THE PENNSYLVANIA BAR ASSOCIATION

Quarterly

93 SHALE GAS LEASING—ACHIEVING CLARITY, TRANSPARENCY AND CONSERVATION: RECENT ACTIONS OF THE PENNSYLVANIA SUPREME COURT AND LEGISLATURE

104 ENCOURAGING ATTORNEY CIVILITY DURING DEPOSITIONS: THE ENDURING IMPACT OF *HALL* V. *CLIFTON PRECISION*

113 MINORITY SHAREHOLDER FREEZE-OUT LITIGATION IN PENNSYLVANIA: REMEDIES PROVIDED AT COMMON LAW AND BY SECTION 1767 OF THE PENNSYLVANIA BUSINESS CORPORATION LAW

Your Other Partner

July 2013 • VOLUME LXXXIV, NO. 3

USI Affinity offices: Philadelphia | Harrisburg | Pittsburgh

Pennsylvania Bar Association Quarterly

VOL. LXXXIV | JULY 2013 | NO. 3

$30.00 PER ANNUM | CURRENT COPIES $6.25

Officers

FOREST N. MYERS, *President*, Shippensburg
FRANCIS X. O'CONNOR, *President-elect*, Great Bend
WILLIAM H. PUGH V, *Vice President*, Norristown
THOMAS G. WILKINSON JR., *Immediate Past President*, Philadelphia
LISA M. BENZIE, *Chair, House of Delegates*, Harrisburg
ANNE N. JOHN, *Secretary*, Uniontown
PHYLLIS HORN EPSTEIN, *Treasurer*, Philadelphia
ROBERT DATORRE, *Chair, Young Lawyers Division*, Harrisburg
LARS ANDERSON, *Chair-elect, Young Lawyers Division*, Kingston
JACOB A. GURWITZ, *Immediate Past Chair, Young Lawyers Division*, Reading

Governors

MELINDA C. GHILARDI, *At-Large*, Scranton
JACQUELINE B. MARTINEZ, *At-Large*, Pittsburgh
BEVERLY H. RAMPAUL, *At-Large*, Lancaster
JAMES J. ROSS, *Unit County*, Ambridge
SAYDE J. LADOV, *Zone One*, Philadelphia
TERRY D. WEILER, *Zone Two*, Wyomissing
JAMES L. GOLDSMITH, *Zone Three*, Harrisburg
RITA G. ALEXYN, *Zone Four*, Mansfield
P. TIMOTHY KELLY, *Zone Five*, Scranton
MARIANN HATHAWAY, *Zone Six*, Washington
STEVEN E. "TIM" RILEY JR., *Zone Seven*, Erie
WILLIAM J. HIGGINS JR., *Zone Eight*, Bedford
HERBERT K. SUDFELD JR., *Zone Nine*, Morrisville
MARION LAFFEY-FERRY, *Zone Ten*, Butler
JEFFREY M. BOWER, *Zone Eleven*, State College
SHELLY R. PAGAC, *Zone Twelve*, Pittsburgh

Editorial

LOUIS F. DEL DUCA, *Editor*
BARRY M. SIMPSON, ESQ., *Executive Director*

All editorial and other communications, including requests for copies of the QUARTERLY and notification of change of address, should be addressed to the office of the Association, 100 South Street, P.O. Box 186, Harrisburg, PA 17108. PBA members receive the QUARTERLY as a membership benefit. Annual subscriptions for non-members are $30. The QUARTERLY is underwritten in part by the Pennsylvania Bar Insurance Fund.
© Pennsylvania Bar Association Quarterly, 2013. All rights reserved.

Minority Shareholder Freeze-Out Litigation In Pennsylvania: Remedies Provided At Common Law And By Section 1767 Of The Pennsylvania Business Corporation Law[1]

By ARTHUR L. BUGAY, ESQUIRE,[2] Philadelphia County
Member of the Pennsylvania Bar

TABLE OF CONTENTS

PENNSYLVANIA'S LEGISLATIVE POLICY SUPPORTS A BROAD ARRAY OF MINORITY SHAREHOLDER REMEDIES 114
CLASSIC CASES ESTABLISHING MINORITY SHAREHOLDER OPPRESSION: DEFINING THE ELEMENTS OF A CLAIM 116
DEFINING MINORITY SHAREHOLDER OPPRESSION: FACTS SUPPORTING A COMMON LAW CLAIM 129
WASTE AND SELF-DEALING AS OPPRESSIVE ACTS, COMMON LAW STANDING AND TRIGGERING EVENTS—ESTABLISHING THE FREEZE-OUT DATE 130
MINORITY SHAREHOLDER REMEDIES: CUSTODIANS, DISSOLUTIONS, DAMAGES, FAIR VALUE, FAIR MARKET VALUE, AND PUNITIVE DAMAGES . 132
STANDING FOR SECTION 1767 CLAIMS 137
CONCLUSION 138

ABSTRACT

Minority shareholders of Pennsylvania closely held corporations[3] *possess powerful remedies as victims of shareholder oppression by majority shareholders and/or others in control of the corporation. Through Pennsylvania common and statutory law, minority shareholders can (1) appoint a custodian to take over the corporation's management; (2) dissolve the company and force its distribution to pay the fair value of their shares; or (3) force the corporation to redeem*

1. This article is dedicated to the Honorable Albert W. Sheppard, Jr., who brought humor and common sense to end many bitter disputes.

2. B.A. Temple University (1986); M.A. (Econ.) Temple University (1988); J.D. Temple Law (1991); L.L.M. Temple Law (Tax 1996); L.L.M. (Trial Advocacy, 2000); Partner, Galfand Berger, LLP. Mr. Bugay specializes in civil litigation and teaches products liability as an Adjunct Professor at Temple's Beasley School of Law.

3. A Pennsylvania closely held corporation is "[a] business corporation that (1) has not more than 30 shareholders; or (2) is a statutory close corporation. 15 Pa.C.S. Section 1103, defining "closely held corporation." A statutory close corporation is "[a] business corporation that has elected to become subject to Chapter 23 (relating to statutory close corporations) and whose status as a statutory close corporation has not been terminated as provided in Chapter 23." *Id. See also, In Re: Smith Estate,* 5 Pa.D&C. 2d 31 (Phila. 1955); *Schmid* v. *Lancaster Avenue Theatre Co.,* 91 A. 363 (Pa. 1914). Shares held by married couples count as one shareholder under this definition.

their shares at fair value.[4] This article focuses upon minority shareholder oppression. It is a sequel to Daniel Dwyer's article which appeared in the last issue regarding derivative actions in Pennsylvania.[5]

Unlike derivative actions, Pennsylvania minority shareholder oppression cases do not require an administrative exhaustion of remedies.[6] Moreover, Pennsylvania's Business Corporation Law ("BCL") provides useful interim remedies to assist in the prosecution of these actions.[7] This article explores the current state of Pennsylvania law by defining minority status, shareholder oppression, valuation and related damages issues through a classic case law analysis. In the process, the article reviews the policies advanced by these cases and outlines the elements of Pennsylvania common law and statutory claims.

[O]ppression . . . ırises[s] when "those n control". . . "have ıcted in such a manıer as to defeat those :xpectations of the ninority stockholders vhich formed the ›asis of [their] partici›ation in the venture."

PENNSYLVANIA'S LEGISLATIVE POLICY SUPPORTS A BROAD ARRAY OF MINORITY SHAREHOLDER REMEDIES

Pennsylvania was among the first states to create a minority oppression statute.[8] In the Pennsylvania Business Corporation Law's ("BCL") 1988 amendments, the Pennsylvania Legislature expanded 15 Pa. C.S. A. Section 1767, a statute with the explicit purpose of "establish[ing] a statutory foundation for the development on a case-by-case basis of safeguards for incorporated partners in dealing with each other."[9] ;ection 1767 also explicitly rejects a strict contract and economics approach, ıdopted in Delaware,[10] established by the Statutory Close Corporation Supplement o the Model Business Corporation Act.[11] The 1990 Committee Comments to Section .767 state:

4. As discussed below, other remedies in equity are also available.

5. *See*, Dwyer, *The Rights of Shareholders, Limited Partners and Non-Managing Limited Liability Company Members in Corporate Covenants Disputes: Derivative Actions in Pennsylvania*, 84 No. 2 Pa.B.A. 47 (April 2013) hereinafter, "*Dwyer*").

6. *See, Dwyer at 50-51, citing 15 Pa.C.S. Section 1782* ("In summary, a plaintiff in a derivative action must ›e a shareholder, or someone similarly situated, who is asserting a right that the corporation has already efused to assert. A refusal implies a demand. Therefore, in order to assert a derivative claim under ›ennsylvania law, the plaintiff must first show that: 1) he was a shareholder at the time of the transaction omplained of, and; 2) that, before initiating the derivative claim, [s/he] demanded that the corporation, ıcting through its board of directors (who under Section 1717 have sole standing to pursue such claims) ›ursue the claim, and; 3) the board of directors and corporation refused to do so."). *See, Baron* v. *Pritzker*, ;2 D&C 4th 14 (Phila. CCP 2001) (Sheppard, J) overruling demurrer to complaint for failure to make preuit demand distinguishing *Cuker* v. *Mikalauskas*, 692 A.2d 1042, 1049 (Pa. 1997) (holding that a plaintiff nust make a written demand on the board of directors before filing a derivate claim).

7. *See*, 15 P.S. Section 1508 (Corporate records; inspections by shareholders), 15 P.S. Section 1554 Financial reports to shareholders).

8. Morris comment: "Only the punctilio, if I say so . . ." 10 Duq. Bus. L. S. 73, 88-89 (Sp. 2008); *See also* ;cott, Minority Shareholder Rights: Pennsylvania's Custodian Statute , 65 Pa.B.Q. 97 (July 1994). *See*, 15 ›.S. Section 1767, Appointment of custodian of corporation on deadlock or other cause.

9. Pennsylvania's "freezeout" statute, 15 P.S. Section 1767, originated in 1933 (P.L. 364, No. 106). At that ime, only Pennsylvania and Illinois had created statutes which "established oppression as a ground for corporate] dissolution. . . ." *See, Matheson and Maler, "A Simple Statutory Solution to Minority Oppression in he Closely Held Business," 91 Minn. L. Rev. 657, 665-666* (Feb. 2007) (*hereinafter, "Matheson"*).

10. *See, e.g. Nixon* v. *Blackwell*, 626 A.2d 1366 (Del. 1993) (rejecting minority shareholders' claim for ›reach of fiduciary duty). *But see, Litle* v. *Waters*, 1992 WL 257 (Del. Ch. Feb. 11, 1992); 18 Del. J. Corp. L. 315.

11. Section 14.30 (a) (2) of the Model Business Corporation Act states that:

The [Court] may dissolve a corporation:

> The Statutory Close Corporation Supplement to the Model Business Corporation Act Section 16(a)(1)(1982) eliminated the availability of relief in cases of oppression of a minority shareholder in the capacity of an employee while continuing to provide relief for officers. In the case of a closely held corporation, the formalistic distinction between an employee shareholder and an officer shareholder is ordinarily inconsequential and subsection (a)(2) follows the New Jersey rather than the Model Act in providing relief for non-officer employee shareholders.[12]

This BCL comment expressly distinguishes Pennsylvania from Delaware law, the traditional corporate law model, with regard to the resolution of minority shareholder oppression cases. Instead, Pennsylvania more closely follows New Jersey law[13] and chooses a more flexible approach to resolve these cases.[14] Instead of strictly construing contracts and imagined "bargained-for" exchanges, Pennsylvania Courts evaluate minority shareholder disputes in equity to enforce the policies of good faith and fiduciary duty reserved for partners and joint adventurers.[15]

Pennsylvania, like many states, recognizes that most close corporations form informally. "In reality, small business investors are not . . . sophisticated[;] founding a business is an inherently hopeful act, and fellow investors are often family members or friends."[16] This is not to say that minority shareholders are incapable of planning

(2) in a proceeding by a shareholder if it is established that:

(i) The directors are deadlocked and the management of the corporate affairs, the shareholders are unable to break the deadlock, and irreparable injury to the corporation is threatened or being suffered, or the business and affairs of the corporation can no longer be conducted to the advantage of the shareholders generally because of a deadlock;

(ii) the directors or those in control of the corporation have acted, or are acting, or will act in a manner that is illegal, oppressive or fraudulent;

(iii) the shareholders are deadlocked in voting power and have failed, for a period that includes at least two consecutive annual marketing meeting dates, to elect successors to directors whose terms have expired;

(iv) the corporate assets are being misapplied or wasted.

12. Committee Comments, 1990, 15 P.S. A. Section 1767, Purdons at 529.

13. *N.J.S.A. 14A:12-7(1)(c)* states:

14A:12-7. Involuntary dissolution; other remedies

(1) The Superior Court, in an action brought under this section, may appoint a custodian, appoint a provisional director, order a sale of the corporation's stock as provided below, or enter a judgment dissolving the corporation, upon proof that[:]

* * *

(c) In the case of a corporation having 25 or less shareholders, the directors or those in control have acted fraudulently or illegally, mismanaged the corporation, or abused their authority as officers or directors or have acted oppressively or unfairly toward one or more minority shareholders in their capacities as shareholders, directors, officers, or employees.

See also, Balsamides v. *Protemeen Chemicals, Inc., 734 A.2d 721 (NJ 1999)*.

14. *See*, Means, *A Contractual Approach to Shareholder Oppression Law*, 79 Ford. L.R. 1161, 1163 (2011) (hereinafter "Means") (". . . law and economics, the dominant mode of corporate law scholarship, appears irreconcilably opposed to minority shareholder protection, a defining feature of the existing law of close corporations. . . . Only two states, [Delaware and Kansas,] have definitively rejected special protection for minority shareholders. *See, Nixon* v. *Blackwell, 626 A.2d 1366, 1379-81 (Del. 1993); Richards* v. *Bryan, 879 P.2d 638, 648 (Kan. Ct. App. 1994)*).

15. *See*, Olson, *Representing Minority Shareholders in Close Corporations Under Modern Business Corporation Acts*, 64 Wash. U.L.Q. 507 (1986). Professor Olson aptly summarizes the plight facing a minority shareholder alleging oppression under the Model Corporation Act and the standard corporate model as follows:

> *When you're up to your ass in alligators, it's hard to remember you came to drain the swamp.*

In other words, as Professor Means notes:

> According to standard law and economics, minority shareholders in closely held corporations must bargain for protection against opportunism by controlling shareholders before investing. . . . Put simply, you made your bed, now you must lie in it.

16. *Means, supra* at 1163. *See also, e.g., Bair* v. *Purcell, 500 F.Supp.2d 468 (M.D. Pa. 2007)*, which examines the breach of fiduciary duty in the context of several close corporations whose assets consisted of

or "unplanned" disagreements, business failure, or dissolution. Anyone starting ;uch a small business should include, among the standard corporate documents,[17] ı buy-sell agreement.[18] Indeed, where such an agreement has been ratified by a ›oard of directors, even in draft form, it can become a key piece of evidence in any ninority freeze-out civil action.[19] Unlike Delaware, Pennsylvania law does not pe-ıalize minority shareholders for failing to foresee future business disputes.[20] nstead, here there is a common law and legislative means by which such disputes :an be resolved in the absence of such agreements. Further, as discussed below, vhere such agreements are present, even in an unratified or unexecuted form, they :an provide an objective measure of "oppression". These documents are most often :reated during "good times", when the business members are in agreement. As uch if, after the honeymoon, things fall apart and a low offer (or no offer) is made or a minority shareholder's stock, a drafted buy-sell agreement can provide a mea-ure for "reasonable expectations" in terms of stock price.[21]

CLASSIC CASES ESTABLISHING MINORITY SHAREHOLDER OPPRESSION: DEFINING THE ELEMENTS OF A CLAIM

Pennsylvania's oppression statute is not a substitute for common law remedies or minority shareholder freeze-out claims.[22] Instead, it incorporates the policies

read distribution franchise rights; *Orchard* v. *Covelli, 590 F.Supp. 1548 (W.D. Pa. 1984)* (same, involving 1cDonald's Restaurant franchise rights).

17. The corporation's articles of incorporation, its private offering memoranda, its bylaws, its financials, nd its board and shareholder minutes are all important documents in a shareholder dispute action.

18. *See, e.g.*, Wood, "*In Business? Get a Buy-Sell Agreement!*" Forbes, February 7, 2011 ("Unless you plan › be lucky forever, you'd better have [a buy-sell agreement]. Without it, a closely held . . . business faces world of financial and tax problems on an owner's death, incapacitation, divorce, bankruptcy, sale or :tirement").

19. For example, in recent litigation, where I represented a minority shareholder, the corporation had atified a drafted, but unexecuted buy-sell agreement, which was admitted at trial. A part of this agree-ıent is shown below:

Purchase Price

> 2. In the event of termination of [any business founder], *for any reason*, including death, disability, or involuntary or voluntary termination, the Purchase Price for their Stock in the Corporation shall be the greater of the Fair Value of such stock on the date of the triggering event, or 2.5 times the Corporation's gross revenue for the prior calendar year multiplied by the Shareholder's Stock percentage as determined by the Corporation's Certified Public Accountant.
>
> 2.1. Fair Value Determined by Appraisal. Upon the Termination of [any business founder], *for any reason*, the Fair Value of the Offered Stock on the date of any deemed offer, shall be determined under this section:
>
> 2.1.1. How computed. The Fair Value of the Offered Stock shall be determined by Qualified Appraisers, the Offering Shareholder shall have the opportunity to appoint (1) Qualified Appraiser at his, her, or its own expense, within five (5) days following the Buyer's acceptance to purchase the Offered Stock. Buyer shall have the opportunity to appoint one (1) Qualified Appraiser at his, her or its own expense, within five (5) days following his, her or its acceptance to purchase the Offered Stock. If the Offering Shareholder or the Buyer or Buyers shall fair to appoint a Qualified Appraiser within this five (5) day period, the other Qualified Appraiser shall unilaterally establish the fair value of the Offered Stock by a written opinion. ***

20. *See, Glenn* v. *Kittanning Brewing Company*, 103 A.340 (Pa. 1918) (affirming injunction, declaring ille-al and invalid a certificate for the issuance of capital stock and ordering the shares to be surrendered); *'eisbecker* v. *Hosiery Patents, Inc.*, 51 A.2d 811 (Pa. 1947) (entering injunction, ordering corporation to dis-ose information and accounting of assets), discussed *infra*.

21. Therefore, where such a document exists in such circumstances, in draft form or if unexecuted, it ıould be admitted into evidence because it is relevant to determining whether there is shareholder "op-ression." *See*, Pa.R.E. 401-403.

22. Section 1767(a)(2) does not include any language that restricts common law equity claims. For this :ason, minority shareholder oppression cases, at common law, and pursuant to Section 1767 provide a :parate remedy to shareholder appraisal rights provided, for example, by 15 Pa.C.S.A. Section 1105, hich expressly restricts jurisdiction over dissenter rights to Subchapter D of the Business Corporation

and reasoning of common law actions. In particular, six[23] landmark decisions, *Dodge* v. *Ford Motor Co.*,[24] *Meinhard* v. *Solomon*,[25] *Donahue* v. *Rodd Electrotype Co. of New England, Inc.*,[26] *Wilkes* v. *Springside Nursing Home, Inc.*,[27] *In re: Kemp & Beatley, Inc.*,[28] and *Balsamides* v.. *Protameen Chemicals, Inc.*[29] should be considered when evaluating minority shareholder disputes. These cases, while decided in other jurisdictions, define key aspects of minority shareholder oppression claims in close corporations.[30] These cases complement Pennsylvania's common law which, by 1918, had already recognized an established fiduciary duty owed by those in corporate control to a corporation's minority shareholders.[31]

The Shareholder Primacy Doctrine: The Duty To Make Distributions To Minority Shareholders

Dodge v. *Ford* is an early common law example of shareholder oppression arising from a dividend dispute. In *Dodge*, decided in 1919, the Michigan Supreme Court stated the "shareholder primacy norm" as follows:

> A business corporation is an organization carried on primarily for the profit of the shareholders. The power of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end and does not extend to a change in the end itself, to the reduction of profits, or to the non-distribution of profits among stockholders in order to devote them to other purposes.[32]

Code, Title 15, Sections 1571-1580. *See, Michaell Partners* v. *IREX Corp., No. 13 EAP 2012 (Pa July 24, 2012); In re: Jones & Laughlin Steel Corp., 412 A.2d 1099(Pa. 1980)* (holding that, under Section 1105's predecessor statute, an appraisal court lacks jurisdiction to determine the validity of a merger). In *Orchard* v. *Covelli, supra*, the United States District Court for the Western District of Pennsylvania denied a motion in limine which claimed that such rights were precluded by the Section 1105 predecessor statute).

23. Several Pennsylvania landmark decisions are also discussed in this section. For additional references to classic cases, see, Smith, *The Shareholder Primacy Norm*, 23 Iowa J. Corp. L. 277 (Winter 1998), (hereinafter "*Smith*").

24. 170 N.W. 668 (Mich. 1919).

25. 164 N.E. 545 (NY App. 1928) (Cardozo, J.).

26. 328 N.E.2d 505 (Mass. 1975).

27. 353 N.E.2d 657 (Mass. 1976).

28. 473 N.E.2d 1173 (NY App. 1984).

29. 734 A.2d 721 (NJ 1999).

30. In addition to the above common law claims and that of breach of fiduciary duty, discussed throughout this article, there are numerous other common law claims that can be brought with a 15 Pa. C.S.A. Section 1767(a)(2) statutory claim for minority shareholder oppression. These claims include, but are not limited to the following: (1) breach of contract; (2) fraud and deceit; (3) ultra vires; (4) self-dealing; (5) waste of corporate assets; (6) wrongful termination; (7) negligent misrepresentation; (8) intentional misrepresentation; (9) unjust enrichment; (10) Pennsylvania's Wage Payment and Collection Law ("WPCL"), 43 Pa.C.S. Section 260.1, *et seq*; (11) federal and state employment civil rights claims; (12) Age discrimination claims; (13) civil conspiracy/aiding and abetting claims; (14) defamation claims, and numerous other common law claims; (15) Interest and costs established by common law and statute; (16) piercing the corporate veil; and (17) punitive damages. Sometimes, in the context of minority oppression matter, securities litigation matters may arise. *See, e.g., Farris* v. *Glen Alden Corp., 143 A.2d 25 (Pa. 1958)* (depriving minority shareholders fair value appraisal rights with regard to their shares in a *de facto* merger which, otherwise, would have been subject to dissenting shareholder appraisal litigation pursuant to Section 515 of the Business Corporation Law, now 15 Pa.C.S.A. Section 1105 (1988) enjoined). *See also, In re: Jones & Laughlin Steel Corp., 412 A.2d 1099 (Pa. 1980)* (holding that appraisal court lacked jurisdiction to consider the validity of the merger unless it is the product of fraud or will result in fundamental unfairness), 477 A.2d 527 (Pa. Super. 1984); *Hershowitz* v. *Nutri-System, Inc., 857 F.2d 179 (3d Cir. 1988); Mitchell Partners* v. *IREX Corporation, No. 13 EAP 2012 (Pa. July 24, 2012)* (holding that 15 Pa.C.S.A. Section 1105, Restriction on Equitable Relief, provides the exclusive means by which a shareholder dissenting to a "proposed plan or amendment of articles authorized under this article.").

31. *See, Glenn* v. *Kittanning Brewing Co., 103 A. 340 (Pa. 1918)*, discussed *infra*.

32. 17 N. W. at 684.

Dodge involved a dispute between Henry Ford and the Dodge Brothers, Horace and John Dodge, the founders and original shareholders of Ford Motor Company ("Ford"). Ford was incorporated in Michigan on June 16, 1903 by a small group of shareholders.[33] The Dodge Brothers manufactured engines and car parts for Henry Ford[34] and Olds Motor Works,[35] a competitor. In exchange for stock, the Dodges invested $10,500.00, mostly in the form of promissory notes. However, their real contribution was to modernize Ford's production plant and to eliminate themselves as suppliers to Ford's chief competitor, Olds.[36]

In 1908, Ford's articles of incorporation were amended to increase its capital stock from $150,000.00 to $2,000,000.00. During this time, with the Model T's success, the company's output and profits increased exponentially.[37] Ford could not make enough cars to satisfy public demand;[38] and its manufacturing plant expanded to make its own parts instead of purchasing them from others. Consequently, production costs dropped dramatically and the price of Ford's cars fell from $900.00 a car to $440.00 a car by the end of July 1916, the eve of America's involvement in World War I.[39]

During this time, ordinary dividends were paid monthly, at quarterly installments, at 5% of Ford's capital stock. In other words, shareholders received $1,200,000.00 a year in ordinary dividends. In addition, Ford's shareholders received approximately $41,000,000 in special dividends between December 13, 1911 and

33. *Id.*, 170 N.W. at 668. When founded, the original signers of the Articles of Incorporation were Henry Ford, whose stock subscription was for 255 shares, John F. Dodge, Horace E. Dodge, who are the plaintiffs, Horace H. Rackham and James Cousin, who each subscribed respectively for 50 shares." *Id.* The case also references "several other persons" without referencing the number but indicates that the other shareholders held much smaller shares and that there were few shareholders.

34. Henry Ford originally was Thomas Edison's chief engineer. In 1893, he completed a prototype for his own gasoline powered engine. In 1898, he patented a carburetor, assigning the patent to William Maybury, Detroit's Mayor, who invested in Ford's first car business, the Detroit Automobile Company. In 1896, Ford built a horseless carriage, called a quadricycle. In 1899, he established the Detroit Automobile Company which, at the time, was one of 60 automakers in America. This company ceased operations in November 1900. Ford tried again in 1901, starting the Henry Ford Company, which also failed. In July 1903, the Ford Motor Company produced its first car, the Model A. In 1908, Ford introduced the Model T, called the "Tin Lizzie", which made Ford a market leader.

35. Olds Motor Works was founded by Ransom E. Olds. Olds produced its first car in 1896. In 1901, it produced a model made popular at the 1901 New York Auto Show. Dodge brothers supplied engines and spare parts to both Ford and Olds before 1903.

36. *See, Smith, supra* at 316: Contribution was to modernize Ford's production plant and to eliminate themselves as suppliers to Ford's chief competitor, Olds.

37. Output and Profit By Year:

Year ending	
Sept. 30, 1910	18,664 cars, $4,521,509.51
Sept. 30, 1911	34,466 cars, $6,275,031.07
Sept. 30, 1912	68,544 cars, $13,057,312.24
Sept. 30, 1913	168,304 cars, $25,046,767.43
Sept. 30, 1914	248,307 cars, $30,338,454.63
July 31, 1915 (10 mos.)	264,351 cars,$ 24,641,423.17
July 31, 1916	472,350 cars, $59,994,918.01

Dodge, supra, at 170 N.W. at 679.

38. *Id.* at 678.

39. On April 2, 1917, President Wilson asked Congress for a declaration of War. Ford's business prospects appeared to be without limit. In its July 31, 1916 statement of financial affairs, Ford listed $59,994,918.01 in cash, deposited in the bank. Further, Ford had earned $59,994,918.01 in net profits. It had 8,000 cars in inventory and could not produce enough cars to satisfy demand. *Id.* Total cash available for distribution exceeded $100,000,000.00. Among other claims, plaintiffs alleged that Ford's conduct violated the Sherman Act as being an attempt to "monopolize" the market through a predatory pricing scheme. *Id.*

October 13, 1915.[40] Nevertheless, notwithstanding these extensive ordinary and special dividend payments, Ford maintained vast cash surpluses.[41] On July 31, 1916, Ford's cash surplus was $111,960,907.53.[42]

Throughout this time, the Dodges, like other Ford shareholders, experienced a huge return on their investment; and there was no end in sight. "It had been the practice under similar circumstances to declare larger dividends."[43] This certainly was the shareholders' expectation.

However, in 1913 a dispute arose between Ford and the Dodges when the Dodge Brothers stopped supplying parts to Ford and decided to become competitors by building their own motor vehicle plant. In 1914, the Dodges tried to sell their shares back to Ford Motor and to Henry Ford for $15,000,000.00; but this was rejected. In 1915 and 1916, they offered to sell these shares again for $25,000,000.00 and $35,000,000.00 respectively; however, these offers were also declined.[44]

In July 1916, Henry Ford controlled Ford Motor Company. At the time of this dispute, the Dodges owned ten percent (10%) of Ford stock while Henry Ford owned fifty-eight percent (58%); a small handful of others owned the remaining shares.[45] During this time, Ford placed his son, Edsel, on the board and had shares issued to him to qualify him for this position.

On July 31, 1916, Henry Ford issued a press release, announcing that Ford would stop paying special dividends. In the release, Mr. Ford declared a social policy goal for Ford and stated that:

> My ambition is to employ still more men; to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes. To do this, we are putting the greatest share of our profits back into the business.[46]

During this time, Henry Ford privately purchased property upon which he planned to build a new production plant to double Ford's production capacity. On

40.

Date	Special Dividend
December 13, 1911:	$1,000,000
May 15, 1912:	$2,000,000
July 11, 1912:	$2,000,000
June 16, 1913:	$10,000,000
May 14, 1914:	$2,000,000
June 12, 1914:	$2,000,000
July 6, 1914:	$2,000,000
July 23, 1914:	$2,000,000
August 23, 1914:	$3,000,000
May 28, 1915:	$10,000,000
October 13, 1915:	$5,000,000

Total: $41,000,000 in special dividends.

41. September 30, 1912, $14,745,095.67
1913: $28,124,173.68
1914: $48,827,032.07
1915: $59,135,770.66
July 31, 1916: $111,960,907.53

42. *Id.*

43. *See, Dodge* v. *Ford, supra*, 170 N.W. at 683.

44. *See,* Smith at footnote 199, citing William C. Richards, The Last Billionaire, Henry Ford (1948).

45. *See Smith* at 317.

46. *Dodge* v. *Ford, supra* 170 N.W. at 683. When Ford made this statement, the plaintiffs testified that he told them "that, as all the stockholders had received back in dividends more than they had invested, they were not entitled to receive anything additional to the regular dividend of 5% a month and that it was not [Ford's] policy to have larger dividends declared in the future, and that the profits and earnings of the company would be put back into the business for the purpose of extending its operations and increasing the number of its employees, and that inasmuch as the profits were to be represented by investment in plants and capital investment, the stockholders would have no right to complain." *Id.*

September 28, 1916, the plaintiffs sent Ford a letter, requesting a private meeting to discuss (1) Ford's decision to stop the company's special dividend; and (2) his intentions to expand the company's production capacities using corporate earnings. On October 10, 1916, Edsel replied that the plaintiffs' letter would be considered by the corporate board. On October 31, 1916, the Ford board met. However, instead of commenting on the letter, it approved a $1,000,000.00 contract to construct an iron ore smelting plant on Henry Ford's land which the company did not then own. Three days later, in another special meeting, the board corrected its error by approving a $23,000,000.00 purchase of this property to build a new production plant.

The day before, on November 2, 1916, the plaintiffs filed suit. Shortly thereafter, notwithstanding Henry Ford's public statement, Ford paid a $2,000,000.00 special dividend.[47] At the bench trial, Henry Ford admitted to having a view that corporations should be operated "incidentally to make money" because "business is a service, not a bonanza."[48]

Based on these statements, the evidence of Mr. Ford's corporate control and the court's adherence to the shareholder primacy doctrine, which required corporations to maximize profits as opposed to carrying out incidental social policies, the trial court ordered Ford to declare a special dividend of $19,000,000.00. It further enjoined Ford from carrying out its board's decision to purchase the assets necessary to build a new plant. The trial court also precluded Ford from accumulating more liquid assets "beyond an amount reasonably required in the proper conduct and carrying on of a business and operations. . . ."[49]

After trial, Ford appealed the decision and the Michigan Supreme Court affirmed the trial court's order for a special dividend.[50] However, it reversed with regard to Ford's plans to build a new plant, stating that "judges are not business experts."[51] The latter was an articulation of the business judgment rule.[52]

---

47. One of the benefits of filing suit where a company has a significant cash position and has stopped dividend payments is that it may prompt the company to reverse its position and pay a dividend.

48. This was through cross-examination wherein Ford was confronted with a statement made to the press in comment to the lawsuit stating that: "I do not believe that we should make such awful profits on our cars. A reasonable profit is right, but not too much." *See, Smith, supra.* Apart from other lessons, this case demonstrates the danger of such press statements and their effect at trial.

49. 170 N.W. at 683. After the verdict, Henry Ford resigned as the corporation's president. He announced plans to start a new car company. Ford's announcement had a dampening effect on Ford stock and he ultimately was able to succeed in buying out all the minority shareholders for substantially less than the stock's fair value. Ford bought these shares for $12,500.00 per share except for two, Mr. & Mrs. Couzens who received $13,000.00 a share. This represented a substantial discount on fair value.

50. The Michigan Supreme Court provided a one third of cash distribution which amounted to approximately $19,000,000.00 as a special dividend. Plaintiffs had originally wanted a 75% distribution which was $39,375,000.00.

51. 170 N.W. at 710.

52. *See, Cuker* v. *Mikalauskus. 642 A.2d 1042 (Pa. 1997)*, where the Pennsylvania Supreme Court held that the business judgment rule is Pennsylvania law. The Court stated the Rule as follows:

> The business judgment rule insulates an officer or director of a corporation from liability for a business decision made in good faith if he is not interested in the subject of the business judgment, is informed with respect to the subject of the business judgment to the extent he reasonably believes to be appropriate under the circumstances, and rationally believes that the business judgment is in the best interest of the corporation. 1 ALI, *Principles of Corporate Governance: Analysis and Recommendations, (1994) ("ALI Principles") Section 4.01(c)*. The Delaware Supreme Court has [stated]:
>
> It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption. *Aronson* v. *Lewis, 473 A.2d 805, 812 (Del. 1984).*

The Rule has been part of Pennsylvania law since 1872. *Id. at 1047, citing Sperling's Appeal, 71 Pa. 11 (1872)* "While directors are personally responsible to the stockholders for any losses resulting from fraud,

Dodge shows that, when a controlling majority, here one dominant shareholder, causes a corporation to deviate from the shareholder primacy doctrine, its duty to maximize profit, and fails to distribute corporate earnings to the detriment of the corporation's minority shareholders, it may be ordered to do so in equity. As discussed below, the shareholder primacy doctrine is significant to a close corporation's duty to pay its shareholders distributions through dividends or wages.[53]

Since such shareholders cannot sell their shares, because there is no market for the sale of a close corporation's stock, without distributions to offset the imputed income from actual earnings, a minority shareholder's stock can even become a useless tax liability.[54] For this reason, for close corporations, "the wrongful suppression of dividends is a common ground upon which courts grant oppression relief."[55]

The Fiduciary Duty To Exercise The Utmost Good Faith, Loyalty, And Fair Dealing And To Share Business Opportunities And Information

The comments to Pennsylvania's oppression statute expressly refer to holders of close corporate stock as "corporate partners". Indeed, the expressed purpose of this statute is "to establish a statutory foundation for the development . . . of safeguards for incorporated partners in dealing with each other, rather than forcing the courts to distort the general rules of corporate law in order to grant relief in closely held situations."[56] For the reason, Judge Cardozo's statement of partnership duty in *Meinhard* v. *Salmon*[57] correctly states the duty of those in corporate control in close corporations to minority shareholders and supports a common law equity action for a breach of fiduciary duty to minority shareholders.[58]

In *Meinhard* v. *Salmon*, decided in 1928, Judge Cardozo stated the law of partnership fiduciary duty that remains universally accepted today, 85 years later, as follows:

---

embezzlement or willful misconduct or breach of trust for their own benefit and not for the benefit of the stockholders . . . they are not liable for mistakes of judgment, even though they may be so gross as to appear to us absurd and ridiculous, provided they are honest and provided they are fairly within the scope of the powers and discretion confided to the managing body."). *See also, Watt's Appeal, 78 Pa. 370 (1875); Swentzel* v. *Penn Bank, 147 Pa. 140 (1892); Stone* v. *Schiller Building & Loan Ass'n, 302 Pa. 544 (1931).*

53. *Dodge* demonstrates the difference between "public" corporations, whose shares have an established market of exchange, and a close corporation, whose shares lack marketability. As Professor Moll notes, "When funds are retained and reinvested in the company rather than paid out as dividends, the minority [shareholder in a close corporation] has little ability to capture [any] increased value [from retained earnings] of the corporate shares . . ." *See, Moll, Shareholder Oppression and Dividend Policy in the Close Corporation,* 60 Wash. and Lee L. Rev. 841, 861 (2003).

54. Close corporations are usually subchapter S corporations. The pass through characteristic of such entities subject shareholders to imputed income which has been described as "phantom taxation" when shareholders do not receive dividends or wages to offset this income. As explained by Christopher Mercer:

> This S corporation election replaces the corporate income tax with a personal income tax burden, on S corporation income passed through to the individual shareholders . . . The S corporation's income continues to be fully taxable. . . .
>
> * * *
>
> While the legal obligation to pay the tax falls to the S corporation shareholders individually, the economic obligation remains with the enterprise as distributions sufficient to pay personal income tax obligations are practically assured. The rare instances in which insufficient distributions are made are best viewed as additional reinvestment.

Christopher Mercer, Business Valuation: An Integrated Theory (Wiley & Son 2008) at 255. *See also, A.W. Chesterton Company, Inc.* v. *Chesterton, 128 F.3d 1 (1st Cir. 1997) at note 1.*

55. *Moll, Shareholder Oppression, supra.*

56. Official Comments to 15 Pa.C.S.A. Section 1767, Purdons at 529.

57. 164 N.E. 545 (NY 1928).

58. *See, Donahue* v. *Rodd Electrotype Co. of New Eng., Inc., 328 N.E.2d 505 (Mass. 1975)* (applying *Meinhard* in a closed corporation setting), discussed *infra*.

> Joint adventurers, like co-partners, owe to one another the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive is the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the role of undivided loyalty by the "disintegrating erosion of particular expectations" (*Wendt* v. *Fisher*, 243 NY 439, 444). Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.[59]

Meinhard involved a partnership dispute among close friends.[60] Defendant Salmon had started a fledgling real estate business;[61] and when he procured a commercial lease from Louisa Gerry, a wealthy New Yorker, who inherited the property at issue, located at the Northwest Corner of Fifth Avenue and 42nd Street.[62] Salmon procured half of the $200,000 in financing needed to develop the property from his friend, Meinhard, a Cleveland woolen merchant.[63] The Salmon/Gerry twenty-two year lease was signed on April 10, 1902. The Salmon/Meinhard partnership agreement was signed six weeks later, on May 19, 1902.[64] It lasted the duration of the lease.

Pursuant to the partnership agreement, Salmon was to have control of the real estate business venture; Meinhard was a silent investment partner. He agreed to pay half the money needed and Salmon agreed "to manage, lease, underlet, and operate" the premises.[65] In exchange for his financing, Salmon agreed to pay Meinhard 40% of the net profits for the first five years and 50% of these profits for the remaining 15 years of the lease, after deducting operating expenses and an additional property management charge.[66] The agreement provided for a 50/50 split of any losses.[67]

As often happens in these cases, what started as a great business venture between two friends soured because of various disputes.[68] In the case, evidence was presented about disagreements over Salmon's claimed management commissions and

59. *Id.* at 546.

60. *See, Thompson, The Story of Meinhard* v. *Salmon and Fiduciary Duty's Punctillo*, Vand. Univ. L. S. Pub. Law and Legal Theory, Working Paper No. 08-44 (hereinafter "Thompson"). Professor Thompson's article provides a fuller factual background and will be referenced in addition to the actual opinion.

61. Thompson at 4. Salmon had just made his first venture three years before. *Id.*

62. Thompson at 3. Ms. Gerry's maiden name was Livingston; her ancestor was Robert Livingston, a founding father who helped prepare the Declaration of independence. *Id.* Her grand uncle was chancellor of New York and an Ambassador to France, where he negotiated the Louisiana Purchase. Her mother's father had purchased the land in 1852, when it was worthless. Before leasing the land to Salmon, Ms. Livingston's family had leased it to William Webb, a shipbuilder, who had erected an eight story hotel, known as the Bristol Hotel, there. *Id.* Ms. Livingston married Elbridge Gerry, who also was a descendant of a signer of the Declaration of Independence. This ancestor, also Elbridge Gerry, was a governor of Massachusetts and the fifth vice president. His name is the origin of the term, "gerrymandering", which originated from his redistricting in Massachusetts to assist his Democratic Republican party in an election. *Id.*; *Encyclopedia Britanica On Line.*

63. 164 N.E. at 547. In truth, he was a dry goods merchant. Thompson at 5, note 20.

64. *Thompson, supra*, at 7, note 33, citing "Plaintiff's Exhibit 3" presented in the case, the Memorandum of Agreement.

65. *Meinhard, supra.*

66. Significantly to the Cardozo opinion, Meinhard had given Salmon an additional partnership share to represent the fee for managing the property. *Id.* at note 35, citing plaintiff's Exhibit 37, August 1, 1906 letter of Meinhard to Salmon.

67. *Id. at 545.*

68. Thompson at 8, citing to the Memoirs of Mr. Meinhard's widow, Carrie Meinhard, *Across My Path, Recollections of an Old New Yorker (New York 1950)* at 58. She states that their friendship became strained when Meinhard did not meet with Salmon in Italy, when the latter was there for his honeymoon.

outside expenses.[69] By the end of the lease, the partners' alienation was nearly complete, even though their venture was personally profitable to both men.[70]

By 1922, the midtown area had developed extensively. In 1911, the New York Public Library, located across the street, was completed.[71] A few years later, Grand Central Station was built.[72] Property values at Fifth and 42nd street had increased to among the highest values in New York City.[73] By then, the Bristol Hotel/Salmon leased parcel had reverted to Louisa's husband, Elbridge Gerry, and their son, Robert, who operated the Gerry's real estate management operation.[74] During this time, the Gerrys had acquired the four surrounding parcels, and arranged for their leases to expire the same day as the Salmon lease.[75] All together, the contiguous area available for lease more than doubled, from 9,312 square feet (the Bristol Building) to 20,899 square feet.[76]

Before termination of the partnership, without Meinhard's knowledge, Salmon agreed with the Gerrys to lease the combined property with a promise to construct a 25 story building at a cost of $3,000,000.00.[77] The lease had a 20 year term, with three twenty year extensions that continued it until the end of the century.[78] Salmon agreed to rent of $350,000.00 that stepped up to $475,000.00. The original rent was $55,000.00. Moreover, the Gerrys agreed to fund $1.5 million of the construction costs in exchange for the higher rent. Salmon created a new corporate entity, Mid-Point Realty Company, of which he was the sole shareholder, which was the other party to the lease. Mid-Point's principal asset was the Salmon/Gerry lease.[79]

In July 1922, after learning about Salmon's secret deal with the Gerrys, Meinhard sued Salmon in Manhattan for breach of fiduciary duty and asked that the lease be held in trust as a venture asset. Meinhard prevailed at trial and on all appeals. The only difference was that his award increased at every appellate level.[80]

At trial, Meinhard was awarded 25% of the net profits, based on the percentage footprint of the Bristol Hotel's parcel area relative to the enlarged leased footprint awarded to Mid-Point Realty through the Gerry lease.[81] On appeal, based on alternative calculations of leaseable space, Meinhard's net profit share increased to 30%.

The case ultimately was presented to the New York Court of Appeals, the state's highest court. There, in a 5-4 decision, written by Judge Cardozo, Meinhard prevailed again; this time the court increased Meinhard's effective percentage to 50%, less one share, which was awarded for management control to Salmon, corresponding to the partners' original agreement wherein Meinhard gave additional revenue to Salmon for management fees.[82] Like other Cardozo decisions, *Meinhard* elevated business transactions to a higher standard of good faith, fair dealing and fiduciary

69. Thompson, *supra* at 9, citing to trial exhibits in the case.

70. *Id. at 10.* They made more than half a million dollars each on a $40,000 out of pocket investment. *Id., citing the Appellate Division Opinion at 223 A.D. at 666.* In 1910, the 17th Amendment was passed, and Meinhard transferred his interest to his wife; but this interest was returned to him at the time of the litigation.

71. *See* History of the New York Public Library, http://www.nypl.org/help/about-nypl/history.

72. Thompson at 10, note 48.

73. Thompson, *supra* at 10, note 48.

74. *Id.* at note 46. Robert took over the family's real estate business in 1910, when his father retired.

75. *Thompson, supra* at 11.

76. *See, Thompson, supra* at 11 with diagram. The Gerry property was 11,587 square feet.

77. *Thompson, supra* at 12; 249 NY at 463.

78. *Id.*

79. *Id.* 249 NY at 462.

80. *Thompson* at 13-16.

81. *Thompson* at 14.

82. 249 NY at 469-71.

relationships.[83] Significantly, the decision was published at the height of the "roaring twenties" when market excess was notorious.[84] Today, the decision's policies create a strong basis for a plaintiff's verdict so that, where *Meinhard* is cited, the plaintiff is usually the winner.[85]

Pennsylvania courts have applied *Meinhard* to enforce fiduciary duties among partners and joint adventurers. In *Clement* v. *Clement*,[86] the Pennsylvania Supreme Court applied *Meinhard* to reverse a Superior Court's decision, *en banc*, to vacate a chancellor's award to appoint a receiver as part of an ordered accounting and dissolution of a partnership between brothers. The Superior Court concluded that the plaintiff's claim, that partnership profits had been siphoned by the defendant over a long period of time during the partnership's 40 year period, was time barred by the doctrine of laches and that the plaintiff had not proven fraud. In reversing, the Pennsylvania Supreme Court stated:

> There is a fiduciary relationship between partners. Where such a relationship exists, actual fraud need not be shown. There [is] . . . evidence of self-dealing and diversion of partnership assets on the part of [defendant]—more than enough to sustain the chancellor's conclusion that several substantial investments made by [defendant] over the years were bank rolled with funds improperly withdrawn from the partnership. Further, we are of the opinion that the doctrine of laches is inapplicable because [plaintiff's] delay in asserting his rights was as much a product of [defendant's] concealment and misbehavior as of any negligence on his part. One should not have to deal with his partner as though he were the opposite party in an arms-length transaction. One should be allowed to trust his partner, to expect that he is pursuing a common goal and not working at cross-purposes. This concept of the partnership entity was expressed most ably by Mr. Justice, then Judge, Cardozo, in *Meinhard* v. *Salmon*, 249 N.Y. 458, 164 N.E. 545 (1928).
>
> * * *
>
> It would be unduly harsh to require that one must prove actual fraud before you can recover for a partner's derelictions. Where one partner has so dealt with the partnership as to raise the probability of wrongdoing, [it] ought to be his responsibility to negate that inference. It has been held that "where a partner fails to keep a record of partnership transactions, and is unable to account for them, every presumption will be made against him." *Bracht* v. *Connell*, 170 A.2d 297, 301 (1933). Likewise, where a partner co-mingles partnership funds with his own and generally deals loosely with partnership assets, he ought to have to shoulder the task of demonstrating the probity of his conduct.[87]

83. *See, Thompson, supra* at 16, Note 67, citing Andrew L. Kaufman, Cardozo (1998) at 450. *Id.*, citing Richard A. Posner, Cardozo and a Study of Reputation 104-5 (1989).

84. *See,* Fitzgerald, "The Great Gatsby" (1925). *See also,* Cardozo's decisions in *Jones* v. *United States*, 298 U.S. 1, 30 (1936) (dissent) ("recklessness and deceit do not automatically excuse themselves by notice of repentance"); *Wood* v. *Lucy Lady Duck-Gordon*, 118 N.E. 214 (NY 1917) (establishing the doctrine of promissory estoppel); *Allegheny College* v. *National Chautaugua County Bank*, 159 N.E. 173 (NY 1927) (enforcing a promise for charitable contribution); *Wendt* v. *Fisher*, 154 N.E. 303 (NY 1926) (duty of loyalty discussed in context of real estate agents duty to disclose a significant relationship to buyer).

85. *Thompson, supra*, at 16 : [The decision] has been cited more than 1000 times, almost always when the result is that a duty will be found and the court wants to set a tone; "if you see *Meinhard* quoted, you can expect that plaintiff is going to win." *See also,* cited, Robert W. Hillman, Closely-Held Firms in the Common Law of Fiduciary Duty: What Explains the Enduring Qualities of a Punctilio, 41 Tulsa L. Rev. 441, 449 (2006). Key statements from the case include the following:

> "[Salmon excluded his] Co-adventurer from any chance to compete. . . ." [He appropriated the opportunity ["to himself in secrecy and silence]. . . ."" No answer is to say that the chance would have been of little value even if seasonably offered, such a calculus of probabilities is beyond the science of chancery. . . ."" Only through disclosure would opportunity be equalized." . . . "Loyalty and comradeship are not so easily abjured." *Id., 249 NY458, 164 NE 545.*

86. 260 A.2d 728 (Pa. 1970).

87. *Clement* v. *Clement*, 436 Pa. 466-469 (1970). *Meinhard* was also recently cited in *Weston* v. *Northampton Personal Care, Inc.*, 62 A.3d 947 (Pa. Super. 2013) (Opinion by Stevens).

Clearly, Pennsylvania's close corporations are recognized as distinct from other corporations. They are more like partnerships or joint ventures, where members have fiduciary duties to one another to act with the utmost good faith and fair dealing.[88] Consequently, the policies of *Meinhard* and *Clement, supra*, which recognize these fiduciary duties, apply to close corporations to support a common law cause of action for breach of fiduciary duty. In such cases, the plaintiff is not constrained to prove fraud. Instead, the scope of culpable conduct is established by direct, circumstantial or inferential evidence showing oppressive conduct. These partnership fiduciary duties were explicitly applied to a close corporation in *Donahue*,[89] discussed below.

Preserving "Corporate Democracy" By Enforcing Fiduciary Duties in Close Corporations

In 1975, the Massachusetts Supreme Court became the first to apply a partnership's fiduciary duties in a close corporate setting. In *Donahue*, a minority shareholder successfully challenged a close corporation's purchase of a retiring majority shareholder's stock, where the company was controlled by the selling shareholder's children and his long-time corporate counsel.[90] Even though the sale was made for the stock's book value, because lower prices were offered to Mrs. Donahue, a minority shareholder, the sale was held to be a breach of fiduciary duty. The court held that the corporation had breached its duties because it had "failed to accord her an equal opportunity to [redeem] her shares to the corporation" at the same favorable price.[91] In reaching its decision, the Massachusetts Supreme Court described why it is fundamentally necessary, at common law, to recognize a remedy for oppressed minority shareholders of close corporations as follows:

> Although the corporate form provides . . . advantages for the stockholders (limited liability, perpetuity, and so forth), it also supplies an opportunity for the majority stockholders to oppress or disadvantage minority stockholders. The minority is vulnerable to a variety of oppressive devices, termed "freeze-outs," which the majority may employ. *See, generally, Note, Freezing Out Minority Shareholders*, 74 Harv. L. Rev. 1630 (1961) . . . "The squeezers [those who employ the freeze-out techniques] may refuse to declare dividends; they may drain off the corporation's earnings in the form of exorbitant salaries and bonuses to the majority shareholder-officers and perhaps to their relatives, or in the form of high rent by the corporation for property leased from majority shareholders . . .; they may deprive minority shareholders of corporate offices and of employment by the company; they may cause the corporation to sell its assets at an inadequate price to the majority shareholders . . . ." F.H. O'Neal and J. Derwin, *Expulsion or Oppression of Business Associates*, 42 (1961). In particular, the power of the board of directors, controlled by the majority, to declare or withhold dividends and to deny the minority employment is easily converted to a device to disadvantage minority stockholders. . . .
>
> * * *
>
> Thus, when these types of "freeze-outs" are attempted by the majority stockholders, the minority stockholders, cut off from all corporation-related revenues, must

88. A Pennsylvania close corporation has less than 31 stock holders ("not more than 30"). 15 Pa.C.S. §1103.

89. 328 N.E. 505 (Mass. 1975).

90. The retiring president sold his shares back to the company for $800 per share. Plaintiffs asked for the same price, but this was declined. Instead, they had made prior offers of $40 - $200 per share, below the stock's book value.

91. *Id.*

either suffer their losses or seek a buyer for their shares. Many minority stockholders will be unwilling or unable to wait for an alteration in majority policy. Typically, the minority stockholder in a close corporation has a substantial percentage of his personal assets invested in the corporation. . . . The stockholder may have anticipated that his salary from his position with the corporation would be his livelihood. Thus, he cannot afford to wait passively. He must liquidate his investment in the close corporation in order to reinvest the funds in income-producing enterprises.

At this point, the true plight of the minority stockholder in a close corporation becomes manifest. He cannot easily reclaim his capital. In a large public corporation, the oppressed or dissident minority stockholder could sell his stock in order to extricate some of his invested capital. By definition, this market is not available for shares in the close corporation. In a partnership, a partner who feels abused by his fellow partners may cause dissolution by his "express will . . . at any time" . . . and recover his share of partnership assets and accumulated profits. . . . If dissolution results in a breach of the partnership articles, the culpable partner will be liable in damages. . . . By contrast, the stockholder in a close corporation or "incorporated partnership" may achieve dissolution and recovery of his share of the enterprise assets only by a compliance with the rigorous terms of the applicable [state corporate law]. . . . The minority stockholder, by definition, lacking fifty per cent of the corporate shares, can never "authorize" the corporation to file a petition for dissolution under [applicable state law] by his own vote. He will seldom have at his disposal the requisite favorable provision in the articles of organization.

Thus, in a close corporation, the minority stockholders may be trapped in a disadvantageous situation. No outsider would knowingly assume the position of the disadvantaged minority. The outsider would have the same difficulties. To cut losses, the minority stockholder may be compelled to deal with the majority. This is the capstone of the majority plan. Majority "freeze-out" schemes which withhold dividends are designed to compel the minority to relinquish stock at inadequate prices. . . . When the minority stockholder agrees to sell out at less than fair value, the majority has won.

Because of the fundamental resemblance of the close corporation to the partnership, the trust and confidence which are essential to this scale and manner of enterprise, and the inherent danger to minority interests in the close corporation, we hold that stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another. [This is the duty of "utmost good faith and loyalty."]. . . . Stockholders in close corporations must discharge their management and stockholder responsibilities in conformity with this strict good faith standard. They may not act out of avarice, expediency or self-interest in derogation of their duty of loyalty to the other stockholders and to the corporation.

* * *

[S]tockholders participating in management [are held] to a standard of fiduciary duty more exacting than the traditional good faith and inherent fairness standard because of the trust and confidence reposed in them by the other stockholders. . . . In these . . . cases . . . we have imposed a duty of loyalty more exacting than that duty owed by a director to his corporation . . . or by majority stockholder to the minority in a public corporation because of facts particular to the close corporation in the cases.[92]

92. *Id.* at 592-593. The *Donahue* Court explicitly extended Judge Cardozo's ruling in *Meinhard* to minority shareholders of a close corporation as follows:

The more rigorous duty of partners and participants in a joint adventure, here extended to stockholders in a close corporation, was described by then Chief Judge Cardozo of the New York Court of Appeals in *Meinhard* v. *Salmon*, 249 N.Y. 458 (1928). . . ." *Id.*, 328 N.E. 2d 505, 594.

Even before *Donahue*, Pennsylvania Courts recognized a fiduciary duty of majority shareholders and those in control of a corporation to minority shareholders.[93] For example, in *Glenn* v. *Kittanning Brewing Co.*,[94] decided in 1918, the Pennsylvania Supreme Court stated:

> The directors of a corporation stand in the position of trustees for the entire body of stockholders, and while stock owned by the director is his individual property to be dealt with as he sees fit in the same manner and to the eame extent as other stockholders[;] yet, when he acts in his official position, he is not merely [acting] as an individual but as representative of others and is prohibited from taking advantage of his position for his personal profit or to reap personal benefit to the detriment of the stockholders whom he represents.

Donahue has been cited favorably in Pennsylvania to describe these specific duties at common law with regard to close corporations.[95] For example, in *Orchard* v. *Covelli*,[96] the United States District Court for the Western District of Pennsylvania expressly adopted *Donahue's* reasoning to deny summary judgment to the plaintiff's common law breach of fiduciary duty claim as follows:

> The judicial relief fashioned in *Donahue* reflected the Court's concern with the vulnerability of minority shareholders in close corporations particularly where the distribution of assets is involved. . . . We think this is a sound result, one which is applied easily to the present case.[97]

As discussed below, these duties also apply to limit application of the employment at will doctrine in the close corporate setting.

Limiting The At-Will Doctrine for Minority Shareholders: Recognizing Employment As An Investment

In *Wilkes* v. *Springside Nursing Home, Inc.*,[98] the Massachusetts Supreme Court applied *Donahue* to award damages to a minority shareholder who was removed from

93. *See, Glenn* v. *Kittanning Brewing Co., 103 A. 340 (Pa. 1918); Weisbecker* v. *Hosiery Patents, Inc., 51 A.2d 811 (Pa. 1947); Ferris* v. *Glen Alden Corp., 143 A.2d 25 (Pa. 1958); Ferber* v. *American Lamp Corp., 469 A.2d 1046 (Pa. 1983).*

94. 103 A. 340 (Pa. 1918).

95. *See, Korman Corporation* v. *Franklin Town Corp., 34 Pa.D.&C.3d 495, 502 (Phila. CCP 1984)* (overruling demurrer to common law claim of breach of fiduciary duty to minority shareholder); *Warehime* v. *Warehime, 777 A.2d 469 (Pa. Super. 2001), rev'd on appeal, 860 A.2d 41 (Pa. 2004)* (reversing on misapplication of the standard of review of findings of fact in equity); *Ceda Mills, Inc.* v. *Duffy, 2012 U.S. Dist. LEXIS 44344 (W.D. Pa. 2012) (affirming findings of the bankruptcy court).*

96. 590 F.Supp. 1548 (W.D. Pa. 1984).

97. *Id.* at 1559. *Orchard* concerned a dispute over a McDonald's franchise business, consisting of approximately 11 restaurants, located in Erie Pennsylvania, operated by brothers-in-law. Covelli had prior experience with a fast food restaurant in Canton, Ohio; and, based on his success, his brother in law, Orchard, joined to start six (6) such restaurants in Erie. They were also joined by a group of investors, known as the Chicago Group. Their respective shares in these operations was agreed to be: 45% Chicago Group; 40% Covelli; and 15% Orchard. Both were involved in the management of the enterprise, but their business arrangement soured after opening their eleventh restaurant, the Buffalo Road McDonald's. Covelli did not disclose to Orchard that the Chicago Group was not part of this enterprise and, instead of receiving 40% of the net profits, he received 85% of these profits. During this time, Covelli negotiated the redemption of the Chicago Group interests. Orchard asked for the same redemption arrangement, which was refused, following their dispute over the Buffalo Road McDonald's. Covelli then, through the corporate counsel, fired Orchard and replaced him on the board of directors with Covelli's son. In *Bair* v. *Purcell, 500 F.Supp.2d. 468 (M.D. Pa. 2007)*, the United States District Court for the Middle District of Pennsylvania also applied *Donahue* v. *Rodd Electrotype, supra* to affirmatively recognize a common law fiduciary duty to minority shareholders in a close corporation. As the Court stated, "We think this [is] a sound result, one which is applied easily to the present case." *Id.* at 1559.

98. 353 N.E.2d 657 (Mass. 1976).

his directorship and fired from the company. In reaching its decision, the Court described how such terminations are part of a classic "freeze-out" scheme:

> "Freeze-outs" ... may be accomplished by the use of ... devices [other than stopping dividends]. One such device ... particularly effective ... is to deprive minority stockholders of corporate offices and of employment with the corporation. ... This "freeze-out" technique has been successful because courts fairly consistently have been disinclined to interfere in those facts of internal corporate operations, such as the selection and retention or dismissal of officers, directors and employees, which essentially involve management decisions subject to the principle of majority control....
>
> [However, t]he denial of employment to the minority at the hands of the majority is especially pernicious in some instances. The guaranty of employment with the corporation may have been one of the "basic reason[s] why a minority owner has invested capital in the firm." [Citations omitted]. The minority stockholder typically depends on his salary as the principal return on his investment, since the "earnings of a close corporation ... are distributed in major part in salaries, bonuses, and retirement benefits." [Citations omitted]. ... [Dismissal also] severely restricts [the minority stockholder's] participation in the management of the enterprise....[99]

In *Wilkes*, the plaintiff founded a nursing home with three partners. Shortly thereafter, they created a corporation. When formed, the partners each contributed $1000 and received 10 shares of stock in exchange.[100] They understood that they would all be working in the business; and they each had distinctive functions and roles therein. Plaintiff was in charge of the building and maintenance; he also served as director and as the corporate treasurer.[101]

After several years of operations, a dispute arose between the plaintiff and another managing director relating to the sale of a portion of the business's real estate; plaintiff objected because the director wanted to use it to operate another nursing home. As a result, the property was sold at a higher price than anticipated and, thereafter, his relationship with the other managing shareholders changed.[102] Plaintiff offered to sell his shares to the company; but this was refused.[103]

Subsequently, a special board meeting was held where the directors voted, over plaintiff's objection, to increase their salaries; plaintiff's salary was unchanged.[104] The next month, at a shareholders' meeting, plaintiff was not re-elected as director. He was also told that his services were no longer needed; his employment was terminated.[105] At the master's hearing, it was found that plaintiff had consistently endeavored to carry on his responsibilities in the same manner as before; he was ready, willing, and able to continue his job responsibilities. The Massachusetts Supreme Court affirmed the master's findings of oppression by stating that there was no "legitimate business purpose" in firing the plaintiff.[106] He had engaged in no misconduct and had never indicated any unwillingness to continue to perform his job duties. It also found that the corporation's shareholders had a long-standing policy that they would share in management through their employment and positions on the corporate board and that employment "would go hand in hand with

99. 353 N.E.2d 657, 662.
100. *Id.* at 659.
101. *Id.* at 660.
102. *Id.* at 661.
103. *Id.*
104. *Id.* at 661.
105. *Id.*
106. *Id.* at 664.

stock ownership."[107] Accordingly, even though Wilkes would not have a remedy for wrongful discharge because of the at will doctrine, the Court applied *Donahue* to provide relief in damages pursuant to a breach of fiduciary duty to a minority shareholder.[108]

The holding in *Wilkes* acknowledges a minority shareholder's legitimate expectation to employment in a close corporation as part of his or her investment in the business. The fiduciary duty of controlling interests to minority shareholders protects this investment interest.[109] Without directly referencing *Wilkes*, Pennsylvania Courts have recognized this protection. In *Bair* v. *Purcell*,[110] the United States District Court for the Middle District of Pennsylvania denied summary judgment filed against a breach of employment contract in an employment at-will oral contract, based on disputed material facts regarding an "implied in fact" contract.

In *Bair*, the parties started a Pennsylvania bread distribution business. To conduct the business, the plaintiffs relocated to Pennsylvania and, in so doing, left their Georgia home and jobs to join the defendants in their on-going operation. Based on this evidence, the court denied summary judgment with regard to the plaintiff's wrongful discharge claim because "[i]n light of the evidence of Plaintiffs' relocation, the distressed sale of their home, their decision to forego other employment opportunities, and their arguably stronger bargaining power than the average employee, a jury could find that plaintiffs provided 'additional consideration' indicating that the parties intended to overcome the at-will presumption."[111]

DEFINING MINORITY SHAREHOLDER OPPRESSION: FACTS SUPPORTING A COMMON LAW CLAIM

Both common law claims and Pennsylvania's Freeze-out statute, Section 1767(a)(2), provide remedies for minority shareholder "oppression". Generally, "oppression" is defined as an "unjust or cruel exercise of authority or power."[112] However, most Pennsylvania Courts use the definition of oppression provided by the New York Court of Appeals in its decision, *In Re: Kemp & Beatley, Inc.*[113] In *Kemp*, two long term shareholder employees requested dissolution of Kemp & Beatley, a manufacturer of table linens, pursuant to Article 11, Section 1104-a, of New York's Business Corporation Law.[114] They had worked there for 35 and 42 years, respectively. Both served in management and one was a director. The director resigned and the plant manager was fired within 18 months of one another. When employed, they enjoyed the receipt of bonuses, which represented performance and the payment of dividends. After their separation from the firm, this policy changed so that bonus payments were no longer tied to stock ownership. Upon petition, a referee found that the cor-

107. *Id.*
108. *Id.*, 353 N.E.2d at 664.
109. Moll, *Shareholder Oppression* v. *Employment at Will in the Close Corporation: The Investment Model Solution*, 1999 U. Ill. L. Rev. 517, 547 (1999).
110. 500 F.Supp.2d 468 (M.D. Pa. 2007).
111. 500 F.Supp.2d at 481.
112. Merriam-Webster Dictionary. www.merriam-webster.com/dictionary/oppression. This definition was used by the Pennsylvania Superior Court in *Leech* v. *Leech, 762 A.2d 718 (Pa. Super. 2000)*.
113. 473 N.E.2d 1173 (NY App 1984). *See, Gee* v. *Blue Stone Heights Hunting Club, Inc., 604 A.2d 1141 (Pa. Cmwlth. 1992)* (citing *Kemp, supra* in the context of a petition to dissolve a non-profit corporation pursuant to 15 Pa.C.S. 5981); *Del Borrello* v. *Del Borello*, 62 D.&C. 4th 417 (Phila. CCP); *Adler* v. *Tauberg, 881 A.2d 1267 (Pa. Super. 2005) (citing, Del Borrello* v. *Del Borello, supra*, to define oppression within context of Section 1767(a)(2)); *Ford* v. *Ford, 878 A.2d 894 (Pa. Super. 2005)*.
114. N.Y. BCL Section 1104-a. *See*, Davidian, *Corporate Dissolution in New York: Liberalizing the Rights of Minority Shareholders*, 56 St. John's L. Rev. 24 (1981).

poration, controlled by others, had engaged in oppressive conduct and that the only remedy was dissolution. In affirming the decision, the New York Court of Appeals defined "oppression" as follows:

> [O]ppression . . . arise[s] when "those in control" of the corporation "have acted in such a manner as to defeat those expectations of the minority stockholders which formed the basis of [their] participation in the venture."[115] The expectations [are] that they would not be arbitrarily excluded from gaining a return on their investment and that their stock would be purchased by the corporation upon termination of employment. . . . It is widely understood that, in addition to supplying capital to a contemplated or ongoing enterprise and expecting a fair and equal return, parties comprising the ownership of a close corporation may expect to be actively involved in its management and operation. . . . [In such circumstances, th]is participation . . . is often his principal or sole source of income[;] providing employment for himself may have been the principal reason why he participated in organizing the corporation. . . . In his capacity as an officer or employee of the corporation, he looks to his salary for the principal return on his capital investment. . . . A shareholder who reasonably expected that ownership in the corporation would entitle him or her to a job, a share of corporate earnings, a place in corporate management, or some other form of security, would be oppressed in a very real sense when others in the corporation seek to defeat those expectations and there exists no effective means of salvaging the investment. . . . [Such expectations depend, in part, on] what the majority shareholders knew, or should have known, to be the [minority shareholder's] expectations in entering the particular enterprise. Majority conduct should not be deemed oppressive simply because the [minority shareholder's] subjective hopes and desires in joining the venture are not fulfilled. Disappointment alone should not necessarily be equated with oppression. Rather, oppression should be deemed to arise only when the majority conduct substantially defeats expectations that, objectively viewed, were both reasonable under the circumstances and were central to the [minority shareholder's] decision to join the venture.[116]

Evidence of oppression includes (1) the violation of the shareholder primacy doctrine through the denial of dividend payments (*Dodge* v. *Ford, supra*); (2) depriving minority shareholders of business opportunities (*Meinhard* v. *Salmon, supra*); (3) violating corporate democracy by giving majority shareholders preferential treatment through, for example, providing preferred prices for redeemed majority stock (*Donahue* v. *Rodd Electrotype, supra*); and (4) terminating the minority shareholder's employment with the corporation (*Wilkes* v. *Springside Nursing Home, Inc., supra*). Oppression does not require all of these events to occur; any one of them may be sufficient to defeat a minority shareholder's reasonable expectations in obtaining a return on his or her investment in the close corporation. As discussed below, another (fifth) category of oppression is self-dealing and corporate waste.

WASTE AND SELF-DEALING AS OPPRESSIVE ACTS, COMMON LAW STANDING AND TRIGGERING EVENTS— ESTABLISHING THE FREEZE-OUT DATE

No Investment Necessary

Significantly, Pennsylvania does not require a minority shareholder to personally invest money in the corporation to establish a breach of fiduciary duty. In *Ferber* v. *American Lamp*,[117] the Pennsylvania Supreme Court affirmed a claim for a minority

115. Citation omitted.
116. *In re: Kemp & Beatley, Inc., supra at 802-805.*
117. 469 A.2d 1046 (Pa. 1983).

shareholder who inherited a 13.33% (2/15th) interest in her father's sole proprietorship, through his will.[118] The will stated that the business would continue and be operated by the father's sons "it being my purpose and intention that after my decease, my sons shall carry on and conduct my business as long as they shall so elect."[119] The will divided profits among his wife and children.

After his death, his sons transferred the assets into two corporations. However, instead of paying dividends, they gave themselves high salaries, generous retirement benefits, and purchased luxury items.[120] In affirming the trial court's finding of oppression, the Pennsylvania Supreme Court stated that it "cannot be disputed [that] . . . Ms. Ferber has been shabbily, even shamefully treated by her brothers during this sixteen year period. . . . [W]e are in full accord with the trial court's observation that Harry, Isadore and Joseph . . . , while providing for themselves what may be termed luxurious compensation have, for all practical purposes, disregarded their father's wish that their sister be provided for in some significant way from the profits of the family business."[121] In some respects, this category of shareholder warrants special protection from majority shareholder abuse. They are perfect victims for freeze-out tactics designed to acquire minority shares at "blue light" bottom dollar discount prices.

Oppression Through Self-Dealing and Waste and Establishing The Freeze-out Date

Ferber also demonstrates a fifth category of oppression, self-dealing and corporate waste. As one victim aptly observed:

> Companies can be run in three ways: They can be run as a business. They can be run with the intention of selling. Or, they can be milked to death. If you can't sell it, you can milk it to death."[122]

In *Ferber, supra*, the Pennsylvania Supreme Court recognized that those controlling a business are able to abuse their positions to redirect funds that otherwise would be paid to shareholders as dividends or other compensation. Accordingly, it is necessary in discovery to evaluate the salaries, bonuses, fringes, and retirement packages that the controlling parties receive to determine whether they have been at the expense of others. This will often require an expert accounting. Other means of siphoning net profits include discounted loans to principals, above market rent, and the payment of income tax for those in control upon the receipt of treasury stock. As discussed below, such information is relevant and useful to objectively establish "oppression" because, along with other evidence, such as prior offers to purchase the corporation, prior redemption arrangements, such valuations provide evidence of mismanagement (when these valuations are made too low or are without basis), preferential treatment (such as demonstrated in *Donahue, supra*), with the award of stock valued below fair value, and a means by which to measure any discount associated with any offer to purchase minority shares.[123]

118. The Pennsylvania Supreme Court reversed on the issue of damages because the trial court included salary and fringes taken by the majority shareholder officers to calculate imputed distributions to the minority shareholder.
119. *Id.*
120. The brothers bought luxury cars, boats, and had generous entertainment allowances.
121. *Id.* Accordingly, Pennsylvania is consistent with Massachusetts, as demonstrated by *Donahue, supra*, which involved a minority shareholder who inherited her husband's corporate stock, in its inclusion of protections to those who inherit or are gifted minority shareholder stock. *See also, Ford* v. *Ford, 878 A.2d 894 (Pa. Super. 2005)*, discussed *infra*.
122. Testimony attributed to defendant officer and director.
123. *See, Ford* v. *Ford, supra.*

Lastly, *Ferber*, like *Clement* v. *Clement*, *supra*, demonstrates the importance of establishing the "freeze-out date" to determine, *inter alia*, the applicable limitations period and whether the doctrine of laches should apply. In *Ferber*, the oppression period was sixteen (16) years. In *Clement*, this extended over a 40 year period. In neither case did the Pennsylvania Supreme Court bar the claim by applying the doctrine of laches.[124] In applying the legal remedies provided by Section 1767, the Pennsylvania two year statute of limitations may apply. In most situations, the triggering event will be obvious. The shareholder will be terminated; the corporation will have stopped paying dividends. These triggering events will establish a freeze-out date. This date, in turn, may have significant consequences for stock valuation. Such valuations are expert matters and require a detailed examination of the corporation's books, their financial disclosures, tax returns, K-1 statements, and other accounting records.

MINORITY SHAREHOLDER REMEDIES: CUSTODIANS, DISSOLUTIONS, DAMAGES, FAIR VALUE, FAIR MARKET VALUE, AND PUNITIVE DAMAGES

Determining the Appropriate Remedy: The Trial Court's Discretion to Appoint a Custodian or To Order Redemption, Receivership Or Sale

Pennsylvania Courts apply equity principles to determine the remedy for established shareholder oppression. Section 1767(a)(2)[125] provides the statutory basis for appointing a custodian of a corporation for the purposes of taking over corporate operations or dissolving it to distribute assets. Such extraordinary measures are recognized as reserved for situations where the dispute is so severe as to be uncorrectable through any alternative remedy.[126] However, trial courts have discretion to fashion alternative remedies even when the action is brought pursuant to the statutory claim provided by Section 1767. In *Orchard* v. *Covelli*,[127] the United States District Court for the Western District of Pennsylvania declined to order dissolution because, given that the entities were profitable going concerns, such an award would be "inappropriate and deleterious."[128] Instead, the Court awarded the plaintiff his "fair value of his interest in the corporation[, finding that] [s]uch relief is adequate to redress his claim of breach of the fiduciary duty and is necessary to bring the business dealings of the parties to an end."[129]

124. Laches is an equitable defense that may bar a claim where (1) there has been an inexcusable delay; and (2) prejudice to the defendant. *See, Jacobs* v. *Halloran, 710 A.2d 1098 (Pa. 1998).*

125. Section 1767(a)(2) provides in relevant part:

> (a) General rule.—Except as provided in subsection (b), upon application of any shareholder, the court may appoint one or more persons to be custodians of and for any business corporation when it is made to appear that: ***
>
> (2) In the case of a closely held corporation, the directors or those in control of the corporation have acted illegally, oppressively or fraudulently toward one or more holders or owners of 5% or more of the outstanding shares of any class of the corporation in their capacities as shareholders, directors, officers or employees . . . .

126. *See Glenn* v. *Kittanning Brewing Co., 103 A. 340 (Pa. 1918); Weisbecker* v. *Hosiery Patents, Inc., 51 A.2d 811 (Pa. 1947).*

127. 590 F.Supp. 1548 (W.D. Pa. 1984), *citing Rumbaugh* v. *Beck, 491 F.Supp. 511 (E.D. Pa. 1980). See also, Raumbaugh* v. *Beck, 601 A.2d 619 (Pa. Super. 1991).*

128. *Id.* at 1559.

129. *Id.*

Pennsylvania Courts, applying Section 1767, have followed this equitable logic to reserve dissolution and distribution for the most extreme cases. In *Leech* v. *Leech*,[130] *Adler* v. *Tauberg*,[131] and *Ford* v. *Ford*,[132] the Pennsylvania Superior Court applied Section 1767(a)(2) to appoint a custodian over the corporation. The standard of review is an abuse of discretion.[133] In *Leech*, two brothers had a dispute over succession for their tool and die business. Ultimately, one brother, Thomas, who was treasurer, announced that he was "leaving" and stopped coming to the business offices. Thereafter, he received a bank notice that his brother, Robert, had the only authorized signature on the corporate account. The following spring, despite announcing his "leaving", Thomas was re-elected as treasurer. Fifteen months after leaving, he returned. However, his brother told him that he should perform his duties elsewhere, off the company premises; and he denied Thomas access to corporate records and restricted the information made available to him. These circumstances were sufficient to establish oppression pursuant to Section 1767(a)(2) and the trial court's appointment of a custodian over the business was affirmed on appeal.[134]

In *Adler*, a majority group within a cardiology practice requested that the plaintiff retire from the practice and from his position as president. The defendants' conduct demonstrates a typical pattern of oppression when younger shareholders attempt to force an older member, often a founder, into retirement. After the plaintiff refused to retire, the defendants demanded that his salary be reduced by a third and then demanded that his contractually-guaranteed salary be thereafter tied to his production. They then diverted patients to themselves and away from plaintiff. Then they issued corporate shares to another doctor, in contravention of the corporation's existing shareholder agreement which restricted the issuance of shares. When their corporate counsel pointed out this violation, he was fired and replaced with new counsel, who rewrote the agreement. They then nominated Tauberg, another doctor in the practice, to the board and authorized themselves to receive additional compensation for their service as officers. The effect was to dilute the plaintiff's interest in net profits and the value of his corporate shares. The defendants paid the new attorney, their personal counsel, using corporate funds. They also used corporate funds to pay for items which the plaintiff did not agree were business related.[135] Given these egregious facts, the Superior Court affirmed the application of Section 1737(a)(2) to appoint a custodian over the business's operations.

130. 762 A.2d 718 (Pa. Super. 2000). The Superior Court did not review the basis for the custodian appointment in this case.

131. 881 A.2d 1267 (Pa. Super. 2005).

132. 878 A.2d 894 (Pa. Super. 2005).

133. In *Ford* v. *Ford, supra*, the Pennsylvania Superior Court, cited *Viener* v. *Jacobs, 834 A.2d 546 (Pa. Super. 2003)* for the applicable standard of review, stated as follows:

> A claim of oppressive conduct, like a claim of breach of fiduciary duty, "sounds in equity, and, as such, our standard of review is limited. We will reverse only where the trial court was palpably erroneous, misapplied the law or committed a manifest abuse of discretion. Where there are any apparently reasonable grounds for the trial court's deicison, we must affirm it. . . . We will not find that the trial court abused its discretion where there is a mere 'difference of opinion' regarding an interpretation of the facts. Rather, an abuse of discretion is found only in flagrant cases where there is not a substantial ground for difference of opinion. . . . When reviewing the results of a non-jury trial, we are bound by the trial court's findings of fact, unless those findings are not based on competent evidence. Absent an abuse of discretion, we are bound by the lower court's assessment of credibility of the parties."

134. *Leech* also provides a seventh (7th) basis for oppression, restricting corporate information from a minority shareholder. The Court was also influenced by the majority's hampering the oppressed shareholder in performing his job at the business. Moreover, in *Leech*, the plaintiff was a 50% owner. As discussed below, Pennsylvania does not restrict Section 1767's remedies to those holding a strict minority of shares. Rather, its application is predicated upon evidence of corporate control.

135. *Id.*

Ford concerns three separate oppression claims related to the operation of a golf course.[136] The case centered around the third lawsuit, filed against the founder's son, Bill, by his mother, sister, and brother. The oppressive conduct, affirmed on appeal, consisted of paying too little for corporate resources, most particularly, labor costs associated with Bill's side business, without adequate compensation. The private businesses yielded approximately $200,000 in gross receipts; however, the defendant paid less than 7 percent, about $13,500 for rental and labor costs paid back to the company. From this and other evidence, the trial court found, and the Superior Court affirmed, that defendant essentially ran the business for his own personal benefit to the exclusion of the other shareholders. The Superior Court affirmed the trial court's appointment of a custodian on these facts.

Valuing Minority Shares In a Forced Redemption

Most often, particularly where the corporation is a profitable enterprise, Pennsylvania courts order the purchase of a minority shareholder's interest in the business. Valuation is often a significant dispute in the litigation, with the defendants arguing for minority and lack of marketability discounts, and the plaintiffs requesting that their shares be redeemed without any discount on value. These disputes center upon whether the Court should order redemption at "fair value," which does not include discounts, or "fair market value," which includes such discounts.

Through equity jurisdiction, several courts apply a pragmatic approach to valuation. For example, in *Orchard* v. *Covelli*, the United States District Court for the Western District of Pennsylvania considered the BCL's statutory provisions for "appraisal rights" to determine such values. Pennsylvania's statutory appraisal rights for dissenting shareholders are established by Subchapter D of the Business Corporation Law.[137] Section 1571 states that dissenting shareholders "shall have the right to dissent . . . and to obtain payment of the fair value of [their] shares . . . ." The key term is "fair value". Section 1572 defines "fair value" as the "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."

However, notwithstanding what appears to be a clear discussion of minority shareholder rights—that they should receive the fair value of their shares—defendants argue for discounts provided by a "fair market value." Confusion arises, in part, from Internal Revenue Ruling 59-60 which is used to value estate stock for closely held corporations and in divorce matters to value stock as marital property.[138] While Rev. Ruling 59-60 describes an appropriate method to determine an "enterprise" value of a going concern, it does not provide a proper valuation standard for an oppressed shareholder's stock.[139]

136. The first two matters were relevant only for background and the question of accord and satisfaction. In the first matter, the original founder was sued by his former partner/shareholders for oppression. This was settled by buying out the minority shareholders for $300,000; as a result, the surviving shareholder, with his wife, son and daughter were the remaining owners. This shareholder, William, became the majority shareholder and was company president. When he died, his son, Bill, became the majority shareholder and president. He was sued by his mother and sister for oppression because he used the business's resources for two sole proprietorships, a pro shop and a golf cart rental business. He settled the case for $200,000.

137. 15 Pa.C.S.A. Section 1571-1580.

138. Rev. Rul. 59-60 is now 54 years old. It establishes the methodology for valuation for many different purposes. Generally it applies to both fair value and fair market value. Specifically, the differences are only with regard to discounting. Due to space constraints, this rule is not reproduced here.

139. *See*, Moll, *Shareholder Oppression and "Fair Value": Of Discounts, Dates, and Dastardly Deeds in the Close Corporation*, 54 Duke L. J. 293 (Nov. 2004). Rev. Rul. 59-60 can be used to establish both fair value and fair market value.

Specifically, the American Law Institute's Principles of Corporate Governance, Section 7.22(a) states that the "fair value of shares should reflect the value of the shareholder's proportionate interest in the corporation without any discount for minority status or, absent extraordinary circumstances, lack of marketability."[140] Further, the Revised Model Business Corporation Act provides for a "fair value" buy-out in cases involving oppression.[141]

Commentators agree that discounting should not be part of the valuation process in shareholder oppression cases. For example, Shannon Pratt, a noted valuation expert, observed that:

> [O]ppression cases . . . overwhelmingly use a fair value standard. Under the fair value standard, the court exercises a great deal of discretion in delimiting the standard's parameters, and, ordinarily, discounts are disallowed. In addition, in shareholder cases, fair value is often regarded as the pro-rata share of an enterprise.[142]
>
> Another commentator summarized the policy basis for denying discounts as follows:
>
> The central problem in equating fair value with fair market value is that the conditions assumed in a fair market value appraisal are not actually present in an oppression setting. A fair market value appraisal assumes the presence of a willing seller and a willing buyer who are under no obligation to act. . . . The seller in a [judicially ordered] buyout setting, however, is . . . an aggrieved minority shareholder who . . . would have preferred to remain a shareholder in the company absent the oppressive conduct. . . . [I]t is the oppression itself that forces the minority to seek an exit from the corporation. . . . Thus, valuing the minority's shares on the basis of a hypothetical sale makes little sense when the minority investor was not looking to sell in the first place. . . . [Further,] [t]he buyer in an oppression lawsuit is typically the oppressive majority shareholder who has been ordered by the court to purchase the shares of the aggrieved minority investor. A purchase dictated by judicial order . . . is far from the willing, no-obligation-to-act assumption of the fair market value standard.[143]

These valuation issues are discussed in *Lawson Mardon Wheaton, Inc.*,[144] where the New Jersey Supreme Court followed this ALI standard to hold that, except in extraordinary circumstances, no discounts should be applied to value shares being tendered by a dissenting shareholder in the context of a statutory appraisal action.[145] However, in *Balsamides* v. *Protameen Chemicals, Inc.*,[146] decided the same day, the New Jersey Supreme Court recognized an extraordinary basis. It permitted a dis-

140. Macey On Corporation Laws, Vol. 1 (Walters Klewer 2013) at Section 14.11(D), 14.108.

141. Model Bus. Corp. Act Section 14.34(c).

142. Shannon Pratt, Alina Niculita, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies* (5th Ed. McGraw Hill, NY 2008) at 42.

143. Moll, *Shareholder Oppression and Fair Value, supra* at 319-320.

144. 734 A.2d 738 (N.J. 1999). *See also, Balsamides* v. *Protameen Chemicals, Inc.*, 734 A.2d 721 (N.J. 1999), decided by the New Jersey Supreme Court the same day.

145. *Id. Lawson Mardon Wheaton, Inc.* concerned the valuation of minority shares in a dissenters appraisal action, instituted in New Jersey's Chancery Court. The case concerned a family run business, founded in 1888, which, until 1991, was operated by the founder's descendants. In 1991, Bowater, PLC, an outside company, offered to buy Lawson for $64.00 per share. Lawson's president, Frank Wheaton, Jr., had sold his shares to Bowater for this price. Bowater was prepared to pay $70.00 per share. Lawson's board rejected this offer and, to forestall any further offers, planned to restructure the company so that it would, *inter alia*, restrict further sales of its stock. Pursuant to their rights under New Jersey's dissenters' statute, N.J.S.A. Section 14A:11-1 to 11, 26 shareholders, holding approximately 15% of the corporate stock, dissented and commenced astatutory appraisal action in Chancery Court. The trial court applied the ALI standard, but found that extraordinary circumstances warranted a 25% discount. The New Jersey Supreme Court reversed, finding that such discounts were not warranted.

146. 734 A.2d 721 (N.J. 1999).

count for lack of marketability where the trial court had ordered the oppressing shareholder to sell his shares to the plaintiff as part of the stated relief.

Balsamides concerned a dispute between former friends who were 50/50 shareholders in a profitable chemical business that supplied the cosmetics industry. Plaintiff was in charge of sales. Defendant, a chemist, was responsible for the "technical and administrative side of the business."[147] As is common in such matters, notwithstanding the extreme profitability of their business, they disagreed after bringing their children into the business. After a 19 day trial, the court found that plaintiff was the oppressed shareholder and ordered defendant to sell his interest in the business. *Balsamides* is unique because it demonstrates the power of the equity court, in applying the oppression statute, to fashion an appropriate remedy, in this case ordering the oppressing shareholder to sell his or her interest in the business at a discount. In so ordering, the trial court applied deep discounts representing minority (non-controlling) interests and for lack of marketability.

The New Jersey Supreme Court upheld the findings of oppression; but, it reversed the trial court's application of a minority discount, stating that:

> [B]ased on our review of the history and policies behind dissenters' rights and appraisal statutes, we found most persuasive those cases holding that marketability discounts generally should not be applied in determining the "fair value" of a dissenting shareholder's stock in an appraisal action. . . . NJSA 14A:12-7(8)(a) governs court ordered dissolution. That section specifically provides that the purchase price shall be a "fair value" "deemed equitable by the court, plus or minus any adjustments deemed equitable by the court if the action was brought" under NJSA Section 14:12-7(1)(c). . . . Thus, the statute gives courts "substantial discretion to adjust [the company's] purchase price" to reflect a marketability discount. Particularly when court actions are filed on account of "oppression as opposed to deadlock[,]" "fair value may be adjusted to the extent the court deems equitable."[148]

Accordingly, *Balsamides* states that discounts may be permitted in equity as a further remedy to punish an oppressing majority or controlling shareholder. Pennsylvania Courts have expressed this sentiment by awarding punitive damages in several oppression cases.[149] Never-theless, the general rule is to deny any discounting for the oppressed minority shareholder's stock.[150]

Punitive Damages

In *Viener* v. *Jacobs*,[151] the Pennsylvania Superior Court affirmed a punitive damage award for an oppressed minority shareholder based on its record finding that:

147. *Id.*
148. *Id.* at 735.
149. *See, Viener v. Jacobs, 834 A.2d 546 (Pa. Super. 2003)* and *DiFabio v. Star Appraisers, Inc., 2007 Pa. Dist. & Cnty. Dec. LEXIS 308 (Lehigh CCP 2007).*
150. Other claims for discounts also have no place in a minority oppression case involving a close corporation. For example, when computing value based on a discounted cash flow (DCF) model, defendants may argue for use of a high tax rate, such as 40% even though the corporation itself, in most of these instances, is a subchapter S entity with pass-through income. As such, taxation is a non-event at the corporate level and an improper deduction. As one commentator states:

> Many analysts mistakenly assume that the tax rate implicit in such date is at the highest marginal rate, or 40%. A review of the data reveals much lower actual tax rates, particularly in the lowest deciles. . . . Many analysts value companies that fall in the tenth decile category. Therefore, many of these companies that appraisers typically deal with pay less income tax. Some commentators have concluded that these data, taken together with the market data indicate that we should be deducting no taxes when we value pass-through entities.

Hitchner, *Financial Valuation: Application and Models* (John Wiley & Sons, Hoboken, NJ – 2006) at 585.
151. 834 A.2d 546 (Pa. Super. 2003). *Viener* is sometimes cited to support application of a fair market value standard. However, a close examination shows that choice of valuation was not at issue and that the valuation testimony was remanded for further testimony. Instead, the Superior Court affirmed the award of punitive damages.

> [T]he defendant's actions . . . led to the usurpation of Viener's right to participate in the governance of a corporation that Viener co-founded. . . . [The defendant's] misuse of corporate funds and property coupled with his failure to undertake sufficient measures to procure the continued success [of available business opportunities] led to its ultimate failure. We agree with the . . . conclusion that minority shareholders in closely-held corporations are particularly vulnerable to this type of wanton neglect and bad faith, and it is therefore necessary to punish this behavior to ensure that it will not occur in future cases.[152]

Accordingly, damages in minority shareholder matters may include (1) redemption of the oppressed shareholder's shares at their pro rata enterprise (undiscounted) fair value; (2) the forced sale of the oppressing shareholder's stock in the corporation, with an established discount; (3) breach of contract damages for employment; (4) the payment of withheld dividends; (5) the repayment of excess taxes paid because of improperly retained earnings; and (6) punitive damages.[153]

STANDING FOR SECTION 1767 CLAIMS

Pennsylvania's freeze-out statute[154] summarizes the elements of a common law claim and limits its remedies to close corporations.[155] There is a *de minimus* standing requirement; the oppressed shareholder must hold at least 5% of the corporation's stock. However, Section 1767 does not displace common law remedies.[156] Instead, section 1767 provides a safe harbor for such claims. This claim is established when there is an established oppression of a minority shareholder by those in corporate control.[157] Pennsylvania's freeze-out statute also provides remedies where "directors or those in control of the corporation have acted illegally[158] . . . or fraud-

152. 834 A.2d 546, 561.
153. When there is a court ordered stock redemption, the corporation should also be ordered to close the corporate books in accordance with 26 U.S.C. Section 1377(a)(2) so that the company's income is not front loaded upon the plaintiff. Other remedies are also available.
154. 15 Pa.C.S. Section 1767(a)(2). *See*, note 128, *supra*.
155. These are corporations which have "not more than 30 shareholders." *See*, 15 Pa.C.S. Section 1103. "[F]or purposes of determining the numbers of holders of record or beneficial owners of the shares of a . . . corporation, shares that are held jointly or in common or in a trust, by two or more persons, as fiduciaries or otherwise, or which are held by spouses, shall be treated as held by one shareholder." *Id.*
156. For example, some states define a close corporation, which is a small corporation which does not have a significant market for its shares because of its size, as one with thirty five or less shareholders or in other states less than 50 shareholders. *See, e.g.*, California or Texas statutes.
157. *See, Weisbecker* v. *Hosiery Wide Patents, Inc., 51 A.2d 811 (Pa. 1947)* (finding oppression at common law); *Ferber* v. *American Lamp Corp., 469 A.2d 1046 (Pa. 1983)* (same); *Korman Corp.* v. *Franklin Town Corp., 34 Pa. D. & C.3d 495 (Phila. CCP. 1984)* (applying *Weisbecker* and *Ferber* to overrule preliminary objections to complaint alleging breach of fiduciary duty to a minority shareholder); *Leech* v. *Leech*, 762 A.2d 719 (Pa. Super. 2000) (affirming trial court's appointment of custodian pursuant to Section 1767 upon a finding of oppressive conduct by those in control of a closed corporation); (*Baron* v. *Pritzker*, 52 D.&C.4th 14 (Phila. CCP) (Sheppard) (applying common law and Section 1767 to overrule preliminary objections to breach of fiduciary duty complaint); *Santoro* v. *Morse, 781 A.2d 1220 (Pa. Super. 2001)* (affirming, in part, trial court's ruling granting of injunction to inspect corporate records and for accounting and imposition of a constructive trust on the majority shareholder's new corporation in favor of the parties' first corporation); *Viener* v. *Jacobs*, 834 A.2d 546 (Pa. Super. 2003) (affirming punitive damage award and remanding compensatory damages award for recalculation, awarded to minority shareholder "frozen-out" of corporation through majority's "outrageous and oppressive" conduct, based on common law and Section 1767(a)(2)); *Adler* v. *Tauberg, 881 A.2d 1267 (Pa. Super. 2005)* (affirming the appointment of a custodian over a corporation pursuant to Section 1767(a)(2)); *Ford* v. *Ford, 878 A.2d 894 (Pa. Super. 2005)* (affirming trial court's appointment of custodian to address oppression, breach of fiduciary duty and self dealing by majority shareholders pursuant to common law and Section 1767(a)(2)); *DiFabio* v. *Star Appraisers, Inc., 2007 Pa. Dist. & Cnty. Dec. LEXIS 308 (Phila. CCP. 2007)* (awarding compensatory damages at common law and pursuant to Section 1767(a)(2) for oppression of minority shareholder).
158. Illegality is not defined in the statute. However, this could refer acts which violate the corporate bylaws, self-dealing, corporate waste, or theft. In *DiFabio* v. *Star Appraisers, Inc., 2007 Pa. Dist. & Cnty. Cec. LEXIS 308 (Lehigh CCP 2007)*, the Court awarded damages to plaintiff pursuant to Section 1767(a)(2),

ulently[159] toward one or more holders or owners of 5% or more of the outstanding shares of any class of the corporation. . . ."[160] The statute's claims are also established by any or all of the oppressive conduct described above and applies where control is not vested in a shareholder majority.[161]

CONCLUSION

Pennsylvania's common law and freeze-out statute provide powerful remedies for oppressed minority shareholders. These matters are fact intensive and require a detailed financial understanding of a business's operations and market. This article is intended to provide a detailed overview of the law surrounding such cases in order to assist practitioners in their evaluation and prosecution.

---

which included compensatory and punitive damages. Among the plaintiff's claims was assault and battery, which occurred when the defendant attacked the plaintiff. The Court also awarded compensatory damages for the attack.

159. Fraud is defined as a material representation which is made falsely, with knowledge of its falsity or one which is made recklessly without regard to whether it is true or false with the intent of misleading another into relying upon it. The action is completed by justifiable reliance upon the misrepresentation with resulting injury. These cases often include an element of fraud or misrepresentation. *See, Gibbs* v. *Ernst, 647 A.2d 882 (Pa. 1994); Restatement (Second) of Torts, Section 525.*

160. 15 Pa.C.S. Section 1767(a)(2).

161. *See, Adler* v. *Tauberg, supra; Santoro* v. *Morse, supra; and Baron* v. *Pritzker, supra.*