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OF THE
STATE OF DELAWARE

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Re: FLI Deep Marine LLC, et al. v. McKim, et al.
C.A. No. 4138-VCN
Date Submitted: March 24, 2009

Dear Counsel:

I. INTRODUCTION

Minority shareholders claim to have learned of several acts of wrongdoing by the majority shareholders. They were convinced from the outset that the company's board was under the dominion and control of the majority shareholders and had

assisted the majority shareholders in looting the company. Nevertheless, instead of presenting their derivative claims on behalf of the company first to this Court and pleading demand excusal, they inexplicably decided to make a demand upon the board of directors. Following demand, the allegedly conflicted directors promptly formed a committee charged with the investigation of the alleged wrongdoing. After the appointment of a special committee consisting of two board members themselves accused of wrongdoing, the minority shareholders concluded that awaiting the results of an investigation was futile, and brought suit here, claiming that demand on the board was excused.

II. BACKGROUND

Deep Marine Holdings, Inc. is a Delaware corporation headquartered in Houston, Texas. Along with its wholly owned subsidiary Deep Marine Technology, Inc., a Texas corporation also with headquarters in Houston, Texas, (together with Deep Marine Holdings, Inc., "DMT"), it provides services to the offshore oil and gas industries.

Two of DMT's minority shareholders, Bressner Partners, Ltd. and FLI Deep Marine LLC (the "Plaintiffs"), bring this stockholder derivative action against Defendants Paul McKim, Daniel Erickson, Francis Wade Abadie, Otto Candies, III,

Eugene DePalma, Larry Lenig, Bruce Gilman, and John Hudgens, (collectively, the "Individual Defendants") and Nasser Kazeminy, Otto Candies, LLC, NJK Holdings Corporation, DCC Ventures, LLC and Otto Candies, Jr., (collectively, the "Controlling Shareholder Defendants," together with the Individual Defendants, the "Defendants").

The Plaintiffs allege that DMT has been exploited and looted for personal economic gain over the past four years by the Controlling Shareholder Defendants.[1] They additionally assert that the Controlling Shareholder Defendants caused the Individual Defendants to "ignore corporate formalities and reasonable business practices."[2] The Plaintiffs base a large portion of these allegations on information provided to them by a "confidential source" in the Spring of 2007.[3] Finally, they accuse the Individual Defendants of breaching their fiduciary duties to the Plaintiffs and DMT by failing to exercise "reasonable and prudent supervision over the management, polices, practices, controls and financial affairs of DMT."[4]

[1] Compl. ¶¶ 30-53.
[2] *Id.* at ¶ 22.
[3] *Id.* at ¶ 30.
[4] *Id.* at ¶ 29.

The Plaintiffs initiated this derivative action after having first made demand on the Board in a letter, dated October 10, 2008,[5] from Plaintiffs' counsel which stated:

> We write on behalf of the [Plaintiffs] to demand that the Board of Directors of DMT take immediate action to remedy serious breaches of fiduciary duty by certain employees, officers and directors of DMT and others who have diverted and/or misappropriated corporate assets (the "Individuals") causing substantial injury to the corporation. We demand that the Board establish a Special Litigation Committee to: (A) investigate these breaches, (B) take action to end any fraudulent activities, (C) bring actions to recover funds wrongfully diverted from DMT and for compensatory damages, and (D) establish procedures and processes to ensure that the wrongdoing and abuses identified herein do not reoccur.[6]

The following day, in response to the Plaintiffs' demand letter, the Board formed a special committee to investigate the allegations asserted in the demand letter and to make a recommendation to the Board in connection with the demand. The special committee was comprised solely of Defendants Gilman and Lenig. Three weeks later, before the special committee had completed its investigation and before

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[5] Demand was made on five individuals then comprising the DMT board: Defendants McKim, Gilman, Lenig, and Erickson, along with John Ellingboe. *Id.* at ¶ 68 & Ex. G.

[6] *Id.*, Ex. G (alleging injury totaling "millions of dollars"). The Plaintiffs acknowledge that this letter constituted a demand on the Board, (*Id.* at ¶ 68) and the Court finds it sufficient to constitute a demand under Delaware law. *See Yaw v. Talley*, 1994 WL 89019, at *7 (Del. Ch. Mar. 2, 1994) ("To constitute a demand, a communication must specifically state: (i) the identity of the alleged wrongdoers, (ii) the wrongdoing they allegedly perpetrated and the resultant injury to the corporation, and (iii) the legal action the shareholder wants the board to take on the corporation's behalf.").

the Board took any action concerning the demand, the Plaintiffs commenced this action and alleged that demand on the Board was futile and should be excused.

The Plaintiffs allege that, only days before their demand, Lenig and Gilman appointed three individuals to the Board resulting in the five director board upon which demand was made. Following the Board's appointment of Lenig and Gilman to the special committee, two of the three new directors immediately resigned while the third was promptly terminated.[7] The Plaintiffs allege that the Board is now comprised of only Lenig and Gilman as a result. The special committee charged with investigating the allegations found in the Plaintiffs' demand letter and making a recommendation to the Board is therefore comprised of the only two remaining board members, both of whom the Plaintiffs accuse of wrongdoing, and of a disabling lack of independence by virtue of their control by Defendant Kazeminy.[8]

The special committee has moved to dismiss the derivative complaint or, in the alternative, to stay these proceedings pending the completion of its investigation. The other Defendants join in that motion. For the reasons that follow, the Court will dismiss the complaint.

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[7] Pls.' Mem. in Opp'n at 3.
[8] Compl. ¶¶ 16, 52.

III. DISCUSSION

A. *Demand and Demand Futility*

A basic principle of the Delaware General Corporation Law is that the directors, and not the stockholders, manage the business and affairs of the corporation.[9] The decision to bring or to refrain from bringing suit on behalf of a corporation is the responsibility of the board of directors.[10] However, the derivative action enables shareholders, in certain circumstances, to bring suit on behalf of a corporation when those in control have refused to do so themselves. The derivative action is, in essence, a suit by the shareholders to compel the corporation to sue coupled with a suit by the corporation, controlled by the shareholders on its behalf, against those allegedly liable to it.[11]

Court of Chancery Rule 23.1 requires that a shareholder seeking to assert a claim on behalf of the corporation first make demand on the directors to obtain the action desired, or to state with particularity the reasons for the shareholder's failure to

[9] 8 *Del. C.* § 141(a).
[10] *Spiegel v. Buntrock*, 571 A.2d 767, 773 (Del. 1990).
[11] *Id.*

make such effort.[12] The rule "is designed to give a corporation, on whose behalf a derivative suit is brought, the opportunity to rectify the alleged wrong without suit or to control any litigation brought for its benefit."[13] The requirement of demand effectuates the "cardinal precept"[14] that directors manage the business and affairs of the corporation.

Action (or inaction) of a board of directors is generally subject to review under the deferential business judgment rule, which presumes that a board is independent, and acts reasonably and in good faith.[15] When a derivative plaintiff seeks to avoid pre-suit demand and proceed with litigation on behalf of the corporation, this Court will ask whether these threshold presumptions of director independence and disinterestedness are rebutted by well-pleaded, particularized facts and whether the complaint presents particularized facts that otherwise create a reasonable doubt that the challenged conduct was a valid exercise of business judgment.[16]

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[12] Ct. Ch. R. 23.1(a) ("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.").
[13] *Lewis v. Aronson*, 466 A.2d 375, 380 (Del. Ch. 1983), *rev'd on other grounds*, 473 A.2d 805 (Del. 1984).
[14] *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984), *overruled on other grounds*, *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).
[15] *See generally Brehm*, 746 A.2d at 264 n.66 (citing *Aronson*, 473 A.2d at 812).
[16] *Levine v. Smith*, 591 A.2d 194, 205 (Del. 1991), *overruled on other grounds*, *Brehm*, 746 A.2d at 244.

But, where a shareholder instead chooses to make a demand upon a board of directors, she concedes the independence of a majority of the board.[17] Thus, where a shareholder's demand has been refused, this Court only examines the good faith and reasonableness of the board's investigation.[18] The Plaintiffs in this action made pre-suit demand on DMT's board of directors. As a result, they have conclusively conceded the independence of the Board, and are precluded from now arguing that demand should be excused because the directors are conflicted.[19]

> Delaware law is quite strict as to the application of Chancery Rule 23.1. If a presuit demand is made upon the directors, the stockholder is deemed to have conceded that a failure to have made a presuit demand would not be excused. The Delaware Supreme Court has held that "once a demand has been made, absent a wrongful refusal, the shareholders' ability to initiate a derivative suit is terminated."[20]

On this point Delaware law could hardly be clearer.[21] Here, the Plaintiffs made demand and, because the allegations in the derivative compliant are precisely those

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[17] *See Stone v. Ritter*, 911 A.2d 362, 366-67 (Del. 2006); *Charal Inv. Co., Inc., v. Rockefeller*, 1995 WL 684869, at *2 (Del. Ch. Nov. 7, 1995); *Rales v. Blasband*, 634 A.2d 927, 935 n.12 (Del. 1993); *Levine*, 591 A.2d at 194; *Spiegel*, 571 A.2d at 775; *Stotland v. GAF Corp.*, 469 A.2d 421 (Del. 1983); *Grimes v. Donald*, 1995 WL 54441 (Del. Ch. Jan. 11, 1995); *Thorpe v. CERBCO, Inc.*, 611 A.2d 5, 10-11 (Del. Ch. 1991).
[18] *See Spiegel*, 571 A.2d at 777.
[19] *Thorpe*, 611 A.2d at 10-11.
[20] *Szeto v. Schiffer*, 1993 WL 513229, at *4 (Del. Ch. Nov. 24, 1993) (internal citations omitted).
[21] There is an instance, pre-*Aronson*, in which a derivative plaintiff avoided the effects of a pre-suit demand. It does not, however, suggest any ambiguity as to the effect of making a demand. In *Abbey v. Computer & Commc'n Tech. Corp.*, 457 A.2d 368 (Del. Ch. 1983), this Court found that a

raised in their demand, they are bound to their concession that demand was required.[22]

Yet, the Plaintiffs implore the Court for exception from this well-established rule. They first argue that the present composition of the Board renders it incapable of making an independent decision regarding the desired litigation. Because both the Board and its special committee are comprised of allegedly conflicted directors Lenig and Gilman, the Plaintiffs argue that the Board's consideration of their demand is "a mockery," "pretend," "contrived," and "a farce meant to give the illusion of independence where none exists."[23] If the allegations in the derivative complaint are true, the Plaintiffs might well be correct. Nevertheless, this Court cannot diverge from settled law.

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board's designation of a special litigation committee with final and absolute authority to make decisions concerning an already filed derivative complaint conceded demand excusal, despite the plaintiff's pre-suit demand. *Abbey* is procedurally distinguishable from this situation where the special committee in question was designated in response to the Plaintiffs' demand, prior to the filing of the derivative complaint, and was not given final and absolute authority. In *Abbey*, this Court found the board to have properly invoked the procedures outlined in *Zapata Corp. v. Maldanado*, 430 A.2d 779 (Del. 1981), and the case is better read as an illustration of the distinction between a board's decision-making authority and its investigative authority. *See* DONALD J. WOLFE, JR. & MICHAEL A. PITTENGER, CORPORATE AND COMMERCIAL PRACTICE IN THE DELAWARE COURT OF CHANCERY § 9.02[b][3], at 9-81 (2009) (citing *Spiegel*, 571 A.2d at 776 n.18).

[22] *See Grimes v. Donald*, 673 A.2d 1207, 1219-20 (Del. 1996), *overruled on other grounds*, *Brehm*, 746 A.2d at 244.

[23] Pls.' Mem. in Opp'n at 1-3, 10.

Curiously, the Plaintiffs' do not make their plea for exception based on new information. Rather, they maintain that the Board lacked independence since at least the time of their demand. Indeed, the Plaintiffs state in their demand letter that "four of the five members of the Board are not independent but are controlled by and beholden to Mr. Kazeminy."[24] In light of these facts, the Plaintiffs' decision to make a demand upon the Board appears improvident. The Plaintiffs ask the Court to undo the consequences of their demand; this Court will not part ways with established Delaware law to grant the Plaintiffs relief from a strategic decision they now regret.

Alternatively, the Plaintiffs argue that their demand "was withdrawn" when the Board failed to comply with the terms of their demand.[25] The Plaintiffs argue that the special committee's failure to keep them informed as the investigation began and to pledge the completion of the investigation by October 31, 2008, (twenty-one days after demand) renders their demand a nullity.[26] There, of course, is no prescribed procedure that a special committee must follow when responding to a shareholder demand.[27] To allow Plaintiffs the ability to dictate the manner in which the Board, or

[24] Compl. Ex. G at 5.
[25] Pls.' Mem. in Opp'n at 5 (citing Compl. Ex. G at 5).
[26] *Id.* at 6.
[27] *Levine*, 591 A.2d at 214.

its special committee, investigates their allegations would "be an unwarranted intrusion"[28] upon the authority our law confers on a board of directors to manage the business and affairs of the corporation. Because the Plaintiffs chose to make a pre-suit demand on the Board they are precluded from now arguing demand futility here.

B. *Stay or Dismissal*

Once a shareholder makes demand on the board, it must allow the board a reasonable time to investigate and respond to the claim prior to filing suit.[29] Whether the board has taken more than a reasonable amount of time to conduct its investigation is a fact question, and one for which no strict formula exists.[30] Reasonable minds might differ as to what time period is necessary to conduct an investigation.[31] Here, the parties disagree as to this point.

The Defendants inform the Court that a five month period is required for the completion of their investigation.[32] The Plaintiffs disagree, and assert that sufficient time has already passed for the conduct of an investigation.[33] Although the Court

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[28] *Id.*
[29] *Charal Inv. Co., Inc.*, 1995 WL 684869, at *3.
[30] *Id.*
[31] *Id.*
[32] Defs.' Br. in Supp. at 22.
[33] Pls.' Mem. in Opp'n at 16.

acknowledges that more time may be required to conduct the necessary investigation because of the delay and interference resulting from the intervening, and premature, filing of the Plaintiffs' derivative complaint, the special committee has offered no persuasive reason as to why its investigation would take so long. Nevertheless, the proper procedure is to dismiss the derivative complaint without prejudice, instead of staying the action and retaining jurisdiction.[34]

IV. CONCLUSION

Accordingly, for the foregoing reasons, the Defendants' Motion to Dismiss the derivative complaint is granted.

IT IS SO ORDERED.

Very truly yours,

/s/ John W. Noble

JWN/cap
cc: Michael P. Migliore, Esquire
Register in Chancery-K

[34] *See Charal Inv. Co., Inc.*, 1995 WL 684869, at *4-5.