Third Circuit Holds That Appraisal Proceedings Are Not The Exclusive Remedy For Minority Shareholders In Squeeze-Out Mergers

Sitting based on diversity jurisdiction, on August 31, 2011 the United States Court of Appeals for the Third Circuit decided an important issue of Pennsylvania corporate law that the Supreme Court of Pennsylvania has not yet addressed, holding in *Mitchell Partners, L.P. v. Irex Corp.* that Pennsylvania's appraisal statute "does not exclude post-merger suits for damages alleging that majority shareholders breached their fiduciary duties to minority shareholders in the process of consummating a freeze out merger . . . ."[1] In reaching its decision in the absence of controlling Pennsylvania precedent, the Third Circuit found decisions of the Delaware Supreme Court persuasive.

I. Facts and Procedural History

Mitchell Partners, L.P. was a minority shareholder of Irex Corporation ("Irex"), a privately held Pennsylvania corporation. In April 2006, the President, CEO and Chairman of the Irex board proposed a plan to transfer ownership of Irex to the board members and a limited number of participating shareholders (collectively the "insider shareholders") by buying out the minority shareholders. The plan involved the creation of a separate holding company, North Lime Holdings Corp. ("North Lime"), owned and controlled by the insider shareholders, that would acquire 100% of Irex through a cash-out merger between Irex and a wholly owned North Lime subsidiary. Mitchell Partners opposed the merger as a squeeze out of minority shareholders at an unfair price.

The Irex board appointed three new, allegedly disinterested directors, who subsequently formed a Special Committee to review the fairness of the proposed merger, and independently negotiate on behalf of the minority shareholders. After the Special Committee determined the "fair value" of Irex stock was $66 per share, the merger agreement was submitted for shareholder approval, and a proxy statement was distributed to Irex shareholders stating that $66 per share was a "fair price" that was "in the best interest of Irex." Mitchell Partners' complaint alleged a number of breaches of fiduciary duties relating to the veracity of the proxy statement, and the influence and control of the insider directors over the Special Committee, allegedly resulting in an unfair and inaccurate determination of the "fair value" of the minority shareholders' stock.

In February 2007, Irex filed an appraisal action against the dissenters, including Mitchell Partners, in the Pennsylvania Court of Common Pleas, requesting that the court confirm that the fair value of the shares was $66 per share. Mitchell Partners countered that the fair value was approximately $181 per share. The appraisal proceeding was ongoing when this case came before the Third Circuit.

In October 2008, Mitchell Partners filed a putative class action in Pennsylvania District Court alleging breach of fiduciary duty and unjust enrichment against Irex, North Lime, and the individual insider directors/officers of Irex. The complaint also alleged breach of fiduciary duty and aiding and abetting breach of fiduciary duty against the Special Committee members. The defendants moved to dismiss all claims for failure to state a claim. The District Court granted the motion, finding that the breach of fiduciary duty lawsuit was barred by the Pennsylvania appraisal statute because the suit was brought after the merger had been consummated and the appraisal statute provided the sole post-merger remedy to dissenting shareholders. Mitchell Partners appealed, and the Third Circuit reversed.

---

[1] *Mitchell Partners, L.P. v. Irex Corp., et al.*, No. 10-4091, 2011 WL 3841007, *12 (3d Cir. Aug. 31, 2011).

II. The Third Circuit's Decision

The Third Circuit disagreed with the District Court's application of precedent, and interpreted the Pennsylvania appraisal statute in light of Pennsylvania and Third Circuit precedent, as well as Delaware case law which it found persuasive, to allow post-merger suits against majority shareholders for damages arising from fiduciary breaches.

First, the court considered Pennsylvania state and Third Circuit precedent. In *In re Jones & Laughlin Steel Corp. (Jones I)*,[2] the Pennsylvania Superior Court ruled that a party could not obtain equitable relief through an appraisal proceeding commenced after a merger was complete. The Pennsylvania Supreme Court affirmed the decision (*Jones II*), emphasizing the interest in preventing a small group of dissidents from blocking a merger desired by the majority of shareholders. However, in affirming the Superior Court decision, the Pennsylvania Supreme Court noted that limiting the appraisal proceeding to questions of fair value did not preclude parties from seeking equitable relief in separate, pre-merger actions.[3] The Third Circuit had previously construed *Jones II* narrowly, reading it as barring parties from obtaining *equitable* relief through appraisal proceedings, but leaving open the possibility of pursuing claims for damages in separate proceedings.[4]

In *Herskowitz v. Nutri/System*,[5] minority shareholders brought suit before the merger occurred, seeking damages for breaches of fiduciary duties by Nutri/System and its board. The defendants moved to dismiss, arguing that the appraisal statute was the sole remedy available to the minority shareholders. In its decision denying the defendants' motion, the Third Circuit emphasized that *Jones II* "took pains to point out that the appraisal remedy preserved shareholder remedies other than statutory appraisal," and read *Jones II* as a "tacit approv[al]" of a separate pre-merger class action seeking injunctive relief or damages.[6] Accordingly, the court held that the statutory appraisal proceedings are not an exclusive remedy, but rather co-exist with common law causes of action. The court explained that "no other rule [would] make sense, for the appraisal remedy is available even absent misconduct of corporate officials."[7]

Based on the language of the statute, *Jones II*, and *Herskowitz*, the Third Circuit found that the Pennsylvania appraisal statute does not prohibit a post-merger suit for damages based on the majority shareholder's breach of fiduciary duty. The court reasoned as follows. First, allowing post-merger suits for damages would not result in dissident groups preventing mergers desired by the majority of shareholders, and therefore, such a rule would not subvert the reasoning behind *Jones II*. Second, the statute itself does not distinguish between pre- and post-merger relief. The distinction between pre- and post-merger suits arose because *Jones II* held against post-merger *equitable* relief, and because *Herskowitz* involved a suit for damages that was filed before the merger was complete, not because there was any policy reason to deprive minority shareholders of post-merger damages for fiduciary breaches. Given that appraisal proceedings are limited in nature and do not consider corporate misconduct, and that in many cases minority shareholders might not discover wrongdoing until after the merger is complete, the court found no reason to distinguish between pre- and post-merger suits for damages.

---

[2] *In re Jones & Laughlin Steel Corp. (Jones I)*, 398 A.2d 186 (Pa. Super. Ct. 1979).

[3] *In re Jones & Laughlin Steel Corp. (Jones II)*, 412 A..2d 1099, 1104 (Pa. 1980).

[4] *See Herskowitz v. Nutri/System*, 857 F.2d 179, 186 (3d Cir. 1988).

[5] *Id.*

[6] *Mitchell Partners*, No. 10-4091, at *9 (citing *Herskowitz*, 857 F.2d at 186-87).

[7] *Herskowitz*, 857 F.2d at 187.

Next, the court considered the limitations of the appraisal remedy as compared to common law fiduciary breach suits. The court explained that the appraisal remedy only permits those minority shareholders who dissented to recover, while suits for breaches of fiduciary duties allow all shareholders that were harmed to recover. The amount recoverable is also more limited in an appraisal proceeding. The court noted that although Delaware employs the same expanded view of "fair value" as Pennsylvania, Delaware "permits separate suits for fiduciary breaches because even the expanded appraisal remedy 'may not be adequate in certain cases, particularly where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching are involved.'"[8]

Lastly, the court examined the language of the appraisal statute and reasoned that majority shareholder self-dealing and misrepresentation "falls within the ambit of fraud or fundamental unfairness," and is therefore exempt from the exclusivity clause of the statute.[9]

In addition to the above stated reasoning, the court noted that although Delaware case law was not controlling, the court's decision was consistent with the view of the Delaware courts on this subject.[10]

Accordingly, the Third Circuit reversed the dismissal and remanded the matter for proceedings consistent with its opinion.

III. The Dissent

The dissent construed the holding of *Jones II* more broadly than the majority, arguing that it was not limited to proceedings in appraisal court or claims in equity.[11] The dissent also asserted that the Pennsylvania legislature's decision to codify the appraisal statute as it was written after it had been interpreted by the courts to preclude post-merger suits demonstrated that the statute itself preserved the distinction.[12] Finally, the dissent noted that the distinction between pre- and post-merger suits had been upheld in a number of Pennsylvania state and Third Circuit cases.[13] As a result, the dissent would have preserved the distinction between pre- and post-merger suits for equitable relief or damages, and dismissed Mitchell Partners' action for fiduciary duty claims.

IV. The Significance of the Decision

This decision harmonizes Pennsylvania and Delaware law with respect to their appraisal statutes. It recognizes the difference between appraisal and common law remedies, and allows minority shareholders to recover damages for fiduciary breaches regardless of when the wrongdoing is discovered, and regardless of whether an appraisal action has been brought.

---

[8] *Mitchell Partners* No. 10-4091, at *11 (quoting *Weinberger v. UOP*, 457 A.2d 701, 714 (Del. 1983)).

[9] *Id.* at *11; *see* 15 Pa. Cons. Stat. § 1105.

[10] *Id.* at *12; *see Cede & Co. v. Technicolor, Inc.*, 542 A.2d 1182 (Del. 1988) (holding that the plaintiff could exercise appraisal rights while seeking damages for corporate wrongdoing discovered in the course of discovery in the appraisal proceeding in a consolidated action, subject to the limitation of a single recovery judgment); *Nagy v. Bistricer*, 770 A.2d 43 (Del. Ch. 2000) (reaffirming that an appraisal action is not the exclusive remedy for minority shareholders in cash-out mergers and that appraisal and fiduciary duty claims can be brought in the same action and granting summary judgment in favor of the minority shareholder plaintiffs on fiduciary breach claims).

[11] *Mitchell Partners* at *14 (Garth, J., dissenting).

[12] *Id.* at *16 (Garth, J., dissenting).

[13] *Id.* at *15 (Garth, J., dissenting).

The Third Circuit decision did not address whether fiduciary breach claims may be brought in the same action as an appraisal proceeding. Delaware courts have ruled that appraisal and fiduciary duty claims may be brought in the same action.[14] However, given the standard laid out in *Jones II*, that appraisal actions are limited to the determination of "fair value," it is unclear whether Pennsylvania courts would come to the same result.

* * *

If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Erin Katzen at 212.701.3340 or ekatzen@cahill.com.

[14] *See Nagy*, 770 A.2d at 58.

This memorandum is for general information purposes only and is not intended to advertise our services, solicit clients or represent our legal advice.