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Haynes and Boone Represents Victorious Directors in Texas Supreme Court Ruling on Shareholder Derivative Suits and Demand Letters

Today the Texas Supreme Court issued a ground-breaking ruling on shareholder derivative suits against Texas corporations. The decision, *In re Schmitz, et al.*, represents the first ruling by the highest court in Texas on the strict statutory prerequisites for commencing shareholder derivative litigation established by the 1997 amendments to the Texas Business Corporations Act (and subsequently incorporated into the more recent Texas Business Organization Code). The Court's decision represents a significant victory for businesses that elect to incorporate under the laws of Texas. Haynes and Boone, LLP represented the directors of Lancer Corporation, the victorious parties in this case.

In an 8-0 decision (Chief Justice Wallace P. Jefferson did not participate), the Court rejected a two-sentence pre-suit demand letter sent by the law firm Lerach Coughlin Stoia Geller Rudman & Robbins on December 20, 2005, only three days before that firm filed a shareholder derivative suit against Lancer directors arising from an announced merger with Hoshizaki America at a share acquisition price of \$22 per share. The firm's letter did not identify a client and did not state that the firm represented any Lancer shareholder. The letter noted the existence of a competing \$23 per share offer, gave Lancer's directors one day to "confirm to us, in writing" that the board was "taking no further steps to consummate or in any way facilitate the previously announced sale to Hoshizaki America, Inc.", and cautioned the directors that "[y]our fiduciary obligations require that you fully and fairly consider all potential offers." After the derivative suit was filed against the Lancer directors on December 23, 2005, in Bexar County, Texas, no effort was made to enjoin the Lancer/Hoshizaki merger, and the transaction closed as planned in early 2006. After the merger, an amended petition was filed seeking rescission, damages and attorneys' fees.

The Lancer directors asserted that the Lerach Coughlin letter was an inadequate pre-suit demand under article 5.14(c) of the Texas Business Corporations Act because it referenced no client, cited no specific wrongdoing by any party, described no injury to the corporation and failed to request any specific remedial action be taken by the Lancer Board. Defendants' motion to dismiss the suit on these grounds was denied, as was a mandamus petition filed in the Fourth Court of Appeals at San Antonio. A mandamus petition to the Texas Supreme Court was accepted, and that Court heard arguments on April 2, 2008.

Shareholder Must Be Identified in the Demand Letter. In its ruling today, the Court held that while article 5.14 "does not expressly state that a pre-suit demand must list the name of a shareholder," "because parts of the article and most of its purposes would be defeated otherwise, we hold that a demand cannot be made anonymously." The Court reasoned that "[g]iven the interrelation between the demand and the subsequent suit, it is hard to see how or why the demand could be made by anyone other than the shareholder who will file the suit." The Court further reasoned that the corporation must be provided the shareholder's name (i) because article 5.14 provides the corporation a specified period to consider the demand and "advise" the shareholder of its determination; (ii) because the "identity of the complaining shareholder may shed light on the veracity or significance of the facts alleged in the demand letter ("a demand from Warren Buffett may have different implications than one from Jimmy Buffett"); (iii) "a corporation cannot be expected to incur the time and expense involved in fully investigating a demand without verifying that it comes from a valid source," and (iv) because of concerns over "the potential for abuse if demands can be sent without identifying any shareholder."

Content of Demand Letter Must Be Particular. The Court found that the demand letter was insufficiently particular. The Court noted that the Texas Business Corporations Act requires a written demand “setting forth with particularity the act, omission, or other matter that is the subject of the claim or challenge and requesting that the corporation take suitable action.” The Court found that, in the context of a potential sale, simply noting the existence of a higher offer is insufficient. “[O]ne cannot say whether the \$23 offer was superior to the \$22 offer without knowing a lot more. A rule requiring that a corporation always accept nominally higher offers, in addition to sometimes harming shareholders, would replace the business judgment that Texas law requires a board of directors to exercise. As a result, a board cannot analyze a shareholder’s complaint about a higher competing offer without knowing the basis of that complaint.” The Court also found that the letter’s admonishment to directors that they “fully and fairly consider all potential offers” was a “bland statement of a corporate board’s duties [that] could be sent to any board at any time on any issue. The demand did not suggest how the board had failed to consider other offers, or what information it might be withholding. Thus, it gives no direction about what Lancer’s board should have done here.”

Mandamus Relief is Appropriate for Inadequate Demand Letters. The Court also held that interim review of the challenged pre-derivative suit demand letter by mandamus was appropriate. The Court held that mandamus may be available upon a showing that (1) a trial court clearly abused its discretion by failing to correctly apply the law, and (2) the benefits and detriments of mandamus render appeal inadequate. The Court held that “allowing this case to proceed to trial would effectively allow a shareholder to sue for damages connected with a merger without giving the corporation’s board an opportunity to make such a decision for itself. As that would defeat the substantive right the Legislature sought to protect, we hold mandamus relief is warranted.”

The Potential Impact. At issue in the *Schmitz* case was not whether a shareholder may make a demand on directors through an attorney but whether, at a minimum, some shareholder must be identified as the source of the demand. The Texas Supreme Court’s decision today recognizes that anonymous demand letters are contrary to the language and spirit of Texas corporate law and would defeat the very purpose of the pre-suit demand requirement. Moreover, a vague warning to the board to mind its fiduciary duties does not sufficiently describe the factual basis for a purported claim “owned” by the corporation and fails to direct the board to take specific action to remedy the grievance. Directors are not clairvoyant and cannot be expected (or required) to act where a shareholder does not specify who he or she is, what specifically has gone wrong and what actions should be taken.

Appellate Significance. Today’s ruling makes clear that mandamus will be available to protect Texas corporations from lengthy, disruptive, and costly litigation brought by shareholders where the statutory demand requirements have not been satisfied. More broadly, when, as here, the very act of proceeding to trial—regardless of outcome—would defeat the substantive right involved, businesses that receive unfavorable interlocutory rulings in Texas state courts should consider seeking mandamus relief.

For more information about this case, visit the firm’s [Securities Litigation](#) or [Appellate](#) practices, or contact one of the lawyers below.

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