

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE
IN AND FOR NEW CASTLE COUNTY

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AUDIO VISUAL XPERTS, INC., a)
Pennsylvania corporation,)
Plaintiff/Third-Party Defendant,)

v.)

C.A. No. 17261-NC

DON G. WALKER,)
Defendant/Third-Party Plaintiff,)

and)

JANET WALKER)
Third-Party Plaintiff,)

v.)

WILLIAM J. SAHM, JR.; THOMAS G.)
BLACKISTON; HEATHER BLACKISTON;)
AUDIO VISUAL XPERTS, INC., a)
Delaware corporation; AUDIO VISUAL)
XPERTS, INC., a Pennsylvania corporation;)
and WILMINGTON SAVINGS FUND)
SOCIETY, FSB,)
Third-Party Defendants.)

MEMORANDUM OPINION

Submitted: February 8, 2000

Decided: February 18, 2000

Francis G.X. Pileggi, Esquire and Denise Adamucci, Esquire, of MANTA AND WELGE, Wilmington, Delaware; Attorneys for Plaintiff and Third-Party Defendants

Daniel L. McKenty, Esquire and Steven F. Mones, Esquire, of MCCULLOUGH & McKENTY, P.A., Wilmington, Delaware; Attorneys for Defendant and Third-Party Plaintiffs.

LAMB. Vice Chancellor

HL

I.

This case is, at its core, a dispute among the three equal-share owners of a closely held Pennsylvania corporation. This court has personal jurisdiction over the defendant, a Delaware resident, but must apply the substantive corporation law of the Commonwealth of Pennsylvania. In the interest of clarity, I will explain only those facts material to the present issue.

At a January 26, 2000 hearing, I denied the plaintiffs' motion to dismiss the defendant's individual counterclaims and reserved judgment with regard to the two derivative claims. I requested that the parties submit supplementary briefs analyzing whether I should dismiss those claims for failure to make a demand. Having reviewed the parties' submissions, I conclude that a Pennsylvania trial court would, in this case, recognize that the "derivative" claims can fairly be considered individual, thus allowing the claims to proceed notwithstanding the failure by the shareholder to make a demand.

II.

Don G. Walker, William J. Sahn, Jr. and Thomas G. Blackiston are the three equal-share owners of Audio Visual Xperts, Inc., a Pennsylvania closely-held corporation ("AVX-Pa"), which provides marketing services through audio visual displays and other media. When Sahn and Blackiston purported to remove Walker from his role as director and took other actions inimical to his interests, Walker filed suit in a Pennsylvania trial court. That suit alleged, *inter*

alia, breaches of fiduciary duty by Sahm and Blackiston.’ The breach of fiduciary duty claim alleged that Sahm and Blackiston misappropriated corporate funds and formed Audio Visual Xperts, Inc., a Delaware corporation (“AVX-Del.”), for the purpose of competing with or diverting the business of AVX-Pa.

Sahm and Blackiston filed counterclaims (alleging that Walker misappropriated entity funds), as well as a motion to dismiss the complaint. The Pennsylvania court summarily denied Sahm’s and Blackiston’s motion to dismiss Walker’s claims. Sahm and Blackiston withdrew the counterclaims before the court could rule on Walker’s motion to dismiss.²

On June 29, 1999, Sahm and Blackiston caused AVX-Pa. to file a complaint in this court, basically mirroring the counterclaims previously withdrawn from the Pennsylvania litigation.³ Walker answered and filed eleven counterclaims.⁴ At the January 26, 2000 hearing, I concluded that the individual

¹ The other claims included: improper removal of Walker as a director, breach of a compensation contract, denial of access to the corporation’s books and records, and oppression in a closely-held corporation.

² Unlike Delaware law, Pennsylvania law does not embrace the concept of compulsory counterclaims. As such, the defendants in that case were able to withdraw their claims even though they were in all respects related to the principal claims.

³ Walker’s counsel indicated that although the Pennsylvania action was temporarily stayed pending the present litigation, Sahm and Blackiston requested a lift of that stay. Presently, the Pennsylvania court is considering certain discovery disputes.

⁴ Walker’s wife, Janet, joined as a third-party plaintiff with respect to certain of the claims. The Walkers named Sahm and Blackiston, Blackiston’s wife, AVX-Del. and Wilmington Savings Fund Society, FSB (“WSFS”) as third-party defendants with respect to some or all of the counterclaims. In this Opinion, I am only concerned with the derivative claims brought by Don Walker (for present purposes, “Counterclaim Plaintiff”) against his “partners” (for present purposes, “Counterclaim Defendants”).

counterclaims, including claimed breaches of contract and fraud, stated cognizable causes of action. The derivative claims seeking relief on behalf of AVX-Pa. are as follows:

Count IV. Misappropriation of corporate funds and taking of a corporate opportunity; and

Count XI. Reimbursement to AVX-Pa. for any attorneys' fees paid by the corporation on behalf of Sahm and Blackiston in this and the Pennsylvania litigation.

Counsel for the Counterclaim Defendants initially argued that the derivative claims should be dismissed, pursuant to Delaware law, for failure to make a demand. I agreed with counsel for the Counterclaim Plaintiff that Pennsylvania law unquestionably applies to the demand issue.⁵ Under the Pennsylvania Supreme Court's opinion in *Cuker v. Mikalauskas*,⁶ it is clear that even in cases in which demand is futile, a plaintiff stockholder must make such demand shortly after filing his complaint. Counterclaim Plaintiff never made a demand. Because the Counterclaim Defendants' counsel focused on Delaware law, I allowed both parties to provide supplemental briefs with regard to whether *Cuker* requires dismissal of all the derivative claims.

⁵ See *Kamen v. Kemper Fin. Services*, 500 U.S. 90 (1991)

⁶ Pa. Supr., 692 A.2d 1042 (1998).

III.

The issue in *Cuker* was “whether the ‘business judgment rule’ permits the board of directors of a Pennsylvania corporation to terminate derivative lawsuits brought by minority shareholders.”⁷ In that case, certain shareholders of PECO, a highly-regulated public corporation, made a demand on the board to institute or authorize litigation against certain of PECO’s officers and directors.⁸ Before the board finished considering that demand, a second group of stockholders (the “Cuker Group”) filed a complaint against PECO and the alleged wrongdoers.” The PECO special committee eventually issued its report, and the board decided to reject the first demand and terminate the Cuker Group’s litigation.”

The Pennsylvania Supreme Court undertook a thorough examination of the business judgment rule and its role in Pennsylvania jurisprudence. The Court also considered the American Law Institute *Principles of Corporate Governance: Analysis and Recommendations* (1994) (the “ALI Principles”). Ultimately, the court adopted *ALI Principles* §§ 7.02-7.10 and § 7.13, dealing with the demand requirement in derivative litigation.” Under § 7.03(b), “[d]emand on the board should be excused only if the plaintiff makes a specific

⁷ *Cuker*, 692 A.2d at 1043

⁸ *Id.* at 1044.

⁹ *Id.*

¹⁰ *Id.* at 1044-45.

¹¹ *Id.* at 1049.

showing that irreparable injury to the corporation would otherwise result, and in such instances demand should be made promptly after commencement of the action.”

The Counterclaim Defendants point out that Counterclaim Plaintiff made no showing of irreparable harm and, in any event, failed to make a demand *promptly* after commencing the litigation. As such, they argue, dismissal is required.¹² The inquiry is not, however, complete. Although the Court specifically adopted those sections, it wrote the following footnote inviting Pennsylvania courts to consider other relevant parts of the *ALI Principles* when considering other cases:

Our adoption of these sections is not a rejection of other sections not cited. We have identified and studied the sections which apply to this case and have adopted those which appear most relevant.

The entire publication, all seven parts, is a comprehensive, cohesive work . . . Issues in future cases or, perhaps, further proceedings in this case might implicate additional sections of the *ALI Principles*. Courts of the Commonwealth are free to consider other parts of the work and utilize them if they are helpful and appear to be consistent with Pennsylvania law.¹³

I conclude that another section of the *ALI Principles* is, in fact, helpful in adjudicating the present case and consistent with Pennsylvania law. Walker cites

¹² *See 2 ALI Principles*, § 7.0.3(d)

¹³ *Cuker*, **692** A.2d at 1049 n. 5.

§ 7.01(d) of the *ALI Principles*, which states:

In the case of a closely held corporation [§ 1.061, the court in its discretion may treat an action raising derivative claims as a direct action, exempt it from those restrictions and defenses applicable only to a derivative action, and order an individual recovery, if it finds that to do so will not (i) unfairly expose the corporation or the defendants to a multiplicity of actions, (ii) materially prejudice the interest of creditors of the corporation, or (iii) interfere with a fair distribution of the recovery among all interested persons.¹⁴

I believe it more likely than not that a Pennsylvania trial court would recognize that in these circumstances, it is more consistent with the *ALI Principles* to treat Walker's claims as individual.¹⁵ Walker is not a stockholder in a large corporation seeking to usurp the power of the board by deciding that certain litigation is in his fellow stockholders' (and the entity's) best interests. Walker is the only stockholder besides the Counterclaim Defendants. No threat of a multiplicity of actions exists. The principal, if not only, creditor of the corporation is actually a party to this case. Finally, Walker is the only person who stands to benefit from any recovery that may be had in this case.¹⁶ Thus, I conclude that a Pennsylvania court would apply § 7.01(d) of the *ALI Principles* to the demand requirement in the context of a closely-held corporation and would

¹⁴ *2 ALI Principles*, § 7.01(d).

¹⁵ *Id.* § 7.01, cmt. e, illus. 3 CL Reporter's Note 4 (explaining the distinction recognized in § 7.01(d) and listing cases from numerous jurisdictions recognizing the same).

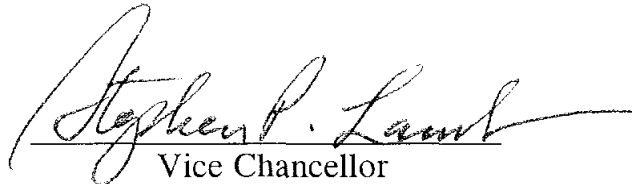
¹⁶ This is so only with respect to the counterclaims. Obviously, if AVX-Pa. prevails in its claims that Walker misappropriated funds, the entity will benefit at Walker's expense.

rule that *Cuker* does not require dismissal of Walker's "derivative" claims for failure to make a demand.

This conclusion is consistent with other aspects of Pennsylvania's corporate law. One of Walker's non-derivative claims rests on a Pennsylvania statute that protects minority shareholders in closely held corporation from oppressive conduct intended to freeze them out of the entity's operations and ownership.¹⁶ This statute makes clear the Pennsylvania legislature's view that that in certain instances, the rules applying to large corporations are ill-suited to address the problems facing closely-held "incorporated partnerships."

IV.

During the hearing on January 26, 2000, after dismissing the rest of the motion, I reserved judgment with respect to Counts IV and XI (the derivative claims) of Walker's counterclaims. For the reasons set forth above, the Plaintiffs/Third-Party Defendants Motion to Dismiss is hereby DENIED with respect to Counts IV and XI of Walker's counterclaims.


Vice Chancellor

¹⁶ 15 Pa.C.S. § 1767(a)(2)