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COMMERCIAL LITIGATION

Phila. Commerce Court Sustains the Pa. Business Judgment Rule

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Special to the Legal

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The Philadelphia Commerce Court recently issued an opinion declaring the business judgment rule alive and well for corporate boards in Pennsylvania. In a case involving a board's decision to sell the company, the court relied upon the findings of a special litigation committee and rejected shareholder allegations that the SLC was biased and did not act in the best interest of the corporation. The Commerce Court opinion provides a useful reminder that corporate boards have broad discretion in their decision-making and that courts will generally stay out of the business of managing corporate affairs.

Philadelphia's Commerce Court addressed these issues in *Fundamental Partners v. Douglas A. Gaudet*. The case involved a derivative and purported class action in which the plaintiffs claimed to act for the shareholders of Penn Millers Holding Corp. The plaintiffs first sent a written demand letter to Penn Millers alleging wrongdoing by the directors in connection with the proposed sale of the company to ACE American Insurance Co. (ACE). The plaintiffs followed that with a complaint filed in the Philadelphia Court of Common Pleas. The plaintiffs sued the Penn Millers board of directors and ACE, alleging that the directors breached their fiduciary duties to the shareholders by causing the company to merge with ACE.

Initially, the plaintiffs claimed that the Penn Millers board failed to disclose to the shareholders all material facts regarding the merger and that the board agreed to sell the company for inadequate consideration. In response, the Penn Millers board appointed a special litigation committee to investigate these allegations. The SLC's written report to the Penn Millers board discussed each of the plaintiff's allegations at length and concluded that the allegations failed to set forth a colorable legal claim and that the company should not initiate litigation to pursue the suggested claims. The plaintiffs then amended their complaint to allege that the members of the SLC were not disinterested; that the SLC investigation was inadequate; and that the SLC's decision was not in Penn Millers' best interest.

In response to the amended complaint, and using the report by the SLC, the defendants filed a motion to dismiss the amended complaint. Based on the Pennsylvania Supreme Court's 1997 decision in *Cuker v. Mikalauskas*, the Commerce Court granted the motion and dismissed the shareholder action.

In *Cuker*, the Pennsylvania Supreme Court formally adopted the business judgment rule for Pennsylvania corporate decisions. Although observance of the business judgment rule had been Pennsylvania policy since as early as 1872, the doctrine had never been expressly recognized by the state's Supreme Court until *Cuker*. In *Cuker*, the Supreme Court made clear that the business judgment rule allows boards of directors to terminate derivative lawsuits brought by shareholders challenging business decisions made in good faith.

> *Even if members of an SLC have some interest in the transaction being reviewed, they are not automatically disqualified from rendering protected business judgments.*

Under *Cuker*, Pennsylvania corporations facing a shareholder's demand that the company file suit against a third party, or even its own directors or officers, will find protection for itself and its board by appointing a special litigation committee. But the SLC must satisfy certain criteria designed to assure an independent and thorough examination of the issue in dispute. The SLC should comprise individuals who are not accused of or implicated in the alleged wrongdoing. The independent SLC then investigates the shareholder complaint and generally should engage independent legal counsel to assist with its investigation. The investigation should be thorough and unbiased. It should result in a written report by the SLC detailing its charge, its investigation, its analysis of the applicable law and its recommended course of action.

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If the SLC determines that suit should be filed, the company can then take the requisite steps to initiate and control its own litigation. If the SLC decides that such a suit is not in the company's best interest after an adequate investigation by disinterested directors, that decision obtains the deference accorded to good-faith business judgments and immunizes the corporation and its board from liability resulting from the decision to forgo litigation. The SLC's decision also acts as the predicate for a motion to terminate the shareholder's derivative action against the company.

The important question, then, is when an SLC is truly "disinterested." Often members of a special litigation committee are officers, directors, shareholders and/or employees of the same company accused of wrongdoing. These individuals may have been involved in the alleged action or inaction at issue or, if not, may be adversely affected by the threatened litigation. Also, members of these committees may stand to benefit from the decision being challenged in terms of business opportunities, employment and/or stock options. Do these factors, alone or in combination, disqualify these individuals from serving as disinterested committee members? Will decisions made by such individuals be sustained under the business judgment rule and be insulated from judicial review?

Judge Arnold New's opinion in *Fundamental Partners* answers many of business judgment rule by attacking the independence and disinterestedness of both the board that approved the merger and the SLC that reviewed plaintiffs' complaints about the merger process.

The plaintiffs claimed that members of the board were not disinterested when they voted for the merger because the terms of the merger entitled them to indemnity from the acquiring company (ACE) if they were sued in connection with the merger. The plaintiffs further claimed that one SLC member had a history of purchasing insurance from Penn Millers for his business and might continue to purchase insurance from ACE following the merger. The plaintiffs also argued that the SLC was not disinterested because all four SLC members would receive accelerated vesting of stock options under the merger terms. The plaintiffs further suggested that the SLC's chosen counsel was tainted by the fact that Penn Millers' CEO knew them, liked them and would continue as a potential client when he became an employee of the acquiring company. Finally, the plaintiffs cited a member of the SLC who did not attach much weight to one of the factors supporting the SLC's written recommendation.

New found that "none of these facts, viewed singly or as a whole," is sufficient to rebut the presumption that the SLC made its decision properly, honestly and in good faith. New noted that indemnification did not make committee members "interested" in the merger, because indemnification by the buyer is a routine provision of merger agreements. Moreover, the indemnity was requested by Penn Millers, and it would have been a merger term no matter which company was the buyer.

The court also rejected the argument that the SLC member who had previously purchased insurance from Penn Millers was disqualified because he might buy insurance from ACE in the future, noting that the member was free to shop for a new insurance provider.

Finally, the court was not persuaded that the CEO's alleged involvement with the hiring of the SLC's counsel tainted the lawyers retained by the SLC. The court observed that the SLC's counsel acted independently, competently and conducted a thorough investigation — all supported by a written report. In sum, the Commerce Court found that the SLC "acted properly, in good faith, and for the best interests of Penn Millers" in deciding not to bring suit against its directors or ACE in connection with the merger. Under *Cuker*, such a decision is protected by the business judgment rule and entitled the defendants to dismissal of the amended complaint.

The Commerce Court decision reinforces the vitality of the business judgment rule in Pennsylvania. It also stands for the fact that, even if members of the SLC have some interest in the transaction being reviewed, they are not automatically disqualified from rendering protected business judgments. Companies whose special litigation committees act within the scope of their authority, in the corporation's best interests and in the absence of fraud, self-dealing or other malfeasance will find the underlying merits of their decisions insulated from judicial review. In those cases, the court's involvement will be limited to determining whether the committee's decision was made after an adequate investigation by disinterested directors, assisted by independent counsel, and with the rational belief that their decision was in the corporation's best interests.

The question as to the independence or "interests" of the directors or committee members at issue can be answered only on

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these questions. The December 2011 opinion applied the *Cuker* factors to determine whether the SLC properly decided not to file suit against the Penn Millers directors and whether that decision was protected by the business judgment rule. Although the plaintiffs conceded that the SLC was assisted by able counsel (Morgan Lewis & Bockius) and had prepared a detailed written report, the plaintiffs attempted to avoid the

The court found that the payment for non-vested stock options was a typical merger provision and is one that makes a director's interests similar to other shareholders'. It also found it of little consequence that one SLC member did business with Penn Millers. The court held that one cannot assume that person's judgment to be clouded by that experience; in fact, the director may have been motivated to act in the best interests of his

a case-by-case basis, bearing in mind that not all "interests" are created equal and that some, such as those present in *Fundamental Partners*, will not automatically remove a committee's decision from the protection of the business judgment rule. As such, the Commerce Court's opinion is a useful accretion to Pennsylvania jurisprudence on corporate decision-making and, particularly, the business judgment rule. •

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