

# DELAWARE CORPORATE

## Expert Analysis

### ***Halebian v. Berv*: A Challenge to the Model Business Corporation Act**

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The Massachusetts Supreme Judicial Court's upcoming decision in *Halebian v. Berv*<sup>1</sup> will have a potentially significant impact on investment companies and other corporations organized under Massachusetts law, as well as potentially important implications for corporations organized under the laws of states that have adopted the Model Business Corporation Act. The MBCA is a model business code adapted by many state legislatures.

At issue is Massachusetts' codified business judgment rule, as it applies to shareholder derivative actions, which requires the dismissal of "[a] derivative proceeding commenced *after* rejection of a demand" if a majority of independent directors "determine[s] in good faith after conducting a reasonable inquiry upon which its conclusions are based that the maintenance of the derivative proceeding is not in the best interests of the corporation."<sup>2</sup>

*Halebian* is before the Massachusetts high court on a certified question from the 2nd U.S. Circuit Court of Appeals: Can the state's business judgment rule be applied to dismiss a shareholder derivative complaint filed before, as opposed to after, the rejection of the demand?<sup>3</sup> The Massachusetts statute is based on the MBCA. The issue before the court is one of first impression under Massachusetts law and the MBCA.

#### **WHICH CAME FIRST, COMPLAINT OR REJECTION?**

The plaintiff shareholder maintains that the relevant statute is inapplicable to the facts at issue in *Halebian* and that Massachusetts business trusts and corporations should lose the protection of the codified business judgment rule if a complaint is filed *before* the formal rejection of the shareholder demand.

Put another way, the plaintiff claims that the timing of a derivative complaint should be dispositive of whether a board of directors may rely on the business judgment rule. Thus, the plaintiff in effect asserts that the Massachusetts Legislature intended to deprive boards of the authority granted under the statute to control derivative litigation where plaintiffs file a derivative complaint while the board is still considering its options.

*The question from the 2nd Circuit: Whether this [MBCA] statute may be applied to dismiss a shareholder derivative complaint filed before, as opposed to after, the rejection of the demand.*

One need only consider the anomalous consequences that the plaintiff's theory would produce to realize that the statute should not be interpreted so narrowly. Most significantly, the plaintiff's interpretation of the statute would leave a gaping hole in the statutory scheme, potentially subjecting routine business decisions to heightened judicial scrutiny based entirely on the timing of the plaintiff's complaint. The *Halebian* plaintiff's interpretation would incentivize boards to rush internal investigations, rewarding expediency over completeness.

Furthermore, the plaintiff's interpretation has potentially negative implications for corporations organized under analogous MBCA statutes in that it opens the door to other possible unintended departures from a carefully crafted statutory scheme, injecting uncertainty into what is intended to be a deliberate and structured process.

### THE MASSACHUSETTS AND MBCA STATUTORY STRUCTURES

As a general proposition, a shareholder must demand action from a board of directors before it files a derivative complaint. Some states, however, such as Delaware and New York, excuse the demand under an exception commonly known as demand futility.<sup>4</sup> The exception states that a demand is excused if a majority of the board is conflicted and could not be expected to independently review the allegations made in the demand.

Massachusetts and many other states, on the other hand, have enacted the MBCA's universal demand statute, which requires a shareholder to issue a pre-suit demand in all circumstances.<sup>5</sup> This statute abolishes the demand futility exception.

The purpose of the universal demand statute is to afford the board of directors the opportunity to exercise its traditional managerial function.<sup>6</sup> After issuing the demand, the shareholder must wait 90 days before filing a derivative complaint unless it is notified earlier that its demand has been rejected or the corporation would be irreparably harmed if the shareholder were forced to wait the 90 days.<sup>7</sup>

If the shareholder files a complaint after 90 days, a court is authorized to stay the derivative action to allow the corporation sufficient time to inquire into the allegations raised by the shareholder in its demand.<sup>8</sup>

Following the board's inquiry into the demand, it may decide to take some or all of the action demanded or reject the shareholder's demand in its entirety. Given the statute's codification of the business judgment rule, this decision is statutorily entitled to deference: "A derivative proceeding *commenced after rejection of a demand* shall be dismissed by the court on motion by the corporation if the court finds that [a majority of independent directors] has determined in good faith after conducting a reasonable inquiry upon which its conclusions are based that the maintenance of the derivative proceeding is not in the best interests of the corporation."<sup>9</sup> This is virtually identical to the MBCA provision, except for the additional language (italicized) that references the timing of the company's motion to dismiss.<sup>10</sup>

### THE HALEBIAN FACTS

CitiFunds Trust III is a Massachusetts business trust that consisted of six mutual funds. In 2005, when Citigroup Inc. sold its asset management business to Legg Mason Inc., including the subsidiary that served as adviser to CitiFunds, the funds terminated their advisory contracts and executed agreements with Legg Mason.

CitiFunds' board of trustees approved the contracts and issued proxies to the shareholders, recommending shareholder approval, which was granted.<sup>11</sup>

The derivative plaintiff, a shareholder of one of the mutual funds, took issue with the agreements and issued a demand letter to CitiFunds' board, claiming that the board had failed to comply with its fiduciary duty by not considering the best interests of the shareholders in connection with the new agreements, namely, by failing to negotiate lower fees.

In response, the board established a demand review committee to inquire into the shareholder's allegations. After the 90-day standstill period, but before the demand was rejected, the shareholder filed its complaint.

About six weeks after the complaint was filed, CitiFunds' board formally rejected the shareholder's demand and authorized the company to move to dismiss the complaint under the governing Massachusetts statute. Judge Naomi Reice Buchwald of the U.S. District Court for Southern District of New York granted the motion and dismissed the complaint.<sup>12</sup>

The 2nd Circuit thought differently. It questioned the judge's interpretation of the governing Massachusetts statute and ultimately certified the following question to the Massachusetts Supreme Judicial Court: "Under Massachusetts law, can the business judgment rule, established under Mass. Gen. Laws ch. 156D, § 7.44, be applied to dismiss a derivative complaint filed timely under Section 7.42 but prior to a corporation's rejection of the demand that serves as the basis for the suit?"<sup>13</sup>

### THE STATE HIGH COURT SHOULD APPLY THE STATUTE IN CONTEXT

The plaintiff reasons that under the plain meaning of the statute a board may move to dismiss a derivative action under the statute only if the complaint is filed after a demand has been rejected. The 2nd Circuit appears to have been swayed by this argument.

The statute reads:

(a) A derivative proceeding commenced *after rejection* of a demand shall be dismissed by the court on motion by the corporation if the court finds that either: (1) 1 of the groups specified in subsections (b)(1) ... has determined in good faith after conducting a reasonable inquiry upon which its conclusions are based that the maintenance of the derivative proceeding is not in the best interests of the corporation . . .

(b) . . . [T]he determination in subsection (a) shall be made by:

(1) [A] majority vote of independent directors present at a meeting of the board of directors if the independent directors constitute a quorum.<sup>14</sup>

The plaintiff's construction places too much emphasis on two words — "after rejection" — particularly given the highly structured scheme employed by the statute, and what a dramatic departure this interpretation poses to that scheme.

This language is more accurately viewed as a reflection of the typical sequence of events in a universal demand jurisdiction: The demand is issued, an inquiry is made, the demand is either acted upon or rejected, and then a complaint is filed.

***As a general proposition, a shareholder must demand action from a board of directors before it files a derivative complaint.***

To deprive a board of the business judgment rule simply because these steps failed to occur in this precise order is inconsistent with the statutory structure established for shareholder derivative actions. Thus the statute should not be read so narrowly; the codified business judgment rule should be available to a board at any time. To find otherwise would represent an excessively stilted view of the statute.

### THE STATUTORY SCHEME SHOULD CONTROL

When read together, the demand, stay and dismissal provisions demonstrate a board's ability to refuse a shareholder demand to initiate litigation at any time. The 90-day period in the universal demand statute is a temporal limitation placed on the complaining shareholder; a shareholder must make a demand and then allow the board a minimum of 90 days to investigate before filing a complaint.

The 90-day period should not be viewed as a deadline for the board of directors to act on the shareholder's demand. In fact, the stay provision authorizes a court to grant a stay in cases where 90 days have passed and a complaint has been filed, but the board has not decided the issue. The statute reads, "If the corporation commences an inquiry into the allegations made in the demand or *complaint*, the court may stay any derivative proceeding for a period as the court considers appropriate."<sup>15</sup>

Furthermore, the Massachusetts and MBCA commentaries explicitly contemplate that courts may apply the business judgment rule in the *Halebian* scenario, where a board determines, after the derivative complaint has been filed, that the action is not in the company's best interests. For example, the commentaries discussing the 90-day standstill period recognize that "[t]he corporation may request counsel for the shareholder to delay filing suit until the inquiry is completed or, if suit is commenced, the corporation can apply to the court for a stay."<sup>16</sup>

Furthermore, the commentaries also say the board's determination that the action is not in the company's best interests may be made "after commencement [of the suit] upon examination of the allegations of the complaint."<sup>17</sup>

### THE STATUTE ADDRESSES THE 2ND CIRCUIT'S CONCERNS

The 2nd Circuit voiced concern about potential abuse by boards if the statute is not interpreted as the plaintiff proposes. For example, the court feared that a board could otherwise move to dismiss an action at any time during its pendency, including, presumably, on the eve of trial.<sup>18</sup>

But this concern is unwarranted. First, a court always retains within its discretion the power to police an action pending before it. Second, in responding to a demand, a board generally prepares a report discussing its independence and the good faith and reasonableness of its investigation, including the directors' investigatory process and substantive inquiry, as well as bases for its conclusions. If the board attempted to manipulate the process in bad faith, it would be evident from the report.

Moreover, a derivative plaintiff's use of the report to establish bad faith or unreasonableness under a *Halebian* scenario is even more likely under Massachusetts law. While the relevant MBCA provision does not reference the board's report,<sup>19</sup> Massachusetts requires one.<sup>20</sup>

Any misuse of the statutory process would go to the ultimate question of the independence of the board and the good faith and reasonableness of its investigation. This is precisely what occurred in *Halebian*. The derivative plaintiff cited to the re-

port and other portions of the record to support its argument that the circumstances of the board's rejection of its demand were inconsistent with a good-faith and reasonable investigation.<sup>21</sup>

### **NO STAY NEEDED TO PRESERVE THE BUSINESS JUDGMENT RULE**

In support of its argument that the business judgment rule does not apply in *Halebian*, the plaintiff asserts that a company investigating a shareholder demand for over 90 days must seek a stay to preserve the availability of the business judgment rule. This proposal raises more questions than it answers. When must a board move for a stay? Before a complaint is filed? If so, in which court? After the complaint is filed? If so, how long after?

The plaintiff's argument is made even more curious by the fact that the defendants obtained stipulations from plaintiff, which were so ordered by the court, adjourning the defendants' time to respond to the complaint until the board ultimately filed its motion to dismiss based on its independent determination, following a good-faith and reasonable investigation, that pursuit of the allegations in the derivative complaint was not in the best interests of the corporation or its shareholders.<sup>22</sup> The plaintiff merely asserts that this was not the type of stay contemplated by the statute.

### **POTENTIAL EFFECTS OF A NARROW INTERPRETATION**

The plaintiff's interpretation of the statute would leave a large hole in the statutory scheme. As Judge Buchwald, who initially considered this dispute, correctly pointed out, the plaintiff's interpretation of the statute "would leave courts with no guidance whatsoever in applying the business judgment rule to a Massachusetts corporation's efforts to respond to a demand if a shareholder decides to file suit prior to the demand's rejection, since no other provision of [the Massachusetts' statutes (or the MBCA for that matter)] governs such actions."<sup>23</sup>

If outside the statute, will the board's decision on how to proceed with respect to the shareholder action, and ultimately the underlying decisions at issue, be subject to increased judicial scrutiny?

The Massachusetts scheme and the MBCA require that a derivative plaintiff satisfy certain pleading requirements to proceed with litigation after its demand has been rejected.<sup>24</sup> What would a derivative plaintiff's pleading obligations be if the complaint were filed prior to the rejection of a demand?

Under the Massachusetts and MBCA schemes, discovery is not available in a derivative action until the complaint complies with the pleading requirements discussed above.<sup>25</sup> Would the statutory bar on discovery continue to apply to the *Halebian* scenario?

Other practical considerations weigh against adopting the plaintiff's proposed construction of the statute. Adopting the plaintiff's interpretation could limit the scope of future internal investigations, as boards or special committees of boards rushed to complete inquiries to ensure their decision would be protected by the codified business judgment rule. A related issue is whether directors tasked with the inquiry could satisfy their duty to become informed during these expedited investigations.

Further, Massachusetts corporations and investment companies may experience an increase in strike suits as plaintiffs sprint to file derivative complaints on day 91 against corporations still considering their options in responding to a shareholder demand.

*To deprive a board of the business judgment rule simply because these steps failed to occur in this precise order is inconsistent with the statutory structure established for shareholder derivative actions.*

## CONCLUSION

Reason and the statutory scheme dictate that a Massachusetts investment company or corporation should be able to avail itself of the codified business judgment rule regardless of when the complaint is filed, including a derivative complaint filed *before* the formal rejection of a shareholder demand.

## NOTES

- <sup>1</sup> *Halebian v. Berv*, No. 10641 (Mass.). The briefs have been fully submitted, and oral argument was held May 4.
- <sup>2</sup> Mass. Gen. Laws ch. 156D, § 7.44(a) (emphasis added).
- <sup>3</sup> *Halebian v. Berv*, 590 F.3d 195, 214 (2d Cir. 2009).
- <sup>4</sup> Del. Ch. Ct. R. 23.1(a); N.Y. Bus. Corp. Law § 626(c).
- <sup>5</sup> Mass. Gen. Laws ch. 156D, § 7.42; Model Bus. Corp. Act § 7.42.
- <sup>6</sup> ING Principal Prot. Funds Derivative Litig., 369 F. Supp. 2d 163, 170-71 (D. Mass. 2005); Model Bus. Corp. Act § 7.42 cmt. at 7-317.
- <sup>7</sup> Mass. Gen. Laws ch. 156D, § 7.42.
- <sup>8</sup> *Id.* § 7.43; Model Bus. Corp. Act § 7.43.
- <sup>9</sup> Mass. Gen. Laws ch. 156D, § 7.44(a) (emphasis added).
- <sup>10</sup> The drafters of the MBCA did not consider this additional language a substantive change to the MBCA provision. Model Bus. Corp. Act § 7.44 cmt. at 7-335.
- <sup>11</sup> *Halebian*, 590 F.3d at 199.
- <sup>12</sup> *Halebian v. Berv*, 631 F. Supp. 2d 284 (S.D.N.Y. 2007).
- <sup>13</sup> *Halebian*, 590 F.3d at 214.
- <sup>14</sup> Mass. Gen. Laws ch. 156D, § 7.44 (emphasis added).
- <sup>15</sup> *Id.* § 7.43 (emphasis added).
- <sup>16</sup> *Id.* § 7.42 cmt.; Model Bus. Corp. Act § 7.42 cmt. at 7-319.
- <sup>17</sup> Mass. Gen. Laws ch. 156D, § 7.44 cmt.; Model Bus. Corp. Act § 7.44 cmt. at 7-329.
- <sup>18</sup> *Halebian*, 590 F.3d at 213.
- <sup>19</sup> In fact, the MBCA commentary states that a written report is not required. Model Bus. Corp. Act § 7.44 cmt. at 7-332.
- <sup>20</sup> Mass. Gen. Laws, ch. 156D, § 7.44(d) (“If the corporation moves to dismiss the derivative suit, it shall make a written filing with the court setting forth facts to show (1) whether a majority of the board of directors was independent at the time of the determination by the independent directors and (2) that the independent directors made the determination in good faith after conducting a reasonable inquiry upon which their conclusions are based.”).
- <sup>21</sup> See Brief for Plaintiff-Appellant at 20-26, *Halebian v. Berv*, 590 F.3d 195.
- <sup>22</sup> Brief for Appellees at 36-37, *Halebian v. Berv*, 590 F.3d 195.
- <sup>23</sup> *Halebian*, 631 F. Supp. 2d at 295.
- <sup>24</sup> Mass. Gen. Laws ch. 156D, § 7.44(d); Model Bus. Corp. Act § 7.44(c).
- <sup>25</sup> Model Bus. Corp. Act § 7.44 cmt. at 7-334; Mass. Gen. Laws ch. 156D, § 7.44(d).



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