ReedSmith

Pennsylvania Supreme Court Allows Post-Merger Suits in Cases of Fraud or Fundamental Unfairness

14 August 2012

Authors: Robert K. Morris

Many practitioners in Pennsylvania have long been of the view that in the case of a Pennsylvania merger, no legal claim under state law seeking equitable relief or damages based on unfairness of the merger, or even fraud, could be brought by shareholders after the merger closed. At that point, shareholders, it was thought, are limited to their rights to receive the fair value of their shares in accordance with statutory dissenters' rights. This view was based on the Pennsylvania Supreme Court decision in *In re Jones & Laughlin Steel Corporation*, 412 A.2d 1099 (1980).[1] There, the court stated, based on an analysis of provisions in the Pennsylvania Business Corporation Law of 1933:

> "We wish to emphasize that today's decision does not condone the manner in which appellants and other minority shareholders were deprived of their equitable interest in J&L. We are not unmindful of the grave unfairness and fraud frequently present in mergers of this type, especially where there is a 'cash-out' of the minority shareholders. See Brudney & Chirelstein, A Restatement of Corporate Freezeouts, 84 Yale L. Rev. 1354, 1358-9, 1367-70 (1978). Our concern, however, does not change the view that appellants' post-merger remedies were limited to the appraisal of their stock." 412 A.2d at 1104.

This view was called into substantial question a year ago by the Third Circuit Court of Appeals, which in a diversity action interpreted Pennsylvania law, specifically section 1105 of the Pennsylvania Business Corporation Law of 1988, as permitting certain non-appraisal post-merger claims, notwithstanding the similarity of the 1988 statute to the 1933 statute interpreted in Jones & Laughlin. *Mitchell Partners v. Irex Corporation*, 656 F.3d 201 (2011).

The governor of Pennsylvania and several business groups filed amicus briefs in support of defendant's petition for rehearing by the Third Circuit in the case. The governor expressed

concern that the Third Circuit had interpreted Pennsylvania law in a manner inconsistent with *Jones & Laughlin*. He urged the Third Circuit to grant rehearing, and certify to the Pennsylvania Supreme Court for its decision the issue of whether section 1105 of the BCL precludes all non-appraisal post-merger remedies.

The Third Circuit accepted this invitation and certified the question for decision by the Pennsylvania Supreme Court, which agreed to hear the case earlier this year. The Pennsylvania Supreme Court handed down its decision on the matter on July 24, 2012. It confirmed the Third Circuit's interpretation of section 1105, holding that shareholders could bring a non-appraisal action, after the closing of a merger, asserting fraud or fundamental unfairness. In such a case, shareholders are not limited to their statutory appraisal remedies. *Mitchell Partners v. Irex Corporation*, (Pa. 2012) (Case J-68-2012).

At issue in the case was section 1105 of the Pennsylvania Business Corporation Law, which reads as follows:

> §1105. Restriction on equitable relief.
>
> 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 [15 Pa.C.S. §1571-1580] (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....

The case involved a merger of Irex Corporation, a Pennsylvania corporation, with a wholly owned subsidiary of North Lime Holdings Corporation, which was a newly formed corporation owned by certain officers, directors and shareholders of Irex. In the merger, such shareholders continued their ownership interest in Irex through their ownership of the parent of the surviving corporation in the merger, to which they had contributed their Irex shares. The other Irex

shareholders, including Mitchell Partners, received cash in the merger, and their ownership interest in Irex was terminated.

After the merger, valuation proceedings were commenced with respect to shareholders, including Mitchell Partners, which had perfected appraisal rights pursuant to Subchapter D of Chapter 15 of the BCL. In addition, after the merger, Mitchell Partners filed a diversity action in federal court naming as defendants Irex, its directors, most of its officers, and North Lime Holdings, asserting Pennsylvania state claims for breach of fiduciary duties, aiding and abetting breach of fiduciary duties, and unjust enrichment.

Defendants argued that these claims were barred by section 1105 of the BCL, under the authority of *Jones & Laughlin*, which had interpreted predecessor provisions in the version of the BCL in effect at the time of the decision (the BCL underwent a comprehensive revision in 1988).[2]

In its consideration of the certified issue, the Pennsylvania Supreme Court focused on the second sentence of section 1105: “Absent fraud or fundamental unfairness, the remedies so provided shall be exclusive.” The court stated that “by straightforward implication,” this language indicates that in any action where there is fraud or fundamental fairness, the remedies “so provided,” i.e., those provided in the statutory appraisal process, are not “exclusive.”[3] The court noted that exceptions to the exclusivity of a statutory appraisal remedy are reflected in the Model Business Corporation Act and in the state corporate law of many jurisdictions, and that such exceptions are consistent with the policy concern that an appraisal remedy may be inadequate to vindicate the interests of minority shareholders where they encounter wrongful conduct.

The court determined that the precedential authority of *Jones & Laughlin* should be limited to the factual pattern there presented. That case arose in the context of a statutory appraisal proceeding initiated in the Court of Common Pleas of Allegheny County, where the plaintiffs sought to raise in the proceeding itself, allegations that the merger was invalid. Thus, according to the court in *Mitchell Partners, Jones & Laughlin* stands only for the proposition that the jurisdiction of the appraisal court did not extend to the consideration of a challenge to the validity of the merger, and did not mandate the barring of suits commenced outside the appraisal

proceeding, notwithstanding broad language in Jones & Laughlin stating that appraisal is the only available post-merger remedy.

In addition, the court gave weight to the fact that a change was effected in the statutory provisions as part of the 1988 BCL amendments. Under the version of the statute at issue in *Jones & Laughlin*, the phrase "in the absence of fraud or fundamental unfairness" did not appear in section 515K, the provision that specified that appraisal rights were exclusive. Such phrase appeared only in the separate section 5E, which specified that "in the absence of fraud or fundamental unfairness," there was no right to enjoin a proposed merger. The court noted that the drafting committee comment to section 1105 enacted in 1988 states that the section is "substantially a reenactment of prior sections 515K and 5E," but nevertheless concluded that the "absence of fraud or fundamental unfairness" phrase in section 1105, as a stated exception to appraisal exclusivity in section 1105, should be given general effect, and should not be limited to situations where a claimant seeks a pre-merger injunction.

In interpreting section 1105, the court found, on the issue not before the court in *Jones & Laughlin*, that the provision does serve in one respect as a restriction on claims in non-appraisal proceedings, but only in that such proceedings must be based on fraud or fundamental unfairness. However, the court did not shed much light on what activity would be considered to constitute fraud or fundamental unfairness for this purpose. The court noted (fn7) that it was "beyond the scope of the certified question" to comment on the application of the fraud or fundamental unfairness exception under the facts of the case. However, the court did state that a cash-out transaction is not *per se* fraudulent or fundamentally unfair, and further stated that "mere inadequacy in price" alone does not constitute fraud or fundamental unfairness.

The Third Circuit, however, had previously held that the allegations in the case – that the majority shareholders of Irex had engaged in self-dealing, withheld critical information from and exerted influence over a supposedly neutral special committee of the Irex board of directors that was constituted to consider the transaction, and omitted critical information from a proxy statement distributed to shareholders – were sufficient to satisfy the carve-out in section 1105 for actions involving fraud or fundamental unfairness.

Generally speaking, most actions challenging mergers are brought before the transaction is closed, seeking injunctive relief, as this provides plaintiffs with the greatest leverage. The Pennsylvania Supreme Court decision in *Mitchell Partners* does not represent any change in the law with respect to such actions. However, the decision does suggest a greater post-closing risk than previously, particularly in situations where discovery in appraisal actions provides a basis for a breach of fiduciary duty claim. Unlike appraisal, where recovery is solely from the subject corporation, breach of fiduciary claims can result in liability for a variety of other parties, including directors and controlling shareholders. Also, the measure of fair value in an appraisal action excludes appreciation in value in anticipation of the corporate action, an exclusion that does not apply in the measurement of damages for breach of fiduciary duties.

---

[1] Reed Smith represented *Jones & Laughlin* in that case.

[2] The applicable BCL provision at issue in *Jones & Laughlin* was section 515K, which stated:

> Any shareholder, who desires to object to, or to dissent from, any proposed plan authorized under any section of this act, and where this act provides that shareholders so objecting or dissenting shall have the rights and remedies herein provided, shall be limited to the rights and remedies prescribed under this section, and the rights and remedies prescribed by this section shall be exclusive.

In addition, section 5E stated:

> A shareholder 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 section of this act, or to claim the right to valuation of and payment for his shares because of any such plan or amendment except that he may dissent and claim payment if and to the extent provided in section 515 of this act where this act expressly provides that dissenting shareholders shall have the rights and remedies provided in section 515 of this act.

[3] The court thus did not adopt a possible alternative reading of the text, which would hold that the words “absent fraud or fundamental fairness” in the second sentence of section 1105, which are stated as an exception to the provision for exclusivity of appraisal remedies, are intended to refer only to the circumstance described in the first sentence of section 1105, i.e., the circumstance where a shareholder may prosecute a pre-merger injunction action. This interpretation is suggested by the fact that the first sentence utilizes the identical phrase “absent fraud or fundamental unfairness” in specifying the sole circumstances where an injunction action may be brought. Under this reading, only pre-merger injunction actions based on fraud and fundamental unfairness would be an exception to appraisal exclusivity. Any other action, including post-merger actions whether or not based on fraud and fundamental unfairness, would be barred by the exclusivity of appraisal remedies.