like any other testimony. You may accept it or reject it, and give it as much weight as you think it deserves, considering the witness' education and experience, the reasons given for the opinion, and all the other evidence in the case.
CHARTS AND SUMMARIES NOT RECEIVED IN EVIDENCE

Certain charts and summaries that have not been received into evidence have been shown to you in order to help explain the contents of books, records, documents, or other evidence in the case. They are not themselves evidence or proof of any facts. If they do not correctly reflect the facts or figures shown by the evidence in the case, you should disregard these charts and summaries and determine the facts from the underlying evidence.
CHARTS AND SUMMARIES IN EVIDENCE

Certain charts and summaries have been received into evidence to illustrate information brought out in the trial. Charts and summaries are only as good as the underlying evidence that supports them. You should, therefore, give them only such weight as you think the underlying evidence deserves.
EVIDENCE FOR A LIMITED PURPOSE

Some evidence was admitted for a limited purpose only. When I instructed you that an item of evidence has been admitted for a limited purpose, you must consider it only for that limited purpose and for no other.
USE OF NOTES

Some of you have taken notes during the trial. Whether or not you took notes, you should rely on your own memory of what was said. Notes are only to assist your memory. You should not be overly influenced by the notes.
BURDEN OF PROOF – PREPONDERANCE OF THE EVIDENCE

When a party has the burden of proof on any claim by a preponderance of the evidence, it means you must be persuaded by the evidence that the claim is more probably true than not true.

You should base your decision on all of the evidence, regardless of which party presented it.
TWO OR MORE PARTIES–DIFFERENT LEGAL RIGHTS

You should decide the case as to each defendant separately. Unless otherwise stated, the instructions apply to all parties.
SECURITIES -- MISREPRESENTATION -- ELEMENTS AND BURDEN OF PROOF

The buying and selling of securities is controlled by the federal securities laws. In particular, the securities laws prohibit misrepresentation or omission of material facts in connection with the purchase and sale of securities.

I will now instruct you concerning plaintiffs' claim against the defendants under Section 10(b) and Rule 10b-5 of the federal securities laws. The plaintiffs have the burden of proving each of the following elements as to each defendant by a preponderance of the evidence:

1. The defendant made an untrue statement of material fact or omitted a material fact necessary under the circumstances to keep the statements that were made from being misleading in connection with the trading of Clarent common stock; and

2. The defendant acted knowingly or recklessly; and

3. The plaintiffs suffered damages as a result of the defendant's misrepresentation or omission.

If you find that each of the elements on which the plaintiffs have the burden of proof has been proved, your verdict should be for the plaintiffs. If, on the other hand, the plaintiffs have failed to prove any of these elements, your verdict should be for the defendant.
SECURITIES--STATEMENTS--DEFINITIONS

Plaintiffs contend that the audit opinion Ernst & Young issued with respect to Clarent's financial statements for the year ended December 31, 2000 was materially false and misleading. In that opinion, Ernst & Young made two representations: (1) that Ernst & Young conducted an audit in conformity with Generally Accepted Auditing Standards, and (2) based on its audit, it was Ernst & Young's opinion that Clarent's financial statements fairly presented, in all material respects, the financial position of the company, and the results of its operations and its cash flows, in conformity with Generally Accepted Accounting Principles at the time stated in the opinion. Since the audit opinion was signed by Ernst & Young, Ernst & Young "made" the statements in the audit opinion.

Plaintiffs also contend that Ernst & Young is responsible for misstatements and omissions in Clarent's first quarter 2001 and second quarter 2001 financial statements. Since Ernst & Young did not sign Clarent's first and second quarter 2001 financial statements, Ernst & Young "made" those statements if plaintiffs proved that Ernst & Young substantially participated or was intricately involved in making the misstatements or omissions.

With respect to Jerry Chang, plaintiffs contend that Jerry Chang is responsible for misstatements and omissions in Clarent's first, second, third and fourth quarter 2000 financial statements, the year end 2000 financial statements, and the first and second quarter 2001 financial statements.

Since Jerry Chang signed the year 2000 quarterly and year-end financial statements, and the first quarter 2001 statements, Jerry Chang "made" those statements. Since Jerry Chang did not sign the second quarter 2001 statements, he "made" those statements if plaintiffs proved that he substantially participated or was intricately involved in making the misstatements or omissions.
SECURITIES—MISREPRESENTATIONS OR OMISSIONS AND MATERIALITY — DEFINITIONS

A fact stated or omitted is material if there is a substantial likelihood a reasonable buyer or seller of securities would consider the fact important in deciding whether or not to buy or sell a particular security.

Whether a fact stated or omitted is material depends on the facts as they existed at the time of the statement or omission.
SECURITIES—KNOWINGLY—RECKLESSLY—DEFINITION

A defendant acts knowingly when the defendant makes an untrue statement with the knowledge that the statement was false, or the defendant omits necessary information with the knowledge that the omission would make the statement false or misleading.

A defendant acts recklessly when the defendant makes an untrue statement with reckless disregard for whether the statement was true, or the defendant omits necessary information with reckless disregard for whether the omission would make the statement false or misleading.

Reckless means highly unreasonable conduct that is an extreme departure from ordinary care, presenting a danger of misleading investors which is either known to the defendant or is so obvious that the defendant must have been aware of it.
LOSS CAUSATION

Damages are "proximately" caused by misrepresentations or omissions when it appears that the misrepresentations or omissions played a substantial part in bringing about, or actually causing, the damage alleged.

Here, plaintiffs must show that the misrepresentations and omissions were a significant contributing cause of damages incurred by the plaintiff. It is not necessary for plaintiff to show that the alleged misrepresentations or omissions were the sole or exclusive cause of the damages he incurred. It is sufficient that the misrepresentations and omissions were a cause of damages incurred by the plaintiffs.

To establish causation of damages, the plaintiffs must prove that the market price of the stock was inflated as a direct or a reasonably foreseeable result of the misstatements or omissions.

If you find that the plaintiffs overpaid for the securities due to an inflated market price of the stock and that misrepresentations and omissions were a substantial contributing factor to that price inflation, then the requisite element of loss causation will be satisfied.
DUTY TO DELIBERATE

When you begin your deliberations, you should elect one member of the jury as your presiding juror. That person will preside over the deliberations and speak for you here in court.

You will then discuss the case with your fellow jurors to reach agreement if you can do so. Your verdict must be unanimous.

Each of you must decide the case for yourself, but you should do so only after you have considered all of the evidence, discussed it fully with the other jurors, and listened to the views of your fellow jurors.

Do not be afraid to change your opinion if the discussion persuades you that you should. Do not come to a decision simply because other jurors think it is right.

It is important that you attempt to reach a unanimous verdict but, of course, only if each of you can do so after having made your own conscientious decision. Do not change an honest belief about the weight and effect of the evidence simply to reach a verdict.
COMMUNICATION WITH COURT

If it becomes necessary during your deliberations to communicate with me, you may send a note through the marshal, signed by your presiding juror or by one or more members of the jury. No member of the jury should ever attempt to communicate with me except by a signed writing; and I will communicate with any member of the jury on anything concerning the case only in writing, or here in open court. If you send out a question, I will consult with the parties before answering it, which may take some time. You may continue your deliberations while waiting for the answer to any question. Remember that you are not to tell anyone—including me—how the jury stands, numerically or otherwise, until after you have reached a unanimous verdict or have been discharged. Do not disclose any vote count in any note to the court.
RETURN OF VERDICT

A verdict form has been prepared for you. After you have reached unanimous agreement on a verdict, your presiding juror will fill in the form that has been given to you, sign and date it, and advise the court that you are ready to return to the courtroom.
### Historical Prices for Brocade Communications Systems Inc. (BRCD)

#### Historical Price

**Set Date Range**
- **Start Date:** Oct 1, 1999
- **End Date:** Nov 1, 1999

**Get Prices**

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*Adj Close* represents the adjusted closing price. The adjustments are typically made to account for events such as stock splits and dividends.
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* Close price adjusted for dividends and splits.
### Historical Prices

**Get Historical Prices for:**

**SET DATE RANGE**

- **Start Date:** Sep 1, 1999
- **End Date:** Oct 1, 1999

**PRICES**

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*Close price adjusted for dividends and splits.*
### Historical Prices for Brocade Communications Systems Inc. (BRCD)

**BRCD: Historical Price Connection Check**

**Get Historical Prices for:**

**SET DATE RANGE**

- **Start Date:** Aug 1, 1999
- **End Date:** Sep 1, 1999

**PRICES**

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*Adjusted close price.*
Here is the historical price data for BRCD:

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* Close price adjusted for dividends and splits.
Brocade Communications Systems Inc. (BRCD)  

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1-Jul-99  99.37  116.50  93.37  113.00  3,342,400  14.12

* Close price adjusted for dividends and splits.

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Get Historical Prices for Another Symbol: GO Symbol Lookup

Stock Screener  Splits

Mergers & Acquisitions

Quotes delayed, except where indicated otherwise.

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EXHIBIT “R”
### BROCADE COMM SYS - Report History

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*NA - Not Available  *NM - Not Meaningful  *NC - Not Calculable
*N - Negative Earnings  *NS - Negative Stockholders Equity

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Subscribers have ability to search through all the fundamentals available using fundamental search.
### BROCADE COMM SYS - Report History

#### General

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#### Balance Sheet

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#### Ratios

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http://www2.barchart.com/prhistory.asp?sym=BRCD
### BROCADE COMM SYS - Report History

#### General
- **Total Revenues, $M:**
  - 12mos: 687.3
  - 2005: 574.1
  - 2004: 596.3
  - 2003: 525.3
  - 2002: 562.4
  - 2001: 513.0
  - 2000: 329.0
- **Depreciation & Amort, $M:**
  - 2005: 47.6
  - 2004: 57.4
  - 2003: 50.0
  - 2002: 34.9
  - 2001: 17.0
  - 2000: 6.9
- **Operating Income, $M:**
  - 2005: NA
  - 2004: 64.1
  - 2003: 59.5
  - 2002: 2.3
  - 2001: 65.9
  - 2000: 75.5
- **Net Income, $M:**
  - 2005: 48.7
  - 2004: 43.1
  - 2003: -32.0
  - 2002: -136.2
  - 2001: 59.7
  - 2000: 2.8
- **Earnings Per Share, $:**
  - 2005: .18
  - 2004: .16
  - 2003: -.12
  - 2002: -.54
  - 2001: .25
  - 2000: .01
- **Dividends, $:**
  - 2005: .00
  - 2004: .00
  - 2003: .00
  - 2002: .00
  - 2001: .00
  - 2000: .00

#### Balance Sheet
- **Current Assets, $M:**
  - 12mos: 845.5
  - 2005: 774.1
  - 2004: 606.8
  - 2003: 541.0
  - 2002: 715.7
  - 2001: 372.7
  - 2000: 283.4
- **Current Liabilities, $M:**
  - 12mos: 496.3
  - 2005: 464.4
  - 2004: 172.7
  - 2003: 166.1
  - 2002: 161.5
  - 2001: 114.9
  - 2000: 64.3
- **Long Term Debt, $M:**
  - 12mos: 45.4
  - 2005: 12.5
  - 2004: 369.1
  - 2003: 459.5
  - 2002: 550.0
  - 2001: 0.0
  - 2000: 0.0
- **Shares Outstanding, K:**
  - 12mos: 272473
  - 2005: 269695
  - 2004: 264242
  - 2003: 257641
  - 2002: 234652
  - 2001: 229762
  - 2000: 222559
- **Common Equity, $M:**
  - 12mos: 553.9
  - 2005: 508.8
  - 2004: 445.7
  - 2003: 698.4
  - 2002: 687.6
  - 2001: 537.9
  - 2000: 390.9

#### Ratios
- **Profit Margin, %:**
  - 12mos: 7.1
  - 2005: 7.5
  - 2004: -5.4
  - 2003: -25.9
  - 2002: 10.6
  - 2001: .5
  - 2000: 20.6
- **Return on Equity, %:**
  - 12mos: 8.8
  - 2005: 8.5
  - 2004: NE
  - 2003: NE
  - 2002: 8.7
  - 2001: .5
  - 2000: 17.4
- **Return on Assets, %:**
  - 12mos: 4.4
  - 2005: 4.4
  - 2004: -3.2
  - 2003: -10.3
  - 2002: 4.2
  - 2001: .4
  - 2000: 14.9
- **P/E Ratio:**
  - 12mos: 35.1
  - 2005: 23.3
  - 2004: NE
  - 2003: NE
  - 2002: 27.5
  - 2001: NM
  - 2000: 406.0
- **Price/Book:**
  - 12mos: 3.11
  - 2005: 1.97
  - 2004: 4.02
  - 2003: 2.42
  - 2002: 2.34
  - 2001: 10.49
  - 2000: 64.60
- **Debt Ratio:**
  - 12mos: .08
  - 2005: .02
  - 2004: .83
  - 2003: .66
  - 2002: .80
  - 2001: .00
  - 2000: .00
- **Interest Coverage:**
  - 12mos: NA
  - 2005: 8.2
  - 2004: NC
  - 2003: NC
  - 2002: 8.4
  - 2001: NC
  - 2000: NC
- **Book Value, $:**
  - 12mos: 2.03
  - 2005: 1.89
  - 2004: 1.69
  - 2003: 2.71
  - 2002: 2.93
  - 2001: 2.34
  - 2000: 1.76
- **Price/Sales:**
  - 12mos: 2.51
  - 2005: 1.75
  - 2004: 3.00
  - 2003: 3.22
  - 2002: 2.86
  - 2001: 11.01
  - 2000: 76.82
- **Dividend Payout, %:**
  - 12mos: .00
  - 2005: .00
  - 2004: .00
  - 2003: .00
  - 2002: .00
  - 2001: .00
  - 2000: .00

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EXHIBIT "S"
What Are the Odds?

You can calculate risk in hundreds of ways, but can you use these statistics to make decisions about buying insurance?

By Marilyn Lewis

You might say that calculating risk has been a human preoccupation ever since our hunter-gatherer ancestors considered whether to chase their dinner across storm-swollen streams. Today, we're still trying to estimate the risks in our lives. Experts can say what the odds are of your house catching fire or of you dying in a car crash. But what do those odds mean to us?

The odds of such events taking place are developed by risk analysts and actuaries, whom help insurance companies set rates for policies. The insurance industry distributes the risk of various perils over large groups of customers. In that way, policy costs can be kept reasonably low and when one group member must collect, the contributions of others cover the cost.

Comparing risks

Here are current odds, according to the Insurance Information Institute, of Americans in 2002—the latest year for which data is available—dying from the following causes over a lifetime:

- Car crash: one in 82
- Motorcycle crash: one in 1,159
- Falling from stairs or steps: one in 2,331
- Airplane accident: one in 5,704
- Hit by lightning: one in 56,439
- Earthquake: one in 120,161
- Dog bite: 206,944

OK, those are the odds. But what exactly do those numbers mean to any of us? In the most literal way, they mean that, for example, one person in every 82 is expected to die in a car wreck at some point during his or her lifetime.

Actuarial calculations, however, were not developed with you and me in mind. They are meant for, and are effective in, measuring the likelihood of events in large populations. That is why experiences like Claude Lilly's defy the odds. Recently, in a 10-day stretch, three people close to Lilly were involved separate serious car accidents. The odds are against such tragic events happening one right after the other, says Lilly, a professor of risk management and insurance at the University of North Carolina in Charlotte.

The odds in real life

Lilly's experience belies the odds, showing why statistical calculations developed for insurance aren't much use to individuals. That's true not only because odds are less likely to hold in individual instances, like Lilly's. It's also true because not every case typifies the odds. Here's an example. The odds your house will catch fire are one in 220 or 230. But if the wiring in your house is old or if you live in wildfire country, obviously your risk is different and your odds are higher. If your house has no fireplace, your odds may be lower.

Stanford business professor Sam Savage explains to companies, which rely heavily on statistics for decision making, how to figure such inaccuracies into their planning. He makes the case that an average event is usually theoretical, not really found in life. He calls this the "flaw of averages" and illustrates the flaw with the hypothetical example of the statistician who drowns crossing a river that is, on average, just 3 feet deep.

Mundane—and dramatic

The odds of hurricane damage nationally are small because the chances in hurricane country are lumped with those in regions where hurricanes never blow. In hurricane-prone areas alone, the odds are, obviously, quite different.

"If you have a house in Miami, there is about a one in 30 chance that house will be destroyed by a hurricane," says Chuck Watson, a hazards research expert. "That same house in Savannah, Ga., it's about a one in 80 chance. In Chicago, your hurricane risk is zero. On the other hand, you've probably got a one in 70 to 100 chance of a tornado." Watson's firm, Kinetic Analysis Corp., based in Savannah, uses satellite-based technology to study the Earth's surface and makes computer models of various hazards to try to predict damage.

Natural disasters are scary and dramatic, making them loom large in our imaginations. But you're far, far more likely to encounter the mundane house fire or car theft. "Your risk of being killed by a hurricane? You're probably talking about odds of one in six or seven hundred," says Professor Lilly. Compare that, he says, with the odds your car will be stolen: about one in 100.

Fire may be the main risk to your house, but even that chance—one in 220 or 230—is a bit deceptive since most house fires don't cause a total loss. The odds your house will be completely destroyed by fire are significantly less—about 1 in 500.

Ultimately, odds aren't much help to individuals because, in some cases, any risk at all is too much. If the loss of your home, for example, is an event from which you could not recover financially, then you can't tolerate even a tiny risk. Or as Lilly puts it, "Even if I told you the odds were one in one thousand, if you couldn't stand to lose your home, if it would wipe you out financially, you'd still want to buy coverage."

More Information

- The University of Virginia's Mathematics Education program's Web site explaining probability: http://teacherlink.org/content/math/interactive/probability/.
- Online maps showing earthquake hazard areas: http://earthquake.usgs.gov/hazmaps/
- A map of "tornado alley": http://www.spc.noaa.gov/faq/tornado/stalley.gif
- The Insurance Information Institute's statistics on the odds of death in the United States by cause of injury http://www.iii.org/factbook/chartindex/chart/ppartid.684480/
- The Insurance Information Institute's online brochure "Am I Covered?" http://www.iii.org/media/publications/brochures/amicovered/ explores what kind and how much insurance consumers need.
- The Society of Actuaries http://www.soa.org/ccm/content/