

WESTERN INVESTMENT HEDGED
PARTNERS LP, et al.

Plaintiffs

v.

SUNSET FINANCIAL RESOURCES,
INC.

Defendant

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IN THE
CIRCUIT COURT
FOR
BALTIMORE CITY
Part 20
Case No.: 24-C-05-009540

MEMORANDUM OPINION

I. Introduction

In this action the plaintiffs are two Delaware limited liability companies, a Delaware limited partnership and an individual, Arthur D. Lipson, all having as their principal place of business Salt Lake City, Utah, and all having a primary business purpose of acquiring, holding and disposing of investments in various companies. In the aggregate, plaintiffs are the owners of 1,021,300 shares of common stock of the defendant, Sunset Financial Resources, Inc., a Maryland Real Estate Investment Trust (“REIT”). Their holdings represent approximately 9.7% of Sunset’s total outstanding common stock, as reported by the company on August 10, 2005.

The complaint contains two counts seeking declaratory relief and two counts seeking injunctive relief concerning amendments to Sunset’s by-laws adopted on August 31, 2005 and October 5, 2005, respectively.

The plaintiff investors, being unhappy with the defendant REIT’s performance, made a letter request on August 27, 2005 for a special meeting of shareholders for the purpose of removing a majority of board members and replacing them with directors sharing the plaintiffs’

interests. According to the complaint, the defendant's board of directors amended its by-laws on August 31, 2005 to increase the number of shareholders required to request a special meeting from 25% to 50%. Thereafter, on October 3, 2005 plaintiffs filed a Preliminary Consent Solicitation Statement with the SEC, seeking written consent to cause a special meeting of the company's stockholders for the purpose, *inter alia*, of removing each member of the current board. According to the complaint, on October 5, 2005, two days after plaintiffs filed their preliminary consent solicitation, the defendant's board of directors again changed the company's by-laws in three additional ways, which plaintiffs contend were intended to serve the purpose of frustrating their efforts to convene a special meeting and effect their desired changes in the board of directors.

On October 28, 2005, plaintiffs filed the present complaint seeking a declaration setting aside the recent amendments to the company's by-laws and enjoining their enforcement.

Following the scheduling conference on December 14, 2005, the parties proceeded with limited discovery and on February 8, 2006, defendant filed a motion for summary judgment and plaintiffs filed a motion to strike defendant's proposed expert testimony. The Court conducted a hearing on the pending motions on March 3, 2006, at which time it granted in part and denied in part plaintiffs' motion to strike defendant's proposed expert testimony and held *sub curia* defendant's motion for summary judgment.

For the reasons set forth in this Memorandum Opinion, the Court will **GRANT** defendant's summary judgment motion.

II. The August 31, 2005 By-law Amendment

On August 31, 2005 defendant's board of directors amended Sunset's by-laws to change

the requirement for calling a special meeting of stockholders from a 25% minority interest to a simple majority interest of Sunset's outstanding shares (§ 1.11). Plaintiffs contend and defendant concedes that the by-law amendment was occasioned by receipt of plaintiffs' August 27 letter, requesting a special stockholders' meeting. Plaintiffs allege that this is an unlawful defense mechanism, enacted for the sole purpose of entrenching the management's board of directors and thwarting the efforts of the plaintiff investors to convene a special stockholders' meeting for the purpose of replacing a majority of the board. Defendant contends that the August 27 letter merely alerted the board to the fact that Sunset's original by-laws permitted a minority of dissident stockholders to require a potentially disruptive and expensive special meeting even in the face of opposition from 75% of the stockholders. Moreover, Sunset's charter requires a 2/3 majority vote of stockholders to remove a director and defendant argues that it would be wasteful and needlessly disruptive to hold a special meeting unless the holders of at least a majority of outstanding shares desired same.

III. The October 5, 2005 By-law Amendments

Defendant's board of directors held a meeting on October 5, 2005, at which time additional by-law amendments were adopted. These by-laws addressed the procedure and time limitations for the board to set record dates for requesting a special meeting and voting at a special meeting (§§ 1.2 and 1.4); the procedure for nominating and electing directors at special meetings (§ 1.11(b)); a requirement for advanced payment of certain costs associated with special meetings (§ 1.2(b)(3)); and a provision permitting the secretary to cancel a special meeting up to ten days before the meeting date if a sufficient number of stockholders revoked their requests for the special meeting (§ 1.2(b)(5)).

Again, the parties dispute the motivation behind the adoption of these by-law amendments. Plaintiffs point to the timing and the obvious relationship between what they consider unlawful defense mechanisms and their efforts to initiate a special meeting for the election of new directors. Defendant characterizes the amendments to the by-laws as form provisions adopted at the suggestion of Sunset's counsel for the purpose of filling in blanks that existed in the original company by-laws.

IV. Discussion

_____ Last year, this Court issued a Memorandum Opinion in *Shaker v. Foxby Corp.*, 2005 WL 914385, in which I set forth my belief “that the directors owed plaintiff [a dissident shareholder] a statutory and common law duty to enact by-laws containing fair voting procedures.” In *Shaker* the Court was ruling on a motion to dismiss or, in the alternative, for summary judgment and I stated further that “the reasonableness and/or the discriminatory effect of the by-law amendments in question raise mixed questions of law and fact, better resolved following discovery.”

(Citations omitted).

Faced with a dearth of relevant case law in Maryland, the *Shaker* opinion relied primarily upon principles of corporate governance extracted from recent Delaware cases, most notably *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437 (Del. Supr. 1971) and *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988), which stand for the general proposition that the deferential business judgment rule is not applicable to board actions taken for the primary purpose of interfering with the stockholder's vote, even if taken advisedly and in good faith.

In *Shaker*, this Court disagreed with defendants' contention that the directors of a Maryland corporation owe no fiduciary duties to stockholders and that the duties they owe are

solely to the corporation, as prescribed in Md. Code Ann., Corps. & Ass'ns, § 2-405.1. In that decision, I quoted with approval the Delaware Chancery Court's language in *Blasius* to the effect that "the shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests ...", *Id.*, 564 A.2d at 659. While embracing the corporate principles established in the Delaware courts concerning the primacy of shareholder voting rights in a change of control context, the Court stopped short of embracing the principle further enunciated in *Blasius* that directors' actions taken in good faith may constitute an "unintended violation" of the duty of loyalty that the board owes to shareholders. *Id.*, 564 A.2d at 663 and cases cited therein.

Plaintiffs here concede that the August 31, 2005 by-law amendment is facially lawful. They are hard-pressed to contend that any of the October 5, 2005 by-law amendments, viewed independently, would be found to be unreasonable exercises of the board's authority.¹

The gravamen of plaintiffs' complaint is that, in the context of this case, where Sunset's board of directors was faced with plaintiffs' request for a special meeting of shareholders and its October 3, 2005 SEC preliminary consent solicitation statement, the enactment of the questioned corporate by-law amendments were unreasonable and undertaken for the primary purpose of entrenching the management board of directors.

Unlike the record before the Court in *Shaker v. Foxby Corp.*, the parties in the present

¹ Plaintiffs attach particular significance to § 1.2(b)(3) of the amended by-laws relating to the requirement of advanced payment of certain costs associated with a special meeting and they contend that this provision could be read to impose prohibitive costs and impair shareholder entitlements. In the Court's judgment, however, the provision is at worst unclear and defendant has stipulated on the record, through counsel, that its sole intent is to impose the costs associated with mailing special meeting notices, as permitted by Md. Code Ann., Corps. & Ass'ns, § 2.502(b)(3).

action have had the opportunity to partake in discovery. Despite the exchange of documents and the opportunity to take deposition testimony, the record contains little of significance to support plaintiffs' claims. To the contrary, plaintiff Arthur Lipson has testified that he would not anticipate any difficulty in complying with the simple majority by-law amendment enacted on August 31, 2005. Although plaintiffs elicited deposition testimony from Sunset's directors Deehan and Bennett suggesting a defensive reaction to plaintiffs' attempts to oust certain board members, the court does not view the board's actions as creating unfair obstacles to the exercise of plaintiffs' shareholder rights. The directors acted in good faith and will not be held accountable for any unintended violations of their duties to the stockholders.

Moreover, unlike the situations in *Shaker v. Foxby Corp.* and *Blasius Indus., Inc. v. Atlas Corp.*, the by-law amendments in question here cannot be characterized so much as "defensive mechanisms" as necessary provisions wholly lacking in the original corporate by-laws and necessary to establish appropriate procedures for conducting special meetings of stockholders. Indeed, one of the primary by-law amendment provisions attacked by plaintiffs as a new obstacle for the stockholders to overcome is the provision in § 1.2(b)(5), allowing the corporation's secretary to cancel special stockholder meetings up to ten days prior to the meeting itself. This is not a new by-law provision. The board had the power to cancel special stockholder meetings under its original by-laws.

Under the circumstances of the present case, the Court does not view Sunset's questioned by-law amendments as exceeding the scope of permissible actions contemplated by Md. Code Ann., Corps. & Ass'ns, § 2-110. Nor does the record evidence suggest that their primary purpose was to frustrate shareholder voting rights in an effort to entrench management's board of

directors. In fact, a question which remained unanswered at the hearing was why Arthur Lipson and the other plaintiffs have not yet attempted to utilize the corporate by-laws, as amended, to further their purposes in calling a special stockholders' meeting and electing their own slate of directors. The simple answer may be that such action would moot their claims in this lawsuit.

V. Conclusion

Having found the enactment of defendant Sunset's by-law amendments on August 31 and October 5, 2005 to be valid as a matter of law, the Court will **GRANT** defendant's motion for summary judgment.

ALBERT J. MATRICCIANI, JR.
Judge
March 7, 2006

cc: All Counsel of Record