# INFINITE CONTROL FOR MAJORITY SHAREHOLDERS?: *SOUND INFINITI, INC. V. SNYDER*[1]

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The cash-out of minority shareholders during a merger, consolidation, or other fundamental corporate change is not uncommon. When the fundamental change is engineered by controlling shareholders for the apparent *purpose* of eliminating minority shareholders, however, questions of fiduciary duty and fair value often arise. Jurisdictions vary in whether controlling shareholders need "business" reasons to undertake such fundamental changes, and what remedies squeezed-out shareholders may pursue. A recent Washington Court of Appeals opinion makes clear that in Washington, controlling shareholders can effect fundamental corporate changes for the sole purpose of removing minority shareholders, and barring certain narrow exceptions, the minority shareholders' only remedy is to receive the "fair value" of their shares.

## 1. Dissenters' Rights and the Appraisal Remedy

### A. In General

All states give shareholders dissenters' rights—the right to receive the fair value of their shares in cash—when they dissent from certain fundamental corporate changes. These changes may include mergers, consolidations, sales of substantially all assets, as well as amendments to the articles of incorporation that adversely affect or eliminate shares. The terms of the fundamental corporate change, in some cases, eliminate small shareholders and give them a set cash price for their shares. When a shareholder exercises dissenters' rights, he or she is objecting to the consideration offered in the fundamental change, be it shares in a surviving company or the cash-out price set by the corporation. If the dissenting shareholder and the corporation cannot agree on the value of the shares, the parties have the option of asking a court to determine the fair value of the shares. This is known as the appraisal remedy.

### B. Historical Development

Dissenters' rights have evolved considerably since their creation many decades ago.[2] Under common law, fundamental corporate changes required unanimous shareholder approval, as the prevailing reasoning at the time was that shares were a type of "vested right" that could not be altered without consent.[3] Lawmakers soon realized that such a high approval threshold impeded the ability of corporations to adapt and maneuver in the marketplace and left those corporations susceptible to the whims or extortion of small minority interests. Lowering the approval threshold for fundamental corporate changes, however, raised opposite concerns. Controlling shareholders could take the business in a dramatic new direction (usually through a fundamental corporate change) and drag other shareholders into a type of investment they may not have foreseen at the time they invested. Thus, to protect these shareholders and allow them to get the value of their investments out of a corporation, lawmakers adopted dissenters' rights statutes.

As corporate statutes and common law relaxed to allow different types of consideration in mergers, the role of dissenters' rights expanded. Prior to these developments, dissenters' rights could only be triggered by a dissenting shareholder; a corporation undergoing a fundamental change had to offer every shareholder shares (i.e., ownership) in the continuing entity. Legislatures eventually amended their laws to permit different kinds of merger consideration (e.g., cash, debt, property), as well as the right to purchase fractional shares, thereby allowing the corporation to trigger the minority shareholder's liquidation. Over time, controlling shareholders began to see fundamental corporate changes as a means to dissect minority shareholders that interfered with (or were merely roadblocks to) the desires of the majority shareholders of the corporation. Those minority shareholders had the choice of accepting the price offered by the corporation or enforcing their dissenters' rights.

### C. Exclusivity

In most states, dissenters' rights and appraisal are the *exclusive* remedy for certain shareholder claims or certain transactions (e.g., short-form mergers). Typically under such statutes, a shareholder who is entitled to dissenters' rights may not challenge the underlying corporate change and may only pursue the appraisal remedy. The scope of this exclusivity is a critical factor in minority shareholder cash-outs and any ensuing litigation. Eliminated shareholders often want to bring claims that do not fit within the historical reach of the appraisal proceeding, e.g., breach of fiduciary duty, or rescinding the fundamental corporate change altogether.

Critics of the appraisal remedy (or at least its exclusivity) point out that the remedy now commonly confronts issues for which it was not designed.[4] Lawmakers created the remedy mainly to provide liquidity to a shareholder making an election to be cashed-out from an arm's length transaction. Accordingly, the appraisal procedures and valuation methods, as well as the case law, developed around that paradigm. Procedural hurdles and costs were placed on the electing shareholder, and courts focused on the fair value of the shares, not any self-interest of controlling shareholders.

Today, the appraisal process is more commonly engaged after squeeze-out transactions, where the remedy functions as more of a judicial check on majority shareholder actions. In this context, the majority shareholders make the election to liquidate the minority and have the ability to engage in opportunism at the expense of the minority. The appraisal process, at its very least, ensures that the majority is not deflating the value of the corporation in its offer to the minority shareholders.

But because the appraisal procedures and case law have developed around the original purpose of liquidity, some critics argue that (1) the valuation methods historically used give lower values, (2) the expense of the process excludes all but the wealthiest minority shareholders, and (3) the procedural hurdles prevent minority shareholders from bringing claims.[5] These critics call for making appraisal a non-exclusive remedy, or for expanding the scope of the appraisal proceeding and shifting the procedural and cost burdens to the corporation.

State laws regarding the scope of exclusivity of appraisal fall along a broad spectrum. Several states, including New York and Massachusetts, lie on one end of this spectrum, requiring cash-out mergers to have a legitimate business purpose and to pass an "entire fairness" test.[6] These are not issues the appraisal proceeding typically addresses, and a minority shareholder may bring a separate action for such claims. Delaware—always an important corporate law state—for a number of years also required a business purpose for most fundamental corporate changes.[7] That requirement has since been abandoned in favor of an "entire fairness" test, which includes both fair price and fair dealing.[8] A number of state statutes explicitly provide that appraisal is not exclusive in a conflict-of-interest transaction, which includes squeeze-out transactions, or where there has been a breach of fiduciary duty to the shareholder.[9]

Continuing along the spectrum, many states have adopted the 1984 or 1999 MBCA which makes appraisal exclusive except in cases of "unlawful or fraudulent" behavior. The term "unlawful" receives various interpretations by courts, but typically includes breach of the majority shareholders' fiduciary duties toward the minority. The 2006 version of the MBCA takes a more nuanced approach that appears to recognize the potential for inadequate remedies under appraisal. The model does not impose exclusivity if the transaction is an "interested transaction," which would include a squeeze-out transaction, unless it has been approved as if it were a director conflicting interest transaction.[10] At the same time, this version of the MBCA also narrows the circumstances under which dissenters' rights are available, preferring a "market-out" for the shareholder where feasible.[11] Only two states, Virginia and Mississippi, have adopted this model, but more are likely to do so as they undertake general revisions to their corporate law. States like Indiana and Connecticut occupy the other end of the spectrum in prohibiting claims outside the appraisal process in all cases.[12] Washington's precise location on the spectrum was, perhaps, uncertain until last year.

### 2. The *Sound Infiniti* case

In *Sound Infiniti v. Snyder*,[13] the Washington Court of Appeals solidified the primacy, and near

exclusivity, of the appraisal remedy in Washington for squeezed-out shareholders. The court held that, barring actual fraud or incorrect corporate procedure, a dissenting shareholder's only remedy is payment for the fair value of the eliminated shares. Even so, the court granted the appraisal process wide latitude when determining "fair value" to account for any pecuniary injustices that a squeezed-out shareholder may have suffered.

### A. Background

The underlying dispute in *Sound Infiniti* involved a minority shareholder squeeze-out. Hannah, Snyder, and Pisheyar were all shareholders of two corporations that owned and operated different Infiniti car dealerships. In both corporations, Snyder owned 51% of the shares and Hannah owned 25%. Snyder and Hannah also both participated in the day-to-day operations and management of the corporations. Pisheyar, on the other hand, held 24% of the shares in one corporation and 19% in the other. And apart from acting as secretary for one corporation and as a director for the other, all parties agreed that Pisheyar's role in the businesses was solely as an investor.

Although both companies were always profitable and stable, the shareholders eventually had a falling out. Pisheyar became increasingly suspicious of Snyder's and Hannah's management of the companies, especially a $900,000 loan from the two corporations to Snyder for the purchase of land for a Nissan dealership in which Pisheyar was not invited to participate. The falling out culminated in a lawsuit filed by Pisheyar against Snyder and Hannah alleging numerous individual and derivative claims, including oppression of minority interests, conversion of corporate assets, and breach of fiduciary duties.

In response, Snyder and Hannah (after losing a motion to dismiss Pisheyar's claims) arranged for both corporations to undergo reverse stock splits that would leave Pisheyar with only a fraction of one share in each corporation. The corporations would then have the right to purchase Pisheyar's fractional shares for their fair value. Importantly for Snyder and Hannah, Pisheyar would cease to be a shareholder of both corporations.

Pisheyar, who received due notice of the proposed corporate changes, sought an immediate temporary restraining order to prevent the reverse stock splits and preserve his claims. The trial court held a hearing at which Pisheyar presented his individual and derivative claims, including the plan to implement the reverse stock splits, the corporations' advance of attorneys' fees to Snyder and Hannah, the improper borrowing money from the corporations, improper employee expense reporting to the IRS, and the purchase of excessive life insurance on Hannah at the corporation's expense.

After two days of testimony and reviewing all the submitted evidence, the trial court determined that Pisheyar had demonstrated neither a likelihood of success of the merits of any of his claims nor any other right to relief. The trial court dissolved the restraining order and the reverse stock splits became effective. The trial court later granted motions to dismiss Pisheyar's lawsuit because (1) he was no longer a shareholder and had no standing to pursue derivative claims; and (2) payment for the fair value of his shares under the dissenters' rights statute, RCW 23B.13.020, was his exclusive remedy for his individual claims.

### B. The Court of Appeals Decision

The Court of Appeals affirmed the dismissal of Pisheyar's claims. Relying on the plain language of the dissenters' rights statute, legislative history, and case law, the court held that (1) barring fraud or improper procedures, appraisal is the exclusive remedy for shareholders dissenting from fundamental corporate changes; and (2) the appraisal proceeding can account for any breach of fiduciary duty claims a dissenting shareholder may have. (Though not discussed in this article, the law is well-settled in the area of derivative claims,[14] and the court spent little time affirming their dismissal.)

First, the court noted that the dissenters' rights statute, RCW 23B.13.020, expressly preserves only two types of shareholder claims outside of the appraisal remedy—those based on (1) the failure of the corporation to comply with the procedural requirements of the WBCA or the corporation's articles or bylaws, and (2) "fraudulent" actions.[15] And as the trial court held, none of Pisheyar's claims fit within these categories.

Without conceding that the statute was ambiguous, the court went on to address Pisheyar's argument for a more expansive reading of the word "fraudulent." As the court noted, Pisheyar's argument was "not unreasonable."[16] Indeed, the commentary in the Washington Senate Journal regarding RCW 23B.13.020 mentions breach of fiduciary duty and self-dealing as potential reasons to allow claims outside the appraisal process.[17] The court observed, however, that this commentary was taken verbatim from the comments to the Revised Model Business Corporation Act (MBCA) (upon which the WBCA is based), and that the Washington legislature adopted a statute materially different from the MBCA. The MBCA exempts claims based on "unlawful or fraudulent" actions from the appraisal process. The Washington legislature affirmatively omitted the term "unlawful" when adopting the model statute. This, the court reasoned, along with the derivative nature of the legislative comments, at least suggests that the legislature intended to circumscribe independent shareholder actions that were not based on actual fraud (or improper corporate procedure).[18]

Lest there be any doubt, however, the court also examined case law from Washington and other states to solidify its reasoning. Only two Washington cases before *Sound Infiniti* have directly addressed the exclusivity of the appraisal remedy.[19] The court observed that both held that the appraisal remedy was exclusive outside of actual fraud or improper corporate procedure. In addition, cases from Delaware and New York cited in the legislative comments supported the court's holding.

Finally, to allay concerns that the court's decision would give majority shareholders freedom to harm minority shareholders and avoid liability by triggering a fundamental corporate change, the court granted the appraisal process wide latitude when determining "fair value" to account for any pecuniary injustices that a squeezed-out shareholder may have suffered. With no cited support from Washington sources,[20] the court declared that a "court overseeing an appraisal action brought pursuant to chapter 23B.13 RCW may account for all prior reductions in the value of those shares caused by actual breaches of fiduciary duty, including the extraction of unreasonable salaries, misuse of corporate funds, or other self-dealing."[21] Moreover, this accounting for diminution in value may extend to any point in time prior to the appraisal-triggering event that the dissenting shareholder held the shares at issue.

### 3. Conclusion

*Sound Infiniti* makes clear that squeezed-out shareholders have no grounds to challenge the squeeze-out, unless there is actual fraud or improper corporate procedure. The court's decision should reassure controlling shareholders that the elimination of minority interests through fundamental corporate changes need not have any business reason or justification other than just that—the removal of the minority interests. Even so, the decision should also reassure minority shareholders with legitimate claims for breach of fiduciary duty that they will not go uncompensated. The court's comfort with limiting independent actions based on the appraisal remedy stemmed, in part, from its belief that the appraisal process has the ability to take such excluded claims into account.

Moreover, the common concerns about the appraisal proceedings discussed above are less warranted in Washington. Our state does not retain some of the historical impediments to minority shareholders getting actual fair value during an appraisal proceeding—i.e, lack of notice or adequate disclosure, antiquated valuation methods, and expense. For example, notice of appraisal rights and a copy of the statute must be given to each shareholder entitled to vote on a fundamental corporate change.[22] Value is determined by those techniques and methods that are generally accepted in the financial community rather than a set formula.[23] Finally, the corporation pays the costs and expenses of the appraisal unless the dissenter acts vexatiously, and the court can award attorney's fees if any party acts in bad faith.[24]

That said, squeeze-outs do have the appearance of self-interested transactions, as recognized by the 2006 MBCA. And yet in Washington they are not subject to the stricter standards of other interested transactions.[25] The Washington legislature and courts have selected a balance that certainly leans in favor of corporate flexibility, but is by no means unfair. It is, at the very least, predictable, which makes it susceptible to good business planning by both majority and minority shareholders.

[1] 145 Wn. App. 333, 186 P.3d 1107 (2008).
[2] *See generally* Elliot J. Weiss, The Law of Take Out Mergers: A Historical Perspective, 56 N.Y.U. L. Rev. 624 (1981).
[3] *See e.g.*, *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590, 595-596, 41 S. Ct. 209 (1921). RCW 23B.10.010(2) now expressly disclaims any vested property right in a corporation.
[4] *See e.g.*, Thompson, Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law, 84 Geo. L.J. 1, at 28 (1995).
[5] *Id*.
[6] *See Alpert v. 28 Williams Street Corp.*, 63 N.Y.2d 557 483 N.Y.S.2d 667, 473 N.E. 2d 19 (1984); *Coggins v. New England Patriots Football Club, Inc.*, 397 Mass. 525, 492 N.E.2d 1112 (1986).
[7] *Singer v. Magnivox Co.*, 380 A.2d 969, 980 (Del. 1977) (overruled by *Weinburger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).
[8] *Weinburger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983)
[9] *See e.g.*, Cal Corp. Code § 1312; 805 ILCS § 5/11.65(b).
[10] Model Business Corporation Act (4th ed. 2008), American Bar Association, §§ 13.01, .40. See RCW 23B.08.700-730 for laws regarding the approval of director conflicting interest transactions.
[11] Model Business Corporation Act (4th ed. 2008) § 13.02.
[12] *See* Conn. Gen. Stat. § 33-386(b); Ind. Code § 23-1-44-8(c); *Yanow v. Teal Industries, Inc.*, 178 Conn. 262, 422 A.2d 311 (1979); *Fleming v. International Pizza Supply Corp.*, 676 N.E.2d `051 (Ind. 1997).
[13] 145 Wn. App. 333, 186 P.3d 1107 (2008).
[14] Under Civil Rule 23.1, a plaintiff bringing a derivative claim must have been a shareholder at the time of the transaction complained about, and must fairly and adequately represent the interests of similarly-situated shareholders in enforcing the rights of the corporation. This requires that the shareholder maintain his or her interest as a shareholder throughout the litigation. *See Haberman v. Wash. Pub. Power Supply Sys.*, 109 Wn. 2d 107, 149, 744 P.2d 1032, 750 P.2d 254 (1987).
[15] 145 Wn. App. 333, 344, 186 P.3d 1107, 1112 (2008).
[16] *Id.*
[17] Senate Journal, 51st Leg., 2nd Spec. Sess. at 3088 (Wash. 1989).
[18] One commentator has noted that the legislative history and statutory language are not necessarily irreconcilable, i.e., claims based on breaches of fiduciary duty can still be brought outside the appraisal process, so long as the breach rises to the level of actual fraud. Stewart M. Landefeld & Eric A. DeJong, Washington Business Entities: Law and Forms (2d ed. 2007), § 7.04, p.7-9 n.46.
[19] Matteson v. Ziebarth, 40 Wn.2d 286, 242 P.2d 1025 (1952); Matthews v. Wenatchee Heights Water, 92 Wn. App. 541, 963 P.2d 958 (1988).
[20] There is support for an expansive view of the appraisal remedy. The official legislative history of RCW 23B.13.010 notes that the purpose of the "inequitable" exception in the definition of *fair value* is to permit the court to consider factors such as rescissory damages if appropriate to all the issues of fairness before the court. Senate Journal 51st Legis. 3086-87 (1989).
[21] 145 Wn. App. 333, 349, 186 P.3d 1107, 1114 (2008).
[22] RCW 23B.13.200.
[23] RCW 23B.13.010.
[24] RCW 23B.13.310.
[25] *See, e.g.*, RCW 23B.08.700 - .730.