Was It Futile?

The Legislature Changed the Law, but the "Futility Exception" Lives On in Our Courts

By Benjamin Engel

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Did the Connecticut General Assembly commit a futile act in enacting § 33–722 of the General Statutes? That is the question presented by several rulings of the state's superior courts. So far, it appears the answer is "yes."

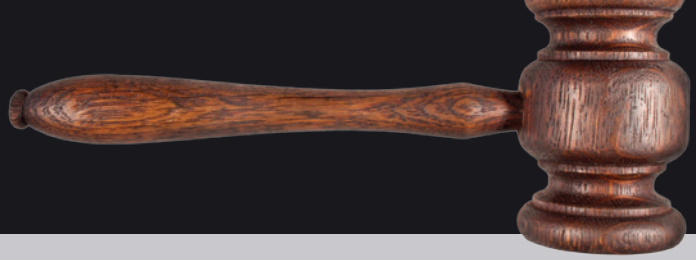
Section 33–722 requires a written demand on a corporation "to take suitable action" before a shareholder commences a derivative proceeding.[1] Because, in a derivative suit, the shareholder sues for the benefit of the corporation, the statute gives the corporation the first opportunity to seek a solution or prosecute the claim.

By its terms, the statute, enacted in 1994 and effective in 1997, eliminated any excuses for not making demand. That would include the "futility exception," under which the shareholder is excused from making the demand if the demand would be "futile"; for example, where the alleged wrongdoers were the controlling directors of the corporation. But the state's trial courts persist in recognizing the futility exception, even though the Official Comment to the Model Business Corporation Act ("MBCA"), on which the statute was based, says demand is required "in all cases."

Are the courts simply continuing the common law, or have they yet to adjust to this not-so-new statute? So far, they haven't said.

Prior to Connecticut's enactment of the MBCA, derivative actions were governed by General Statutes § 52–572j, a provision still on the books.[2] That provision permitted an action "[w]henever any corporation…fails to enforce a right which may properly be asserted by it…." Connecticut courts required the making of a demand prior to commencing a derivative action, but, in cases such as *Tibball v. Galog*,[3] the court excused the shareholder's alleged failure to make demand based on futility: "It cannot be expected that [the defendant], as a director charged with breaching his fiduciary duty, would be amenable to a request to take legal action against himself…"[4]

There certainly were, and still are, good reasons to recognize a futility exception. The court in *Tibball* catalogued the circumstances that have been held to warrant the exception: (1) where the directors acquiesce in or are parties to the alleged wrongdoing, (2) where the directors are accused of a patent breach of fiduciary duty and are named



as defendants, (3) where the directors have profited from the transaction underlying the litigation and are named as defendants, and (4) where the directors and controlling shareholders are antagonistic and adversely interested.[5] Under such circumstances, it is plain to see why a court would conclude that it is counterproductive to dismiss a lawsuit based solely on a shareholder's failure to make a futile demand.

However, the Connecticut Business Corporation Act ("CBCA") took its own view. Section 33–722 of the CBCA, based verbatim on § 7.42 of the MBCA, requires the making of written demand on the corporation to take suitable action and the expiration of 90 days from the date of demand. (The 90 days may be shortened under specified circumstances.) Absent such demand and waiting period, the statute provides, "[n]o shareholder may commence a derivative proceeding."[6] There is no hint of a futility exception in the words of the statute.

The MBCA is accompanied by Official Comments, which have been recognized as authoritative interpretations of the CBCA.[7] The Official Comment to MBCA § 7.42 states:

> Section 7.42 requires a written demand on the corporation in all cases…This approach has been adopted for two reasons. First, even though no director may be 'qualified' (see section 1.43), the demand will give the board of directors the opportunity to re-examine the act complained of in the light of a potential lawsuit and take corrective action. Secondly, the provision eliminates the time and expense of the litigants and the court involved in litigating the question whether demand is required. It is believed that requiring a demand in all cases does not impose an onerous burden since a relatively short waiting period of 90 days is provided and this period may be shortened if irreparable injury to the corporation would result by waiting for the expiration of the 90-day period.[8]

There are certainly legitimate reasons for this approach. Take the following fictional example. Suppose XYZ Corporation has two 50 percent shareholders, who are also the sole directors: A, who is in charge of sales, and B, who is the sole owner of a separate management company that provides services to XYZ. A year ago, B's management company signed an agreement obligating itself not to provide services to a competitor of XYZ. Subsequently, the two shareholders fall into nasty disputes over XYZ's business model. A causes XYZ to introduce a new product line already offered by another customer of B's management company. A then writes to B, purportedly on behalf of XYZ, demanding that B cause the management company to discontinue servicing the competitor. B refuses and A sues B and B's management company, including derivative counts claiming that B's actions constituted breach of contract and breach of fiduciary duty.

It may seem futile for A to have to make demand on the board of directors to rectify the problem and have to wait 90 days before bringing suit. After all, the board could not assemble a majority to take any action above the objections of B. However, there are several reasons that the demand and waiting period are not futile, even in these apparently extreme circumstances.

First, the demand and waiting period requirements assure that the board will decide whether to sue *under current circumstances*. In the above example, one shareholder/director sues the other based on an agreement signed a year earlier. Even if, a year before, B's management company agreed not to service a competitor, things had changed in the interim. Only after the agreement was signed did the competition begin, and only due to the actions of XYZ. Or suppose events have occurred making the publicity from such a lawsuit extremely detrimental to XYZ. Under such circumstances, a board would likely be unable to commence suit consistent with its fiduciary duties. So why, just because A and B are now in a dispute, should A be allowed to sue B derivatively on a cause of action that, if the board were deciding currently, would not be commenced? Requiring demand and board action forces both directors to determine their conduct based on the best interest of XYZ at the relevant time.

Second, A may be wrong on the facts. With demand and a waiting period, B may have the opportunity to convince A that, in fact, the restrictive covenant did not require the management company to discontinue relationships that complied at the time of the agreement, or that the asserted competition was not material.

Third, notice of imminent legal action may motivate B to terminate or modify the other management relationship rather than disadvantage XYZ. By contrast, preemptive commencement of a lawsuit against B could deplete XYZ's resources and therefore be counterproductive from the company's point of view.

In such circumstances, a formal demand as precursor to suit may concentrate the mind of the directors, who may then decide that resolving the situation is preferable to allowing suit to commence.

Whatever the merits of the argument, one thing is clear: the Connecticut General Assembly adopted § 33–722 along with the rest of the CBCA.

But since adoption of the CBCA, the Connecticut Superior Courts have shown no awareness of the intent of the provision as explained in the Official Comment. The few Connecticut courts that have issued written opinions on the subject have treated the futility issue as if § 33–722 was no different from § 52–572j. For instance, in *Musto v. Opticare Eye Health Ctrs.*,[9] the court dismissed, for lack of standing, a derivative action for want of an adequate demand. In so doing, however, the court suggested that it would have entertained a claim of futility; it cited a Delaware case[10] allowing a futility exception and noted that the parties in *Musto* had not briefed the issue of futility. It gave short shrift to any legislative history of § 33–722.[11]

Musto's early suggestion of a continuing futility exception has been replicated by two later published Connecticut cases, which also show no evidence that the intent of MBCA § 7.42 had ever been brought to the attention of a Connecticut court. In *Guarino v. Livery Ltd., Inc.*,[12] the Court cited the pre-CBCA precedent of *Tibball*, overlooked the Official Comment and other evidence of intent and, unnecessarily after enactment of § 33–722, analogized the issue to the doctrine of futility in administrative law complaints. Similarly, *Messina v. FTF Crawlspace Specialists, Inc.*[13] suggested that the futility exception has continuing vitality, but with no indication of having considered the intent of § 33–722.

Some of the confusion may reflect not only the vestigial effect of pre-CBCA Connecticut law, but also the influence of Delaware cases such as *Aronson v. Lewis*,[14] which was cited in *Tibball*, and *Stepak v. Dean*,[15] cited in *Musto*. *Aronson* and *Stepak*, however, were construing a Delaware rule differing significantly from § 33–722. Unlike § 33–722, which requires that all derivative actions be preceded by demand, Delaware Chancery Court Rule 23.1 specifically allows a plaintiff who has *not* made demand to plead, in lieu thereof, his "reasons…for not making the effort."[16]

Moreover, of course, Connecticut courts continue to be cited to the law of other states that have not adopted a counterpart to § 33–722. Connecticut courts have decided cases under the law of Delaware, New York, and Nevada, none of which has adopted a counterpart to § 33–722 and all of which, according to the Connecticut courts, recognize a futility exception.[17]

There are points to be made both in favor of, and against, retention of the futility exception. It is a safe bet that eventually the issue will be decided in Connecticut on the appellate level. **CL**

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Notes

1. Sec. 33–722 provides as follows:
   Demand. No shareholder may commence a derivative proceeding until: (1) A written demand has been made upon the corporation to take suitable action; and (2) ninety days have expired from the date the demand was made unless the shareholder has earlier been notified that the demand has been rejected by the corporation or unless ir reparable injury to the corporation would result by waiting for the expiration of the ninety-day period.
   Conn. Gen. Stat. Ann. § 33–722 (West 2009).
2. Sec. 52–572j provides in pertinent part as follows:
   Derivative actions by shareholders or members. (a) Whenever any corporation or any unincorporated association fails to enforce a right which may properly be asserted by it, a derivative action may be brought by one or more shareholders or members to enforce the right, provided the shareholder or member was a shareholder or member at the time of the transaction of which he complained or his membership thereafter devolved on him by operation of law. . . .
   Conn. Gen. Stat. Ann. § 52–572j (West 2009).
3. *Tibball v. Galog*, No. CV940311149S, 1994 WL 468251 (Conn. Super. Ct. Aug. 26, 1994).
4. *Id.* at *4.
5. *Id.* at *3.
6. Conn. Gen. Stat. Ann. § 33–722, supra note 1.
7. See, e.g., *Stone v. R.E.A.L. Health, P.C.*, No. CV 98414972, 2000 WL 33158565, at *7 (Conn. Super. Ct. Nov. 15, 2000) (citing the Official Comment to MBCA in its decision).
8. Model Bus. Corp. Act Ann. § 7.42 cmt. (4th ed. 2008). A "qualified" director essentially means a director who is disinterested and independent. This concept was adopted by the MBCA in 2005. Previously, this Official Comment used the term "independent" instead of "qualified."
9. *Musto v. Opticare Eye Health Ctrs.* No. CV990359863S, 1999 WL 439348, at *2, *4 (Conn. Super. Ct. June 15, 1999).
10. *Stepak v. Dean*, 434 A.2d 388 (Del. Ch. 1981).
11. *Musto v. Opticare Eye Health Ctrs*., supra note 9, at *2.
12. *Guarino v. Livery Ltd*., *Inc.*, No. X04CV030127824, 2003 WL 22853729, at *2 (Conn. Super. Ct. Nov. 18, 2003).
13. *Messina v. FTF Crawlspace Specialists*, *Inc.*, No. CV010085715S, 2003 WL 21495495, at *1 (Conn. Super. Ct. June 10, 2003).
14. *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).
15. *Stepak v. Dean*, 434 A.2d 388 (Del. Ch. 1981).
16. De. R. Ch. Ct. Rule 23.1 (West 2009). Rule 23.1 provides in pertinent part as follows: "The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort." *Id*.
17. *Christiani v. BenefitPoint, Inc*., No. X07 CV044025119, 2008 WL 803117 (Conn. Super. Ct. Mar. 7, 2008) (applying Delaware law); *Miller v. Allaire*, No. X05CV054007126S, 2006 WL 161064 (Conn. Super. Ct. May 23, 2006) (applying New York law); *Taneja v. FamilyMeds Group, Inc*., No. CV084036740, 2009 WL 415454 (Conn. Super. Ct. Jan. 16, 2009) (applying Nevada law).