

3d Circuit Permits Pennsylvania Minority Shareholder To Sue Majority Shareholders For Breach Of Fiduciary Duty *After* Completion Of Cash-Out Merger

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In August, 2011, the U.S. 3d Circuit Court of Appeals held that the fact that the Pennsylvania Business Corporation Law (the PBCL) gives appraisal rights to minority shareholders “squeezed out” by a merger *does not* preclude other remedies, including a breach of fiduciary duty claim. In so doing, the 3d Circuit overruled the lower court, which had dismissed the fiduciary duty claim of a minority shareholder (Mitchell) on the basis that appraisal rights are the exclusive remedy available to minority shareholders under such circumstances.

The moral of this case is that principals of a company who want to insulate themselves from liability should not proceed on the mistaken assumption that they will be shielded from claims arising from alleged deficiencies in the merger proceedings or alleged misstatements of fact simply because appraisal rights are available to the minority shareholders.

The merger in this case was structured by the majority insider shareholders of Irex. The directors and insider shareholders exchanged their Irex stock for stock in a newly formed corporation (North Lime), which was wholly owned by the directors and insider shareholders. The minority shareholders, including Mitchell, were squeezed-out and paid cash in exchange for their stock.

In May 2006, the Irex shareholders were informed of the contemplated merger at a purchase price per share of \$60. Mitchell opposed the merger because he felt the purchase price was grossly inadequate. The Irex board formed a special committee of “disinterested” directors to evaluate and negotiate the merger transaction with North Lime on behalf of the Irex shareholders. Mitchell’s complaint alleged that the members of the special committee were not, in fact,

disinterested because of various prior business relationships with the Irex Board members who were insiders. Following negotiations between North Lime and the Irex special committee, the purchase price per share was increased to \$66, a price which Mitchell claimed was still grossly inadequate.

A majority of the Irex shareholders (including North Lime, which then owned 71 percent of the Irex stock) approved the merger. Mitchell and one other Irex shareholder did not vote for the merger. An appraisal action was filed which is still pending.

Mitchell then filed a lawsuit against Irex, North Lime, and the directors, officers, and special committee members, alleging various breaches of fiduciary duty. The defendants filed a motion to dismiss the case, and argued that a shareholder’s only available post-merger remedy is to receive the fair value of the shareholder’s shares, as determined in the statutory appraisal proceeding. The Eastern District Court agreed with the defendants and dismissed Mitchell’s claim, based entirely on legal grounds. Accordingly, on Mitchell’s appeal of the dismissal, the 3d Circuit assumed all facts alleged by Mitchell to be true. Mitchell alleged that the interested board members (i) controlled the information flow to the special committee, (ii) misstated or omitted certain material information in the proxy statement soliciting shareholder support for the merger, and (iii) calculated the purchase price per share with intentional disregard for the effect that the a pending favorable settlement of a litigation against an Irex affiliate would have on the Irex stock price.

The 3d Circuit held that the PBCL provides dissenting shareholders with the appraisal right to be paid fair value for their shares, and noted that Section 1105 of the

PBCL restricts the types of relief available to dissenting shareholders beyond the appraisal right. The *extent* of that restriction was the subject of the 3d Circuit's analysis.

Mitchell argued that while Section 1105 clearly prohibits dissenters from seeking a premerger injunction absent fraud or fundamental unfairness, a dissenting shareholder could nonetheless bring a postmerger common law claim against insiders for breach of fiduciary duty. This was because a breach of fiduciary duty may not actually become apparent until after a merger was completed, and in Mitchell's view the legislature could not have intended for the limited relief provided by appraisal rights to be the exclusive post-merger remedy.

The 3d Circuit agreed, concluding that the prior Pennsylvania cases on which the Eastern District Court had relied were inapplicable to the issue presented. The court interpreted the prior cases to stand for the proposition that the only matter over which a court in an *appraisal proceeding* had jurisdiction was determining fair value. Nothing prevented a minority shareholder, the court reasoned, from maintaining an

independent common law action for breach of fiduciary duty, *in addition to* an appraisal proceeding. As such, it held that a postmerger common law claim against majority shareholders for breach of their fiduciary duty to minority shareholders was not precluded by the exclusivity language in the PBCL. This interpretation is in accord with Delaware's case law, which permits postmerger suits for breaches of fiduciary duty, in addition to statutory appraisal rights.

Having reversed the decision of the lower court, the 3d Circuit acknowledged that Mitchell had yet to actually prove any of the factual allegations which constituted the basis of its fiduciary duty claims. Accordingly, the claim was sent back to the District Court, where the case is still pending.

To discuss any questions you may have regarding the opinion discussed in this Alert!, or how it may apply to your particular circumstances, please contact Michael M. Sherman at msherman@cozen.com or 215.665.2155, or Mark M. Dugan at 215.665.2191 or mdugan@cozen.com.