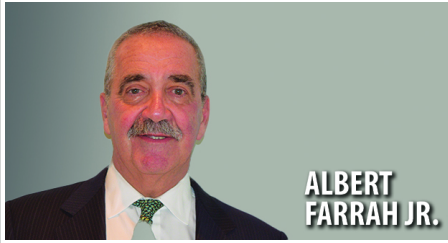


Derivative suit against sole officer can proceed

Panel is not needed to determine if action in co.'s 'best interests'

By: Eric T. Berkman February 11, 2016



An independent panel should not be appointed pursuant to G.L.c. 156D, §7.44(f), to determine if a shareholder derivative suit against a closely held corporation's sole officer and director would be in the company's best interest, a Superior Court judge has ruled in a case of first impression.

The plaintiffs — siblings who collectively owned half the company — had sued the defendant, who owned the other half, alleging that he had been grossly negligent in the company's operations.

The corporation, which had been named a nominal defendant as required by state law, moved to have the court appoint a panel of independent individuals to determine whether a derivative action should proceed.

But Judge Kenneth A. Salinger denied the motion.

"This motion is an attempt by [the defendant] to circumvent normal corporate decision making powers and processes and deprive the [plaintiffs] of their rights, as shareholders, to decide whether this suit is in the Corporation's best interest," Salinger wrote. "There is no good reason to take the decision about whether this action is in the Corporation's best interests away from the [plaintiffs], who together hold a one-half interest in the Corporation and give it to some independent panel."

The seven-page decision is *Kelleher, et al. v. Squires, et al.*, Lawyers Weekly No. 12-003-16. The full text of the ruling can be ordered by clicking here.

Flawed statute?

Boston lawyer Albert L. Farrah Jr., who represented the plaintiffs, said the case underscores the flawed nature of Section 7.44(f).

While appointing an independent panel could theoretically provide benefits by eliminating derivate actions that are not in a corporation's best interests or by fostering dialogue between competing parties and a neutral, the statute as written gives no guidance to judges about any aspect of either authorizing a panel or reviewing a panel's recommendation, Farrah said.

Accordingly, until the Legislature provides more direction regarding the standards for appointing independent panels, "parties seeking relief under [the statute] should be prepared to make compelling, well-supported arguments why a court should ignore decades of Massachusetts jurisprudence and refer a properly pled derivative shareholder's action to a special panel, rather than allowing that action to proceed through the court system," he said.

Brendan Pitts of Milton, counsel for the defendant, said he was surprised by the decision.

"We have a situation where there was a corporate stalemate with a 50-50 split in ownership, so there were no disinterested shareholders available," he said. "There was no attempt to circumvent any corporate governance structures; we were simply trying to exercise the only remedy available to a corporation under the statute to address a stalemate."

David B. Mack, a Burlington attorney who handles shareholder disputes, said the decision will be of interest to attorneys because so few courts, either in Massachusetts or elsewhere, have ruled on a similar motion.

At the same time, Mack said, the decision highlights the reluctance of courts to interfere in matters of corporate governance, particularly when there is nothing to suggest a plaintiff is pursuing a claim of malfeasance in bad faith.

"This case suggests that it will take a very unique set of circumstances for a court to step in and appoint an independent panel under the statute," Mack said. "Those circumstances clearly were not present here."

Securities litigator John D. Donovan Jr. of Boston said the decision demonstrates the reality that the derivative

statute as written works best for larger companies, especially publicly traded ones.

"The whole derivative jurisprudence is very difficult to apply in the close corporation context where you often have shareholder stalemates, 50-50 ownership positions, and very small boards, like what you had here," Donovan commented.

The judge exercised restraint and required people to follow corporate procedures as long as possible instead of leaping to bypass the procedures through the premature appointment of an independent panel, he noted.

"He was insisting upon compliance with corporate norms, even in a small, closely held corporation," Donovan said. "That's really what this decision is about."

John C. Koslowsky of Milton, who represented the defendant officer/director, could not be reached for comment prior to deadline.

Derivative action

On July 11, 2011, John H. Kelleher, who owned 50 percent of The Squires of Hanover, Inc., a Massachusetts corporation that operated The Squires restaurant in Hanover, died intestate after being hit by a car while crossing the street.

Kelleher's stake in the company passed to his four children, plaintiffs Madeline, James, Catherine and Evelyn Kelleher. Defendant Paul Squires, who had managed the restaurant since its establishment in 1981, owned the other 50 percent.

Squires also was the company's lone officer and director and, after Kelleher's death, exercised complete control of the company's operations, including handling money and managing property.

According to the plaintiffs, Squires had been making decisions unilaterally regarding the distribution and use of company funds without consulting the other shareholders.

The plaintiffs also claimed Squires converted corporate assets to his own use and had been grossly negligent in his management of the company. Specifically, Squires allegedly had spent more than 40 percent of the company's annual revenues on food and alcohol, which is significantly more than the industry standard.

It was further alleged that Squires paid significantly more than industry standard in labor costs while increasing his salary more than 75 percent between 2011 and 2014.

The plaintiffs went on to claim that Squires used company funds to pay his lawyers for work on personal legal matters.

On July 2, 2015, after meeting statutory demand requirements, the plaintiffs brought a derivative action in Superior Court against Squires and, nominally, against the corporation alleging gross negligence and conversion.

The corporation subsequently asked the court to appoint an independent panel pursuant to Section 7.44(f) to determine whether the derivative action was in the company's best interests.

Best interests

Addressing the corporation's motion, Salinger described the independent panel authorized under section 7.44(f) as an "unusual creature."

Under both common law and the state Business Corporation Act, when a majority of directors are accused of malfeasance but the majority of stockholders are not the alleged wrongdoers, those stockholders have the authority to determine whether the corporation should pursue a lawsuit against the company's executives for alleged breach of their duty to the corporation, the judge explained.

"Thus, if a court establishes an independent panel to determine whether a derivative proceeding is in the corporation's best interest, it is taking away power to exercise business judgment that is normally reserved to the board of directors and shareholders and giving it to strangers," Salinger said.

Salinger further noted that in enacting the statute in question, the Legislature established no standards for deciding whether or when a court should appoint such a panel. Nor had any Massachusetts appellate or trial court reported a decision on the issue, he said.

In fact, the judge said he knew of only two reported cases nationwide in which an independent panel was appointed, and in both cases all the parties agreed to it.

Salinger said the appointment of an independent panel was not appropriate here.

First, the judge said, the corporation's motion appeared to be an attempt by Squires to get around normal corporate decision-making powers that would ordinarily give the Kellehers the right as shareholders to decide for themselves whether a derivative action was in the company's best interests.

Meanwhile, there appeared to be no good reason to take such a decision away from the Kellehers and give it to an independent panel, Salinger said.

"It is an implied condition of becoming a stockholder in a corporation that its general policy shall be determined by the [disinterested] holders of a majority of the stock and that disagreements as to its dominating policy and as to the details of its management shall be settled by the stockholders, and that recourse cannot be had to the courts to adjust difficulties of this sort," the judge said, quoting the Supreme Judicial Court's 1915 decision in *Bartlett v. New York, New Haven & Hartford R.R. Co.*

That is precisely why corporations rely on independent shareholders to exercise their business judgment in deciding whether to bring malfeasance claims against officers or directors in cases in which, such as here, there are no independent directors who can make a decision for the company, Salinger stated.

At the same time, the judge noted that the corporation had made no prima facie case that the Kellehers themselves should not be trusted to exercise their business judgment on the corporation's behalf, that they are acting in bad faith, or that a derivative action would not, in fact, be in the company's best interests.

"If the Kellehers prevail, they will obtain an award of money damages against Squires on behalf of the Corporation," Salinger said. "If they lose, the Corporation should not be affected [because it is] only a nominal defendant."

Accordingly, the judge concluded, the motion should be denied.

Kelleher, et al. v. Squires, et al.

THE ISSUE: Should an independent panel be appointed pursuant to G.L.c. 156D, §7.44(f), to determine whether a shareholder derivative suit against a closely held corporation's sole officer and director would be in the company's best interest?

DECISION: No (Superior Court)

LAWYERS: Albert L. Farrah Jr. of Farrah & Farrah, Boston (plaintiffs)

Paul K. Flavin of Colucci, Colucci, Marcus & Flavin, Milton, and John C. Koslowsky of Milton (defense)

LAWYERS WEEKLY NO. 12-003-16

Massachusetts Lawyers Weekly

Corporate – Derivative action – Appointment of panel

ORDERING FULL TEXT OPINIONS

To search the marketplace for this full text opinion, click the Lawyers Weekly Number below.

12-003-16

Please Note: Supreme Judicial Court and published Appeals Court opinions are not available for purchase, but can be accessed online by clicking on the full-text opinion link under "related articles."

For information on ordering full text opinions, click here.

Issue: FEB. 15 2016 ISSUE



Copyright © 2016 Massachusetts Lawyers Weekly

10 Milk Street, Suite 1000,

Boston, MA 02108

(800) 451-9998

