

IN THE COURT OF COMMON PLEAS OF PHILADELPHIA COUNTY
FIRST JUDICIAL DISTRICT OF PENNSYLVANIA
TRIAL DIVISION - CIVIL

FUNDAMENTAL PARTNERS, et al., : OCTOBER TERM, 2011
: :
Plaintiffs, : NO.: 003519
: :
vs. : COMMERCE PROGRAM
: :
DOUGLAS A. GAUDET, et al., : Control No. 11112589
: :
Defendants. :

OPINION

In this derivative and class action, plaintiffs claim to represent all the shareholders of Nominal Defendant Penn Millers Holding Corporation ("Penn Millers"). Plaintiffs allege the directors of Penn Millers breached their fiduciary duties to Penn Millers and its shareholders by causing Penn Millers to merge with defendant ACE American Insurance Company ("ACE").¹ Plaintiffs complain the directors personally benefit from the merger with ACE and the board failed to disclose to the shareholders all material facts regarding the transaction.

Shortly before filing this lawsuit, plaintiffs made the requisite demand on Penn Millers to bring an action against the board of directors.² In response to this demand, the board appointed a Special Litigation Committee ("SLC") to determine if such claims should be brought. On November 8th, after this suit was filed by plaintiffs, the SLC issued its report in which it determined that bringing an action against the directors in connection with the merger would not

¹ The merger has not yet occurred. Plaintiff filed a Motion for Temporary Restraining Order to enjoin the shareholder vote on the proposed merger, which vote is scheduled for November 29, 2011.

² See Drain v. Covenant Life Ins. Co., 551 Pa. 570, 580-581, 712 A.2d 273, 278 (1998) citing to § 7.03 of the American Law Institute Principles of Corporate Governance ("Before commencing a derivative action, a holder or a director should be required to make a written demand upon the board of directors of the corporation, requesting it to prosecute the action or take suitable corrective measures . . .").

be in the best interests of Penn Millers. In response to the report, plaintiffs filed an Amended Complaint in this action, in which they allege the SLC's members were not disinterested, its investigation was inadequate, and its decision was not in the best interest of Penn Millers.³

Defendants filed an expedited Motion to Dismiss the Amended Complaint based on Section 7.08 of the American Law Institute Principles of Corporate Governance adopted in Cuker v. Mikalauskas.⁴ The parties undertook expedited discovery on the issues raised in the Motion to Dismiss and fully briefed and argued the Motion, so it is now ripe for resolution by the Court.

The parties agree Cuker controls the court's decision on the Motion to Dismiss. Under Cuker, where a business decision, such as the decision of the SLC not to proceed with suit, is challenged in court, the court's first, and often only, responsibility is to determine if the decision was properly made. "If a court makes a preliminary determination that a business decision was made under proper circumstances, . . . then the business judgment rule prohibits the court from going further and examining the merits of the underlying business decision."⁵ In other words, if the court determines the SLC properly decided not to bring any claims against the directors with respect to the merger, then the court cannot look beyond the SLC's decision to determine if the board's decision to merge was proper.

In order to determine whether the SLC's decision not to bring suit was properly made, the court should consider the following:

1. whether the [SLC] was disinterested;
2. whether it was assisted by counsel;

³ Amended Complaint, ¶ 23.

⁴ 547 Pa. 600, 692 A.2d 1042 (1997).

⁵ *Id.* at 611, 692 A.2d at 1047.

3. whether it prepared a written report;
4. whether it was independent;
5. whether it conducted an adequate investigation; and
6. whether it rationally believed its decision was in the best interests of the corporation (i.e., acted in good faith).⁶

"If all of these criteria are satisfied, the business judgment rule applies and the court should dismiss the action."⁷

It is 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 interests 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.⁸

Plaintiffs do not dispute the SLC was assisted by very able counsel nor do they dispute that it prepared a written report. Instead, plaintiffs attempt to meet their evidentiary burden by pointing to the following facts revealed in discovery:

1. The four directors who comprised the SLC were not disinterested because they, like all the other directors, are entitled under the terms of the merger to be indemnified by ACE for their actions in connection with the merger;
2. The four SLC directors, like all the other directors, are entitled under the terms of the merger to payments ranging from \$6,000-\$11,300 for their non-vested stock options;
3. One of the four SLC directors has a long history of purchasing insurance for his business from Penn Millers, and he may continue to purchase insurance from ACE after the merger;

⁶ Cuker, 547 Pa. at 612, 692 A.2d at 1048

⁷ *Id.*

⁸ *Id.* at 607, 692 A.2d at 1045-46.

4. Penn Millers' CEO, who will continue to be employed by ACE after the merger, made the initial introductions between Penn Miller's insurer and SLC's counsel, so the latter could discuss counsel's compensation; and
5. One of the four SLC directors did not attach much weight to one of the factors cited in the SLC's report in support of the SLC's decision.

None of these facts, viewed singly or as a whole, is sufficient to rebut the presumption that the SLC's decision was made properly, honestly, and in good faith.

The indemnification of the SLC directors is a routine provision in merger agreements, one the directors would have received if the deal was consummated with ACE or with any other entity who agreed to purchase Penn Millers. Such indemnification is not viewed as increasing a director's wealth and thereby making him/her interested in the transaction.⁹

Similarly, the payment to the SLC directors for their non-vested stock options is a routine provision in many merger agreements. It makes the directors' interests the same as those of the other shareholders; if a greater per share price is paid to the shareholders, then a greater amount is also paid to the directors for their options.¹⁰ The *de minimus* amounts the directors are receiving for their options in this merger cannot be presumed to taint their judgment and do not give the SLC directors an improper interest in the merger.

Although plaintiffs claim one director has done, and may continue to do, business with Penn Millers, the court does not see how this history would cause him to misjudge the actions of the board in approving the merger transaction. As a long-term customer of Penn Millers, as well

⁹ See Grover v. Simmons, 642 A.2d 792, 804 (Del. Ch. 1993) ("Normally, the receipt of indemnification is not deemed to taint related director actions with a presumption of self-interest. That is because indemnification has become commonplace in corporate affairs, and because indemnification does not increase a director's wealth.")

¹⁰ See Krim v. ProNet, Inc., 744 A.2d 523, 528, n. 16 (Del. Ch. 1999) ("The vesting of options does not create a conflict as a high exchange ratio for [the company] shares benefits the option-holding directors as much as, if not more than, the regular stockholders.").

as a director of it, he is presumed to wish it well rather than ill. His judgment cannot be assumed to have been clouded by the possibility his company may do business with Penn Millers/ACE in the future.

With respect to Penn Millers' CEO's alleged involvement in negotiating the SLC's independent counsel's rates, this appears, at best, to be a red herring. There is no evidence counsel acted other than independently and competently.

Finally, one SLC director's decision to emphasize the threatened AM Best down-grading rather than the purchase by a third party of a significant portion of Penn Millers' stock, does not call the entire SLC report into question. Both factors were cited in the report as relevant to the board's decision to sell Penn Millers, but not every SLC director must personally attach equal weight to each factor.

Plaintiffs make one additional argument in an attempt to save their claims from dismissal. They argue their claim for tortious interference with shareholder voting rights is a direct claim, not a derivative claim, and therefore is not barred by Cuker.¹¹ No such direct cause of action by the shareholders against the directors exists in Pennsylvania. Instead, such a claim must be brought derivatively, or not at all.¹² If brought derivatively, such a claim may be barred by the business judgment rule set forth in Cuker.

There is no evidence the SLC acted improperly in deciding not to bring suit against the Penn Millers' directors in connection with the merger. Instead, the evidence confirms the SLC acted properly, in good faith, and for the best interests of Penn Millers. Under the rule set forth

¹¹ The case footnote cited by plaintiffs for this proposition is inapposite, dicta, and not controlling precedent. See WorldWideWeb Network Corp. v. Entrade, Inc., 2003 Phila Ct. Com. Pl. LEXIS 84 (2003).

¹² See 15 Pa.C.S. § 1717 ("The duty of the board of directors, committees of the board and individual directors under section 1712 (relating to standard of care and justifiable reliance) is solely to the business corporation and may be enforced directly by the corporation or may be enforced by a shareholder, as such, by an action in the right of the corporation, and may not be enforced directly by a shareholder or by any other person or group.")

in Cuker, the court must respect the SLC's properly made business judgment not to bring suit, and the court must dismiss this action.

CONCLUSION

For all the foregoing reasons, defendant's Motion to Dismiss is granted and plaintiff's Amended Complaint is dismissed.

BY THE COURT


ARNOLD L. NEW, J.

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ORDER

AND NOW, this 23rd day of November, 2011, upon consideration of defendants' Motion to Dismiss the Amended Complaint, the response thereto, and all other matters of record, after hearing oral argument, and in accord with the Opinion issued simultaneously, it is **ORDERED** that the Motion is **GRANTED** and the Amended Complaint is **DISMISSED**.

BY THE COURT


ARNOLD L. NEW, J.