ALERTS AND UPDATES

Third Circuit Holds That Pa. Appraisal Statute Does Not Prevent a Dissenting Shareholder from Separately Pursuing Claim for Breach of Fiduciary Duty Post-merger

September 8, 2011

In deciding an "important issue of Pennsylvania corporate law that the Supreme Court of Pennsylvania has not yet explicitly addressed," the U.S. Court of Appeals for the Third Circuit recently reinstated a dismissed lawsuit and held that minority shareholders who dissented to a merger were not limited to state appraisal proceedings as their sole post-merger remedy. *Mitchell Partners, L.P., v. Irex Corp., et al.*, Nos. 10-4040 and 10-4091 (precedential opinion, August 31, 2011). The Third Circuit predicted that the Supreme Court of Pennsylvania would hold that Pennsylvania's appraisal statute does not prevent a shareholder from pursuing a separate, post-merger lawsuit for breaches of fiduciary duty.[1]

I. Allegations of the Complaint: Insider Shareholders Purportedly Plan to Acquire Control of the Corporation and to Buy Out Minority Shareholders at an Unfair Price.

In *Mitchell Partners*, a corporation's president/CEO/chairman allegedly concocted a plan where favored insider shareholders would acquire 100-percent control of the corporation through a merger with a holding company controlled by those insider shareholders. The plaintiff was a substantial minority shareholder (the "Minority Shareholder"), but it was not among the favored insider shareholders. The corporation formed a special committee (the "Special Committee") to review the proposed merger and to negotiate on behalf of all minority shareholders. However, according to the Minority Shareholder, the insider directors influenced and controlled the Special Committee's consideration of fair value for the minority stock in several ways, thereby breaching the fiduciary duties they owed to all minority shareholders.[2]

At the time of the shareholder vote, the holding company held 71 percent of the corporation's shares and voted those shares in favor of the merger. The Minority Shareholder and one other shareholder dissented and did not vote in favor of the merger; the transaction closed 10 days later.

II. Federal District Court Dismisses the Minority Shareholder's Class Action Complaint, Holding That the Minority Shareholder's Exclusive Post-merger Remedy Was an Ongoing Appraisal Proceeding in Pennsylvania State Court.

Pennsylvania law provides a shareholder who dissents to a merger the right "to obtain payment of the fair value of his shares." 15 Pa. Cons. Stat. § 1571. Three months after the transaction closed, the corporation filed an appraisal action against the Minority Shareholder and the other dissenter in the Pennsylvania Court of Common Pleas.[3] In an appraisal action, a dissenting shareholder is entitled to the fair valuation and payment of the dissenter's shares. *Id.* § 1571.[4] The corporation claimed that the fair value of the shares was $66 per share; the Minority Shareholder countered that the fair value was approximately $181 per share.

While the appraisal proceeding was still pending, the Minority Shareholder filed a class action complaint in federal court alleging breach of fiduciary duty; aiding and abetting breach of fiduciary duty; and unjust enrichment against the corporation, the holding company, the individual insider directors and officers, and the Special Committee members. The defendants contended, and the federal district court agreed, that the federal action was foreclosed by Pennsylvania state law—namely 15 Pa. Cons. Stat. § 1105, titled "Restriction on equitable relief" ("Section 1105").[5] The federal district court held that, because the lawsuit was brought after the merger had been consummated, it was barred by the appraisal statute, which the federal district court reasoned provided the sole post-merger remedy to dissenting minority shareholders. The Minority Shareholder appealed the dismissal of the complaint.

III. Third Circuit Reverses and Reinstates the Complaint, Holding (and Predicting) That the Pennsylvania Supreme Court Would Permit a Dissenting Shareholder to Litigate, Post-merger, a Separate Lawsuit for Breach of Fiduciary Duty.

Because the Pennsylvania federal courts heard the lawsuit under their "diversity of citizenship" jurisdiction, the district court and the Third Circuit needed to apply the law as established by the Pennsylvania Supreme Court. While some Pennsylvania state court opinions (the "*Jones* opinions") have held that dissenting shareholders could not challenge the validity of mergers in a state court appraisal proceeding and that the sole issue over which an appraisal court had jurisdiction was the appraisal itself,[6] the Pennsylvania Supreme Court had never addressed the narrow issue of whether a separate, post-merger suit for breach of fiduciary duties could be litigated. While there was Third Circuit precedent (the "*Herskowitz* opinion") entitling a

shareholder to bring, prior to the merger, a separate claim for a breach of fiduciary duty,[7] there was no Third Circuit precedent specifically holding that a minority shareholder could bring a breach of fiduciary duty claim *post-merger*, as the Minority Shareholder attempted to do.

Nevertheless, based on the language of Section 1105, the *Jones* opinions and the *Herskowitz* opinion, the Third Circuit predicted that the Supreme Court of Pennsylvania would permit a post-merger suit for damages based on the majority shareholders' breach of their fiduciary duties. The Third Circuit reached this prediction for several reasons:

- As argued "persuasively" by the Minority Shareholder, the appraisal remedy permits recovery only from the corporation, and therefore, any statutory limitations would extend only to lawsuits against the corporation. Moreover, barring fiduciary duty suits against majority shareholders would do little more than insulate alleged tortfeasors from responsibility for their conduct.
- The "fair value" available in an appraisal proceeding is a narrower remedy than the damages potentially available for fiduciary breaches. A dissenting shareholder who proves a breach of fiduciary duty might be entitled to damages beyond those available in an appraisal proceeding (*e.g.*, appreciation or depreciation in share value, punitive damages). Furthermore, appraisal actions are available only to those shareholders who perfect their rights as dissenters. A minority shareholder might consent to a merger, while unaware of a breach of fiduciary duty that may only become evident post-merger. Under those circumstances, if the appraisal proceeding were the exclusive post-merger remedy, that harmed shareholder might never recover.
- The limitations established under Section 1105 were to prevent a dissident group of shareholders from blocking a merger desired by the majority shareholders and to avoid lawsuits that stymied corporate consolidation and growth. A post-merger damages action would not contravene that goal.
- Moreover, Section 1105 states that the appraisal remedy is not exclusive where there is "fraud or fundamental unfairness." The Third Circuit concluded that allegations of majority self-dealing and misrepresentations, as claimed in this case, fell within the ambit of Section 1105's carve-out that permits suits other than appraisal in the event of fraud or fundamental unfairness.

- Finally, the Third Circuit credited the "persuasive force" of Delaware case law,[8] which similarly authorized post-merger lawsuits other than appraisal proceedings.

Thus, a minority shareholder who dissents to a merger would not be limited to an appraisal proceeding as his or her sole remedy in Pennsylvania courts. Where a minority shareholder believes majority shareholders breached fiduciary duties in consummating a merger, a separate post-merger lawsuit would be permitted by the Pennsylvania federal courts—and, as the Third Circuit predicted, by the Pennsylvania state courts as well.

For Further Information

If you have any questions about this *Alert*, please contact Wayne A. Mack, Matthew M. Ryan, any member of the Commercial Litigation Practice Group or the attorney in the firm with whom you are regularly in contact.

Notes

1. The federal district court and the Third Circuit heard this lawsuit pursuant to their jurisdiction over “diversity of citizenship” cases, whereby a federal court can hear suits between a citizen of the state where the suit is brought, and a citizen of another state. *See* 28 U.S.C. § 1332. Under those circumstances, the federal court must apply the law declared by the supreme court of the relevant state (in this case, the law declared by the Pennsylvania Supreme Court). Where there is no applicable law of the highest court of the state, then federal courts must make a prediction as to the law that would be applied were the issue before that state court. As noted by the Third Circuit, the Pennsylvania Supreme Court has never specifically addressed whether a minority shareholder was entitled to bring, post-merger, a common law breach of fiduciary claim.
2. For example, the insider directors allegedly convinced the Special Committee to apply a steep “asbestos discount” to the share price to reflect the bankruptcy of a corporate subsidiary saddled with approximately 100,000 unresolved asbestos litigation claims. This “asbestos discount” was inappropriately inflated because, allegedly known to the insider directors but withheld from the Special Committee, the subsidiary had initiated litigation against its insurer for coverage of those claims, which litigation was soon to settle on terms highly favorable to the subsidiary.

3. Under Pennsylvania law, an appraisal action is to be initiated by the corporation in a state court action against the dissenting shareholder after the shareholder has dissented and after the merger has been consummated. 15 Pa. Cons. Stat. § 1579.

4. Fair value is statutorily defined as "[t]he fair value of shares immediately before the effectuation of the corporate action to which the dissenter objects, taking into account all relevant factors, but excluding any appreciation or depreciation in anticipation of the corporate action." *Id.* § 1572.

5. Specifically, Section 1105 provides:

   A shareholder of a business corporation shall not have any right to obtain, in the absence of fraud or fundamental unfairness, an injunction against any proposed plan or amendment of articles authorized under any provision of this subpart, nor any right to claim the right to valuation and payment of the fair value of his shares because of the plan or amendment, except that he may dissent and claim such payment if and to the extent provided in Subchapter D of Chapter 15 (relating to dissenters rights) where this subpart expressly provides that dissenting shareholders shall have the rights and remedies provided in that subchapter. Absent fraud or fundamental unfairness, the rights and remedies so provided shall be exclusive. Structuring a plan or transaction for the purpose or with the effect of eliminating or avoiding the application of dissenters rights is not fraud or fundamental unfairness within the meaning of this section.

6. *In re Jones & Laughlin Steel Corp. (Jones I)*, 398 A.2d 186 (Pa. Super. 1979), *aff'd*, *In re Jones & Laughlin Steel Corp. (Jones II)*, 412 A.2d 1099 (Pa. Super. 1980).

7. *Herskowitz v. Nutri/System*, 857 F.2d 179 (3d Cir. 1988).

8. *Cede & Co. v. Technicolor, Inc.*, 542 A.2d 1182 (Del. 1988).