

PENNSYLVANIA HIGH COURT MAY RULE ON MINORITY SHAREHOLDERS' RIGHTS

by

The Hon. Dick Thornburgh and David R. Fine

The United States Court of Appeals for the Third Circuit has asked the Pennsylvania Supreme Court for assistance in resolving a case involving the rights of minority shareholders who believe they were “squeezed out” in a cash-out merger, and the result will decide whether a Pennsylvania appraisal statute provides those minority shareholders with their exclusive remedy. On the path to that result, *Mitchell Partners, L.P. v. Irex Corporation* also demonstrates how federal courts may determine novel state-law questions.

The background of the case is straightforward. Mitchell Partners, L.P. (“Mitchell”), was a minority shareholder of Irex Corporation (“Irex”). In the lawsuit, Mitchell alleged that Irex’s CEO and board chairman sent a confidential memorandum to directors, officers, and select shareholders describing a plan to consolidate ownership of Irex into a to-be-formed holding company, North Lime Holdings (“North Lime”). The Irex directors, officers, and select shareholders would trade in their Irex stock, which constituted a majority of the outstanding shares, for North Lime stock, and the minority shareholders’ stock would be cashed out at \$66 a share. Mitchell objected and argued that the plan would effectively “squeeze out” minority shareholders for an unfair price. Irex and North Lime went forward with the merger and the \$66-per-share cashout.

After the transaction closed, Irex filed an action in a Pennsylvania trial court seeking an appraisal and a determination that \$66 per share was a fair price. In that proceeding, which is ongoing, Mitchell countered that the proper price was \$181 per share. A year and a half later, Mitchell filed a proposed class action in federal court alleging that Irex, North Lime, and the majority shareholders were liable for breach of fiduciary duty, aiding and abetting a breach of fiduciary duty, and unjust enrichment.

The district court granted the defendants’ motion to dismiss. They argued, and that district court agreed, that the sole remedy available to minority shareholders after a merger is the appraisal process Irex began. Mitchell appealed. In its August 31, 2011, opinion, the Third Circuit first noted that the Pennsylvania Supreme Court had not yet addressed the question of whether the appraisal process is, in fact, the only post-merger remedy available to minority shareholders. Judge Dolores Sloviter wrote for the panel, which included Judge Julio Fuentes and Senior Judge Leonard Garth, and she explained that federal courts addressing undecided state-law questions are usually required to review state-court decisions and then to predict what the state Supreme Court would do if confronted with the question.

Judge Sloviter wrote that there was no controlling Pennsylvania authority. She looked then to Third Circuit authorities and noted that, in *Herskowitz v. Nutri/System*, the court had concluded that minority shareholders could file a suit pre-merger claiming a breach of fiduciary duty and seeking damages. Thus, she concluded that “the statutory appraisal cause of action coexists with common law causes of action.” Judge

The Honorable Dick Thornburgh is Of Counsel, and **David R. Fine** is a partner, both with the international law firm K&L Gates LLP. Mr. Thornburgh, a former two-term Governor of Pennsylvania and former Attorney General of the United States, is the Chairman of WLF’s Legal Policy Advisory Board.

Sloviter recognized that *Herskowitz* dealt with a *pre*-merger claim while *Irex* involved a *post*-merger claim. Nonetheless, she concluded that nothing in the appraisal statute distinguished between *pre*- and *post*-merger claims. Judge Sloviter noted that the appraisal statute allowed only limited claims against the corporation (not its majority shareholders) and, so, the minority shareholders who filed a fiduciary-duty claim were seeking only to have a second forum rather than to disrupt the merger itself. Thus, she concluded, the statutory remedy was not exclusive, and the minority shareholder's claim could proceed in federal court. Judge Fuentes joined her opinion.

Judge Garth dissented. He opined that there was no need to predict Pennsylvania law because the state courts had resolved the issue. He pointed to the 1980 Pennsylvania Supreme Court decision *In re Jones & Laughlin Steel Corp.* and its conclusion that the statutory appraisal process is "to be the exclusive post-merger remedy available to dissenting shareholders." (Judge Sloviter's opinion read *Jones* as concluding that the court in an appraisal proceeding did not have jurisdiction over any issue or claim other than appraisal.)

While the court of appeals' decision is usually conclusive on such legal issues, the Third Circuit's August 2011 opinion turned out to be only the start of the appellate process. Within weeks of the opinion, *Irex* and the other defendants sought rehearing by the court of appeals. They received significant support when Pennsylvania Governor Tom Corbett, the Pennsylvania Chamber of Business and Industry, the Pennsylvania Manufacturers Association, and the Greater Philadelphia Hispanic Chamber of Commerce filed motions seeking leave to file *amicus curiae* statements in support of rehearing. On September 27, less than a month after first deciding the case, the Third Circuit panel granted the petition for rehearing and indicating that the court would certify the issue of remedy exclusiveness to the Pennsylvania Supreme Court.

The certification process is an interesting but seldom used means by which a federal court asks a state court to answer an important state-law issue. The Pennsylvania Supreme Court is one of a number of state courts of last resort that accept certified questions. The Pennsylvania procedure has been in place for a dozen years, and it allows only federal appellate courts to certify questions. In that time, the state supreme court has answered questions for the Third Circuit a handful of times and for the United States Supreme Court once.

The Pennsylvania Supreme Court's internal operating procedures set out strict requirements for certification petitions: the question must be unsettled by existing cases and of particular public importance; the question of law must be the subject of conflicting decisions in other courts or the question must relate to the constitutionality or interpretation of a Pennsylvania statute. Importantly, the material facts in the case may not be in dispute so that the only remaining task is to determine what the law is and then to apply it to those facts. In the final analysis, the state court has significant discretion about whether to answer a question certified by a federal court.

It is far from clear that, after applying those standards, the Pennsylvania Supreme Court will accept the *Irex* case. On the one hand, the case is important and, if the state court credits the Third Circuit majority's reading of Pennsylvania law, the legal issue is one of first impression in Pennsylvania. On the other hand, the Pennsylvania jurists could agree with Judge Garth, the dissenting member of the Third Circuit panel, who asserted his view that the Pennsylvania Supreme Court had already answered the legal question in *Jones*.

The Third Circuit clerk filed the certification petition with the Pennsylvania Supreme Court on October 3, 2011. There is no deadline for the state court to decide whether it will accept the question for review. If it agrees to answer the certified question, it will probably take at least another year or more for the state court to answer the question. If the court denies the certification petition, the Third Circuit will be left to make its own prediction and, given the preview offered in the pre-certification opinion, it seems likely the court would predict that the minority shareholder's common-law claims for damages could proceed. Thus, for *Irex* and others focused on corporate-law jurisprudence regarding minority rights, the Pennsylvania Supreme Court's decision on the certification issue will be far more than just the resolution of an interesting and novel procedural question.