

Chancery Court Claims for Breach of Fiduciary Duty Dismissed for Failure to Establish Demand Utility

Wednesday, October 10, 2018

In *Jennifer L. Stritzinger v. Dennis Barba, et al.* Civil Action No. 12776-CB, the Delaware Court of Chancery granted the defendants' motion to dismiss Stritzinger's derivative lawsuit for breach of fiduciary duty for alleged mismanagement of Newark Country Club (the "Club"), a private corporation located in Newark, Delaware. The Court dismissed Stritzinger's suit finding Stritzinger failed to establish demand futility before filing suit against the Club.

The Club struggled financially in recent years, suffering net losses of over \$400,000 in 2016 alone. During that time, developers had approached the Board of Directors of the Club (the "Board"), consisting of 12 directors, regarding opportunities to sell the Club. The Board rejected these offers each time, instead preferring to keep the Club open for the recreational enjoyment of its members. Stritzinger, who was an equity holder in the Club but not a recreational member, thought the Board was not acting in the best interest of the equity holders in rejecting these proposals.

On May 21, 2016, Todd Ladutko, a member of the Board, emailed the rest of the Board with a proposal to help solve the Club's financial difficulties. Ladutko suggested that the members of the Club create a limited liability company to loan money to the Club, and the loan would be secured by a mortgage on the Club's property. Following the proposal, the Board held a "town hall meeting" with its members in which it discussed several options for the long-term future of the Club. Those options included merging with another Club, selling the Club to a land broker, working with the City of Newark to sell the city development rights, or adopting Ladutko's suggestion of forming an LLC to provide the Club with a loan.

The Board decided to accept Ladutko's plan and several members and equity holders in the Club formed Newark Country Club Mortgage Company, LLC (the "Mortgage Company"). Responding to concerns and questions from its members, the Board of the Club explicitly stated that the goal of a potential loan arrangement with the Mortgage Company would be to repay short-term obligations and that it would not rescue the club from its long-term financial difficulties.

On December 4, 2016, the Board adopted a financing agreement with the Mortgage Company. Five of the twelve board members held equity in the Mortgage Company, and they did not participate in the vote to enter into the loan agreement. On January 4, 2017, the Mortgage Company loaned the Club \$399,000 at an interest rate of 5.75%.

Stritzinger initially filed a complaint with a motion for expedited proceedings seeking to prevent a transaction between the Club and the Mortgage Company on September 27, 2016. On November 3, 2016, the Court rejected Stritzinger's motion for expedited proceedings because Stritzinger was unable to show the threat of irreparable harm. On September 14, 2017, Stritzinger amended her complaint, and in response to defendants' motion to dismiss, filed a second amended complaint. In the current decision, the court addressed defendants' motion to dismiss Stritzinger's amended complaint.

Count I of the complaint alleged that the Board of the Club breached its fiduciary duties to the members. The defendants moved to dismiss the claim on the grounds that Stritzinger had not made a pre-suit demand on the directors, nor had she shown that demand would have been futile. Because Stritzinger did not make a demand of



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the Board, the Court utilized the *Aronson v. Lewis* factors to determine whether demand would have been futile. Under *Aronson*, a plaintiff can show demand would be futile by stating “particularized factual allegations that raise a reasonable doubt that (1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.”

The court held that Stritzinger had not met either of the *Aronson* factors and therefore it dismissed Count I. While five of the twelve board members were interested in the transaction because they held equity in the mortgage company, the other seven members were independent. The court noted that Stritzinger’s complaint did not allege that any of the remaining seven directors had a “personal interest in the Loan transaction”, nor did the complaint allege that the seven directors were “beholden” to the five directors who were interested.

Stritzinger argued, however, that the first prong of *Aronson* was met because the seven disinterested members of the Board acted in bad faith and faced a substantial likelihood of liability for their actions. The Court noted that there is a dispute as to whether a “substantial likelihood of liability” theory used to challenge the impartiality of directors fits into the first or second prongs of *Aronson*. However, the court determined that it did not need to resolve that dispute because the complaint did not allege facts that could lead to a conclusion that the Board acted in bad faith. The fact that the Board had a town-hall style meeting to assess its options was exculpatory, and suggestive of the fact the Board acted in what it thought was the best interest of the Club. Additionally, the terms of the loan agreement were commercially reasonable.

The court dismissed Count II of the complaint for failure to state a claim for relief. Stritzinger sought the appointment of a receiver for the Club, because of her allegations that the Club had been recklessly mismanaged. The Court of Chancery may appoint a “custodian or receiver upon evidence of fraud, gross mismanagement, positive misconduct by corporate officers, breach of trust, or extreme circumstances showing imminent danger of great loss which cannot otherwise be prevented.” The court refused to grant such a remedy because “such form of relief is radical and should be granted grudgingly”, and because Stritzinger’s allegations were “conclusory and unsubstantiated”.

As a result the court granted the defendants’ motion to dismiss on both counts with prejudice.

PDF Attachment of *Jennifer L. Stritzinger v. Dennis Barba, et al.* Civil Action No. 12776-CB (Del. Ch. August 31, 2018)

Geoffrey Locher contributed to this post.

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