Shareholders’ Claims after Selling Shares to the Company Prior to a Higher - Valued Exit – Cause of Action or 20/20 Hindsight?

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The sale of a company at an unexpectedly strong valuation usually is a cause for celebration (for the sellers, at least). However, shareholders who sold their shares to the company or other insiders in earlier transactions at lower valuations may feel shortchanged, or worse, particularly if those transactions occurred relatively close in time to the sale of the company.

Such shareholders may try to bring claims against the company or related parties, including claims for fraud and breach of fiduciary duties, despite the waivers and disclaimers typically found in the redemption and other agreements pursuant to which such sales are consummated. The company and related parties, on the other hand, may feel that they fulfilled any disclosure or other legal obligation owed to the selling shareholder and provided the selling shareholder an opportunity for liquidity that might not otherwise have existed, but that the selling shareholder is trying to take advantage of knowledge of subsequent events that were uncertain at the time of the sale and for which the company and the related parties thus continued to be at risk.

This paper reviews recent cases from three jurisdictions involving private companies in which shareholders whose shares were redeemed prior to a more valuable exit or other company event subsequently sued the company and related parties, including individual directors and officers. It first describes the potentially competing views of the fiduciary duties of the company’s insiders in such circumstances. It then describes the courts’ findings in these cases, particularly as applied to claims of fraud and breach of fiduciary duties1 and the potential deficiencies in the waivers and disclaimers included in the redemption or other sale agreements. This paper also suggests strategies that shareholders and companies can take to reduce risks.

Introduction

Before addressing the specific situations described in the cases, it is helpful to consider how courts traditionally have viewed fiduciary duties in the context of a repurchase by the company or a purchase by an insider.

As a general matter, a director, officer, or majority shareholder who affirmatively misleads a minority shareholder in connection with a purchase of shares, thereby inducing the minority shareholder to sell the shares, may be liable for, among other things, common law fraud. Fraud claims can also be made on the basis of omitted information, but they can be more

1 Insiders of private companies who purchase shares from minority shareholders also may be subject to claims under federal securities rules, including Rule 10b-5. See, e.g., SEC v. Stiefel Laboratories, complaint filed Dec. 12, 2011.
difficult for the complaining shareholder. Shareholders also may try to make claims for breaches of fiduciary duty when they believe that a director, officer, or majority shareholder has failed to disclose important information affecting the value of the company’s stock.2

Tests of fiduciary duties applied in these contexts by U.S. courts traditionally have fallen into one of three categories:3

1. “Majority” Rule

The so-called “majority” rule provides that a director or officer stands effectively as an outsider when he or she trades in the company’s stock, and therefore has no duty to disclose information that the director or officer may have with respect to the company or the value of the stock, limited perhaps only by affirmative actions and statements and intentional concealment.4 The theory is that a director owes no fiduciary duty to any individual shareholder, but rather only to the shareholders as a group.

However, courts have questioned whether this is in fact the rule amongst the majority of courts, as few cases seem to reach their holdings based on this theory alone, especially in recent years. Furthermore, cases quoting this rule often do not include any special information that should have been disclosed that was not otherwise available to shareholders. Finally, this rule addresses directors and officers purchasing for their own accounts and leaves open the question of what duties may be owed in the context of a share redemption or other repurchase by or on behalf of the company.

2. “Minority” Rule

The “minority” rule provides that directors are considered “trustees for individual shareholders with respect to their stock.”5 The rule has been interpreted quite expansively by some courts, as some have held that, regardless of the relative sophistication or access to information of the parties, directors and officers cannot transact with shareholders without disclosing all information they have that could affect the value of the stock.6

Although these claims often crop up in the context of close corporations, partnerships, or limited liability companies, some commentators have noted that the same principles should apply to larger corporations.7

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2 William Meade Fletcher, Fletcher Cyclopedia of the Law of Corporations, Sept. 2012 (hereinafter Fletcher), §1168.
3 The courts in the Allen and Wayport cases described below also provide their views on these three views.
4 Fletcher, §1168.10.
5 Fletcher, §1168.20.
6 Id.; see, e.g., Blakesly v. Johnson, 608 P.2d 908, 915 (Kan. 1980) (holding that a majority shareholder, director and president of the company breached his fiduciary duty to a minority shareholder, who was also a director and manager, by failing to disclose certain details of another transaction affecting the value of the company’s shares).
3. “Special Facts” Rule

Finally, the “special facts” or “special circumstances” rule falls between the majority and minority positions and states that, although there is not per se a fiduciary duty on the part of officers and directors in transactions for shareholders’ stock, such a duty can be found where certain facts cause a fiduciary relationship to arise.8 Courts have found such facts to include, for example, “the corporation is closely held and its shares are unlisted, the familial relationship of the parties, the forthcoming sale of corporate assets, the forthcoming offer for shares by a takeover bidder, the fact that the director initiates the sale, the relative ages and experience in financial affairs of the director and shareholder, and the true financial condition of the company.”9 When such a duty applies, the officer or director must disclose “those matters relating to the corporate business of which the officer has knowledge …, so that the [shareholder] may have the benefit of such knowledge in judging the advantages of the deal.”10

In fact, the courts in both the Texas and Delaware cases described below found that their states would follow the special facts doctrine or rules supported by that doctrine.

Application in Recent Cases

Recent cases in Texas, Delaware, and California evaluate the actions of company insiders in connection with purchases of shares directly or on behalf of the company. In all three cases, key claims include breach of contract and breach of fiduciary duty.


In March, 2012, the Texas Court of Appeals reversed a dismissal of certain fraud and fiduciary duty claims brought by a former shareholder of a limited liability company after the company bought back his shares and then sold itself two years later at a significantly higher valuation.11

The lawsuit arose out of an investment of $700 and a pledge of a $34,300 certificate of deposit by Allen in exchange for an 8% equity stake in Chief Holdings, L.L.C., an oil and gas company. Rees-Jones invested $6,000 and held a 60% ownership interest and was sole manager. Chief grew rapidly. In 2003 Rees-Jones decided to offer to redeem the other investors’ shares. He hired an auditor to appraise the value of Chief’s oil and gas reserves and an outside appraiser to estimate the market value of the company. The appraiser determined that Chief’s net asset value was $138.3 million and that minority interests were worth $1.13 million per 1% interest, after adjustments for minority interest and marketability discounts.

In November 2003, Rees-Jones sent a letter to the other investors, attaching the two reports, and offered to redeem the investors’ shares. The letter also contained rather pessimistic

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8 Fletcher, §1171.
9 Id., citations omitted.
10 Id.
projections for the company. The redemption was delayed, but in June 2004 Allen agreed to sell his shares to the company for $8.2 million. Allen signed a redemption agreement that included mutual releases under which Allen and Chief (as quoted by the court):

“fully and finally and forever settle, release and discharge each other’ from ‘any and all claims, demands, rights, liabilities and causes of action of any kind or nature’ relating to the redemption agreement, excluding breach of contract claims.”

The redemption agreement also included an “independent investigation” clause under which Allen acknowledged, among other things, that the reports were not up to date.12

Two years later, Devon Energy Holdings purchased Chief for $2.6 billion, approximately 20 times the valuation of the company in the redemption. In response to Allen’s questions, Rees-Jones attributed the drastic difference to unforeseeable improvements in horizontal drilling technology.

Allen claimed that Rees-Jones knew about these advancements at the time of the redemption and improperly failed to disclose the true position of the company. Allen sued Rees-Jones and Chief, asserting violation of the Texas Securities Act (TSA), statutory and common law fraud, breach of fiduciary duty, and shareholder oppression. Rees-Jones and Chief denied

12 The “Independent Investigation” clause provided in full as follows (as quoted by the court, with paragraph breaks added for ease of reading):

“Independent Investigation. The Redemption Price has been calculated and agreed to by [Allen] and [Chief] on the basis of an appraisal by Phalon … (the “Appraisal”), which in turn was based on a reserve report prepared by Haas Petroleum Engineering Services … (the “Reserve Report”). [Allen] acknowledges and agrees that he has received and read the Appraisal and the Reserve Report and has had the opportunity to obtain any additional information (including information concerning events occurring after the dates of the Appraisal and Reserve Report) necessary to permit him to evaluate the Company’s proposal to acquire the Interest, and he has had an opportunity to discuss the Appraisal, the Reserve Report and such additional information with representatives of [Chief], the preparers of those reports and his own advisors and consultants and obtain answers to any questions that he may have had. [Allen] further acknowledges and agrees that the Appraisal and the Reserve Report are estimates of value and reserves only and could differ from the value and reserves that might be determined in some other context by some other appraiser, engineer or other party.

[Allen] has based his decision to sell the Interest on (i) his own independent due diligence investigation, (ii) his own expertise and judgment, and (iii) the advice and counsel of his own legal, tax, economic, engineering, geological and geophysical advisors and consultants.

Events subsequent to the dates of the Appraisal and Reserve Report may have a positive or negative impact on the value of the Interest but [Allen] and [Chief] agree that the redemption of the Interest shall be consummated at the Redemption Price in recognition of the fact that such price was the price on the basis of which [Allen] agreed to sell, [Chief] agreed to buy, and [Chief] agreed to undertake to raise the required capital to facilitate the Closing . . . .

Therefore, the parties hereto agree that the Redemption Price [herein] shall be the price at which the Interest shall be redeemed regardless of any difference in opinion on whether the Appraisal or Reserve Report are reflective of actual values or reserves and regardless of any change in value of the Interest that may occur subsequent to the dates of the Appraisal and Reserve Report, and each party hereby releases the other from any claims that might arise as a result of any determination that the value of the Interest at the Closing was more or less than the Redemption Price.”
the claims and moved for summary judgment, which the trial court granted. Allen appealed to the Texas Court of Appeals and the court struck down Allen’s shareholder oppression claim but found certain of his claims permissible with respect to fraud and fiduciary duty.

Impact of Contractual Release. The court first addressed the enforceability of the release contained in the redemption agreement, as noted above, and as further included in the “independent investigation” clause described above. Allen argued that the release was fraudulently induced and thus not enforceable. The court agreed, noting that the redemption agreement did not waive fraudulent inducement claims specifically and that the release did not otherwise provide a “clear expression” of an intent to waive fraud, which courts generally did not infer from a general release of all claims.

Fraud. The company argued that Allen could not prove two essential elements of his fraud claim: an actionable statement and reliance.

With respect to the first point, the court evaluated statements made by Rees-Jones in his November 2003 letter, finding that some of his statements of fact and statements of intent formed an actionable basis for a claim in fraud. The court noted that opinions generally are not actionable in fraud, though they may be when

“(1) the speaker expresses the opinion with knowledge that it is false, (2) the speaker has superior knowledge and should have known that the other party was justifiably relying on the speaker’s superior knowledge, or (3) the statement of opinion is so intertwined with other misstatements of fact that the representation as a whole amounts to a false representation of fact.”

Likewise, the court noted that predictions generally are non-actionable, given that “the future is generally unascertainable.” However, predictions may be actionable if the “speaker purports to have special knowledge of facts that will occur or exist in the future.”

For example, the court agreed with Allen that Rees-Jones’ statement that “I do not expect ‘step-out’ or ‘expansion area’ wells to carry anywhere near the value of the ‘core area’ wells, and the end result of this drilling could be a decline in the value of our company,” while an opinion, when combined with other representations by Rees-Jones regarding the state of drilling technology and other matters amounted to an actionable representation. However, the court found that Rees-Jones’ statement that “I don’t expect our growth to continue at this pace” to be a non-actionable opinion, noting that Rees-Jones did not tie this statement to a specific representation of existing fact, as he had in the case of the statement regarding the value of various wells.

As for the reliance element, the company argued that Allen disclaimed his reliance through the release and other language included in the redemption agreement. The court noted that a general “merger” or “integration” clause such as that included in the redemption agreement generally does not amount to such an expression of intent not to rely on each other’s representations. The court also noted that the Independent Investigation clause, as described above, among other things, did not include:
“(1) an all-embracing disclaimer that Allen had not relied on any representations or omissions by Chief;

(2) a specific ‘no liability’ clause stating that the party providing certain information will not be liable for any other person’s use of the information; and

(3) a specific waiver of any claim for fraudulent inducement based on misrepresentations or omissions.”

Ultimately, the court concluded that Allen, based on emails he sent at the time he redeemed his shares disputing the valuation, could not have justifiably relied on the statements made by Rees-Jones regarding the value of the company or the redemption price. However, the court found that Chief did not prove that Allen could not have relied on any of Rees-Jones’ other statements, such as the status of horizontal drilling technology and his decision not to sell the company. Thus, the court reversed the trial court decision to dismiss all of Allen’s statutory and common law fraud claims.

**Fiduciary Duties.** The court also considered Allen’s claim that Rees-Jones breached his fiduciary obligations to Allen. Allen alleged that Rees-Jones owed him two fiduciary duties: (1) that owed by a majority shareholder to minority shareholders and (2) that owed by the officers and directors of a closely-held corporation to a shareholder redeeming stock. Because Chief was a limited liability company and not a corporation, the court looked to aspects of closely held corporations and partnership law in evaluating these duties.

Allen failed on his first claim. The court recognized that other jurisdictions have found a fiduciary duty by a majority shareholder to minority shareholders in a close corporation in the context of a share redemption by drawing on analogies to partnership law or theories of access to information and control on the part of the majority holder. However, most Texas appellate courts have declined to recognize a “formal” duty. Thus, the court held that no formal relationship exists between a majority holder and a minority holder in the context of a share redemption.

Allen succeeded on his second claim. The court again made comparisons to partnership law, pointing out that partners in a partnership owe one another a fiduciary duty. The court went on to note that other jurisdictions often find that members of a limited liability company owe one another fiduciary duties on the same theories as partnerships. The court noted that “as the sole member-manager of Chief with a high degree of control, Rees-Jones’s position with Chief was similar to that of a general partner in a limited partnership.” Furthermore, the court agreed that Allen was more of a passive investor without the same kinds of access to information or control as Rees-Jones. The court found that such a relationship “supports” finding a fiduciary relationship by Rees-Jones, as controlling majority holder, to Allen, as non-managing minority holder.

The court also found that the type of transaction here—a share redemption—was conducive to finding a fiduciary duty. The court referred to the three traditional rules for fiduciary relationships in the context of transactions with shareholders, as described above, and
found that the “special facts” test supported finding a “formal” fiduciary relationship when a limited liability company’s member-manager offers to redeem the shares of minority members in a way that benefits the member-manager individually, particularly when the member-manager also is majority owner and controls the company’s daily affairs and thus has inside information.

The court concluded that a formal fiduciary duty exists when (1) a person has “a legal right of control” and “exercises that control by virtue of his status as the majority owner and sole member-manager of a closely held [limited liability company],” and (2) purchases a minority shareholder’s interest or causes the company to do so, resulting in increased ownership for the member-manager. The court noted, however, that it was not deciding the scope of that fiduciary duty.

The court also noted that Chief’s articles were written such that Rees-Jones owed no duties except in the case of a breach of loyalty to Chief “or its members.” Rees-Jones argued this meant the members together as a class, but the court concluded that the articles would be ambiguous under Rees-Jones’ interpretation and found that Rees-Jones did owe a duty of loyalty to the members individually.

Other Claims. The court rejected Allen’s claim of shareholder oppression. The court defined shareholder oppression as:

“(1) Majority shareholders’ conduct that substantially defeats the minority's expectations that, objectively viewed, were both reasonable under the circumstances and central to the minority shareholder’s decision to join the venture; or

(2) Burdensome, harsh, or wrongful conduct; a lack of probity and fair dealing in the company's affairs to the prejudice of some members; or a visible departure from the standards of fair dealing and a violation of fair play on which each shareholder is entitled to rely.”

The court noted that Allen had not alleged the “typical” misdeeds of shareholder oppression cases, such as denying access to books and records, wrongful withholding of dividends, waste or excessive compensation. The court also noted that there is “little necessity” for a shareholder oppression claim when the holder has nondisclosure and fiduciary duty claims.13

2. Delaware: In re Wayport (Del. Ch., May 1, 2013)

The Delaware chancery court addressed fiduciary duty, fraud and related disclosure obligations of insiders in the context of purchases of stock from other shareholders in In re Wayport. In an interesting comparison, another court in Texas heard claims presented by Bobbitt Noel, another investor in Chief who had sold shares back to Chief at the same time and for the same valuation as had Allen, and made similar claims. In 2011, following a five week trial, a jury awarded $116 million to Noel. The court subsequently affirmed the award and added $63 million in disgorgement and $17 million in interest, for a total of nearly $200 million. Chief and Rees-Jones appealed, and the parties ultimately settled. See “Rees-Jones, Devon Energy Put $200M Investor Suits To Rest,” Law360, Jan. 11, 2013.
Wayport and found that the shareholders had failed to show nondisclosure of information sufficient to constitute “special facts,” though one of the insiders might have committed fraud by remaining silent after having spoken previously and thus assumed a duty to speak.14

Stewart was the original CEO and the named inventor on many of the patents of, as well as a director of, Wayport, a privately held Delaware corporation. Wayport had two VC investors, each of whom had exercised board designee rights. After the tech bubble burst in 2000, Stewart resigned from his positions, and communications between him and the company eventually became strained.

Stewart sold some shares to another VC investor in 2006, at $3.00 per share. In 2007, he considered selling more shares to the same investor. The investor agreed, but lowered the price to $2.50. Stewart asked the company to give him the information it had given to the investor, and the company provided what it said was such information. The existing VCs also exercised, to some extent, their first refusal rights to buy some of Stewart’s shares. By that time, the company, which had been investigating ways of monetizing some of its intellectual property assets, had received non-binding bids for some of its patents. Stewart knew of some of the company’s efforts in this regard, but did not know of the bids. As Stewart negotiated the sale of his shares to the company’s investors, the managing member of the general partner of Trellis, one of the earlier VC investors, told Stewart that he was not aware of any “bluebirds of happiness” relating to the company. Stewart then sold the shares to the various VCs, although Stewart refused to include in the purchase agreement a representation proposed by Trellis that the parties had equal information. The patent sale was signed and closed shortly thereafter. Later that year, before learning of the patent sale, Stewart sold more of his shares to the same buyers, on the same terms. A little over a year later, the company was sold for $7.20 per share.

Stewart sued, asserting claims for, among other things, breaches of fiduciary duties of loyalty and disclosure and fraud. The court dismissed several claims, including all claims with respect to sales before 2007, and the case went to trial in September, 2012.

**Fiduciary Duty of Disclosure.** The court noted that the duty of disclosure “derives from” the duties of care and loyalty, and is not an independent duty; its scope and requirements accordingly depend on context. In the context of a purchase or sale of shares by a fiduciary from or to an existing shareholder, the court found that Delaware would follow the “special facts” rule, pursuant to which fiduciaries must disclose information when “‘possessed of special knowledge of future plans or secret resources and deliberately misleads a shareholder…’” The court noted, though, that the standard for finding a “special fact” is higher than that for finding a fact to be “material,” stating that to show a special fact plaintiffs would have to show knowledge of a “substantial transaction, such as an offer for the whole company.”

The court found that the existence of the bids for the patents was not “material,” but agreed that the sale of the patents was “material.” However, the court also found that plaintiffs had not shown the sale to “substantially affect the value of their stock” and so did not rise to the level of a “special fact” triggering a disclosure obligation.

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14 In re Wayport, Inc., Lit’n (Del. Ch., May 1, 2013).
Fraud. Stewart also claimed that certain of the other investors had defrauded him by not updating a statement that they knew had become materially misleading. The court agreed that Trellis had assumed a duty to update the “bluebirds” statement, and that such statement became materially misleading in the context of the sale of the patents. The court also found that Trellis’ statement satisfied the other elements of fraud, since, among other things, Trellis made the statement to induce Stewart to sell his shares. However, the other defendants, the court found, had not made any prior representations and thus had no duty to update.


The Delaware Supreme Court faced similar claims in Nemec v. Shrader, though in that case the company had an existing call option over the shareholders’ shares.

On March 31, 2006, Nemec and Wittkemper retired from Booz Allen. Nemec had been a director and committee chairman for Booz Allen, and Wittkemper had been head of European business. Booz Allen, the court noted, was a corporation but had begun as a partnership and retained “the attitude and culture of a partnership,” with corporate officers it called partners and 300 shareholders in total as of July 2008. Both Nemec and Wittkemper received shares as part of their compensation. Under the company’s stock plan, each officer had a put right effective from the date of his or her retirement for a period of two years, after which the company had the right to redeem the stock at any time, in each case at “book value” (defined in the plan with reference to the company’s net assets). At retirement, Nemec owned 76,000 shares (2.6% of the company) and retained all of his stock during the two year period following his retirement. Wittkemper owned 28,000 shares (or nearly 1% of the company) and sold most of his shares.

Approximately one year after Nemec and Wittkemper retired, Booz Allen began plans to sell its government contracts business. The company ultimately negotiated a purchase price of $2.54 billion. In April 2008, Booz Allen redeemed Nemec’s and Wittkemper’s shares pursuant to the call option under the stock plan, for approximately $162 per share. At the time, all parties were more or less certain that the sale of the government contracts business would close, and it did, on July 31, 2008, raising the book value of the company to an estimated $700 per share.

Nemec and Wittkemper filed suit against Booz Allen directors in the Delaware court of chancery, alleging (i) breach of the covenant of good faith and fair dealing, (ii) breach of the fiduciary duty of loyalty by the directors, and (iii) unjust enrichment. The court granted the defendants’ motion to dismiss in its entirety, and Nemec and Wittkemper appealed.

The Delaware Supreme Court, in a 3-2 split decision, addressed each count in turn.

Covenant of Good Faith and Fair Dealing. First, the Court analyzed whether the directors had breached the implied covenant of good faith and fair dealing when the company redeemed Nemec’s and Wittkemper’s shares at a time when the sale of the government contracts business was “virtually certain” to occur. The Court explained that the implied covenant should be applied when circumstances arise that neither party could have anticipated at the time of contracting and “when the party asserting the implied covenant proves that the other party has

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15 Nemec v. Shrader (Del. 2010).
acted arbitrarily or unreasonably, thereby frustrating the fruits of the bargain that the asserting party reasonably expected.” The Court reiterated that in applying these principles it must “assess the parties’ reasonable expectations at the time of contracting....”

The Court disagreed with Nemec and Wittkemper that this circumstance was unforeseen; rather, it agreed that “contractually negotiated put and call rights are intended by both parties to be exercised at the time that is most advantageous to the party invoking the option.”16 The Court also relied on the sophistication of the appellants, refusing to believe that “long term stockholders of a prestigious mergers and acquisition consulting firm would have no expectation that a future acquirer would be interested in purchasing all or part of the Company.”

The Court also responded to the dissent’s argument that the redemption did not further a legitimate purpose of the company, explaining that, by redeeming the retired shareholders’ stock, the company created more overall wealth for the working shareholders. The Court noted that otherwise the working shareholders potentially could sue the company for favoring the retired shareholders. In the Court’s eyes, the directors did not breach their fiduciary duty by exercising their “absolute contractual right to redeem the retired stockholders’ shares at a time that was most advantageous to the Company’s working stockholders.” The Court also noted that Nemec and Wittkemper “got the benefit of their actual bargain.”

Fiduciary Duty. Nemec and Wittkemper also argued that the directors breached their fiduciary duty of loyalty, since the redemption led to a transfer of value to the company’s other shareholders, including the directors. However, because the breach of the duty of loyalty claim arose out of the same conduct that was the basis of the breach of contract claim discussed above, the Court determined that the breach of contract claim was the proper means for adjudicating the directors’ behavior. Put another way, the directors’ duties when redeeming the retired shareholders’ shares were “intended to be defined solely by reference to [the Stock Plan.]”17

Unjust Enrichment. Nemec and Wittkemper also argued that the directors unjustly enriched themselves by redeeming their shares. The Court affirmed the dismissal of this claim as well, noting that a claim of unjust enrichment is not appropriate “when the alleged wrong arises from a relationship governed by contract.”


The Court of Appeal of California, in Neubauer v. Goldfarb,18 applied California contract law and public policy and Delaware fiduciary duty principles to find that the officers and controlling shareholders may have violated their fiduciary duties and committed other torts in

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17 A later Delaware Supreme Court decision in the context of a partnership dispute cautioned courts in applying Nemec’s seemingly broad endorsement of parties’ freedom to contract for fiduciary obligations, explaining that Nemec should not be read as permitting drafters of company governance documents to draft terms that manifestly contravene Delaware statutes that expressly require the presence of particular fiduciary duties. Gerber v. Enterprise Products Holdings, LLC, 67 A.3d 400, n.48 (Del. 2013).

connection with the repurchase of shares from a minority shareholder prior to a recapitalization of the company at a higher valuation.

In 1989, Neubauer purchased a 40% stake in HCC Industries, Inc., a closely held Delaware corporation, for approximately $1 million. The remaining 60% was held by Andrew Goldfarb (president and CEO), Andrew’s brother, and another officer. In 1994, Neubauer and Goldfarb agreed that Goldfarb would pursue a sale of HCC, with Neubauer to receive a pro rata share of the proceeds. Over the following two years, Goldfarb approached various potential buyers. At one point, Goldfarb told Neubauer that it was essential to the success of a sale that Neubauer provide evidence that he was willing to sell his shares in the transaction as well. The estimated value of the sale at that time was $74 million and, to facilitate the sale to a third party, Neubauer agreed to give HCC a two-year option to purchase his shares for $18 million (a little less than his pro rata amount).

Negotiations over that sale faltered, and Goldfarb told Neubauer that Neubauer would have to reduce the price under the option proportionately, which Neubauer agreed to do. Goldfarb began receiving other indications of interest in HCC, at a higher price, but told Neubauer that the company was not going to sell for as much as they had hoped. Accordingly, Neubauer agreed to amend his option price down again, ultimately to $14.4 million, or about $70 per share, which option HCC exercised in November of 1997. Three months later, a buyer purchased a 60% stake in HCC for $98.5 million, or about $347 per share.

Neubauer sued the company, Goldfarb, his brother and another officer alleging breach of contract, breach of fiduciary duty, fraud, negligence and false statements in the purchase of securities in violation of California securities law. The trial court granted summary adjudication to the defendants with respect to all but the breach of contract claim. The parties settled the breach of contract claim, and the plaintiffs appealed with respect to the other claims.

Impact of Contractual Waiver of Fiduciary Duties. The defendants claimed that disclaimers in the option agreement prevented Neubauer from bringing claims of breach of fiduciary duty.19 However, the court (applying California law pursuant to the choice of law provision in the option agreement) found such a waiver to be void as against public policy, turning first to the California Civil Code for the proposition that any attempt to waive a claim with respect to willful injury to the property of another was void against public policy.20 The court also noted that the California Corporations Code prohibits directors from attempting to limit liability in a corporation’s articles for “acts or omissions that involved intentional

19 Id. at 223. The option agreement provided:

“Seller acknowledges that neither HCC nor its officers, directors or controlling shareholders have any fiduciary duty to seller or HCC in connection with the execution of this agreement or a sale including, but not limited to, the fairness of the overall consideration or the allocation thereof.”

The option agreement further provided:

“[s]eller ... has requested and received such information in connection with the execution of this agreement as he believes to be necessary in order to make an informed decision to enter into this agreement and to bind himself as set forth herein.”

misconduct” or absence of good faith from a director.21 The court thus held that the waiver in the option agreement was void and, more generally, that “waiver of corporate directors’ and majority shareholders’ fiduciary duties to minority shareholders in private close corporations is against public policy.”

The court also noted that, even if such duties could be validly waived, any such waiver would have to be fully informed, and Neubauer had alleged that Goldfarb had withheld material information relevant to the value of his stock.

Impact of Contractual Release of Claims. The defendants claimed that releases in the option agreement barred Neubauer from bringing tort claims.22 The court explained, however, that the releases in the option agreement were general and did not waive claims for the kind of allegations Neubauer was making. Although these releases contain stronger waivers than did those at issue in Allen—for example, the agreement stated the remaining shareholders would likely garner a higher price and that the final deal structure could be more favorable to those shareholders—the court still found them to be too general. To the court, this language prevented Neubauer from suing because the other shareholders would get a better price, but it did not prevent his claim that the officers failed to disclose and misrepresented the true value of the company at the time Neubauer negotiated the agreement itself with them.

Fiduciary Duty of Disclosure. The court then turned to whether the officers had breached their fiduciary duties. For this point, the court turned to Delaware law (the jurisdiction of formation for HCC).

The court noted that, under Delaware law, directors and majority shareholders owe a fiduciary duty of “complete candor” to disclose “‘all the facts and circumstances’” surrounding a transaction with minority holders.23 Directors have been found liable in this context for failures to disclose income and cash flow projections and appraisals of share value. Since Neubauer

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21 Id. at 225, citing Cal. Corp. Code §204(a)(10).

22 The releases in the option agreement provided:

“Seller understands and acknowledges that certain of the other stockholders of HCC will receive, in a sale, compensation and payments both for their shares and otherwise that will have the effect of them receiving a proportionate amount of the aggregate consideration in the sale that is greater per share than seller will receive hereunder. Seller agrees, subject to the other conditions of this agreement being met, not to assert any claim, or to institute any legal, equitable, administrative or other proceedings against HCC or any of its affiliates or stockholders as a result of such difference.”

And:

“Seller acknowledges and agrees that the final form of a sale may be substantially different from what has been disclosed to him as the present form of sale currently under negotiation, due to factors such as … negotiations, due diligence, tax restructuring, changes in the post-sale ownership of HCC by the other stockholders, and other factors, and that it could involve a different buyer. Such final structure may have the effect of being more favorable to individual stockholders of HCC than to seller… So long as seller receives the cash amount contemplated by this agreement, seller will assert no claim against HCC or any of its affiliates or stockholders in connection herewith.”

alleged Goldfarb failed to disclose both, and Goldfarb admitted to not providing financial information, there were issues of fact that should survive the motion to dismiss.

In addition, Neubauer argued that Goldfarb failed to provide him with updates to the information he initially disclosed to Neubauer about the share value, thereby inducing him to amend the option agreement for downward price adjustments. The court found that Delaware law supported the proposition that the duty of complete candor required disclosure of information affecting the value of the company’s shares to minority shareholders even after the shareholder has agreed to sell his shares but before the sale actually takes place. The Delaware case cited by the court explained that subsequent events should be disclosed if they cause a “significant slant” on information already discussed. The court limited this rule by emphasizing “subsequent events may have significance, and thus require disclosure, only as they relate to information originally disclosed.”

What Can Companies Do?

These cases show some of the pitfalls that companies, and shareholders, should address in selling shares to the company and other insiders.

1. Establishment of Contractual Rights to Buy Shares

Although all the cases discussed above involved a contract of some sort, the contract at issue in Nemec (i.e., the company’s stock plan) was effective from the beginning of the shareholder’s share ownership. The contracts in Allen, Wayport and Neubauer (a redemption agreement, a sale agreement and an option agreement), on the other hand, were signed at the time the shareholder was being asked to sell shares to the company, at which time the shareholders later claimed the companies and other insiders had additional information as to the increasing value of the company. Thus, there was more potential for the shareholders to argue that there was a breach of fiduciary duty or some misrepresentation or omission at the time of contract formation. Companies should consider whether there are terms they would like to request at the time they agree to issue shares, such as the call rights held by the company in Nemec, recognizing, though, that such terms may have an adverse effect on at least the perceived value of those shares.

2. Releases and Disclaimers

The releases discussed in Allen and Neubauer came under fire for not being sufficiently specific. To maximize the potential for prevailing against a fraud claim, releases should disclaim reliance on statements and omissions and, ideally, release claims of fraud; relying on general waivers, or on overall integration clauses, does not appear to be enough. Of course, asking for such a release may lead to awkward negotiations, so some balance must be sought.

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24 Id. at 232, citing Kahn v. Household Acquisition Corp., 591 A.2d 166 (Del. 1991).

25 Id. citing Kahn, 591 A.2d at 171.
3. **Disclosure**

Directors and majority holders who may be seen as fiduciaries should be careful to take steps to comply with any applicable duty of candor, though the sufficiency of disclosures in this regard can be difficult to judge, particularly when making decisions at the time rather than with the benefit of hindsight.

4. **Diligence**

Shareholders should do their diligence, if the opportunity is available. Shareholders may have made progress in their claims in *Allen* and *Neubauer*, but the litigation process took years. If they are unable to do their diligence, they should avoid agreeing to disclaimers suggesting that they did their own diligence.

5. **Disclaimer of Duties in Charter Documents**

While there are limits on what can be disclaimed, companies trying to avoid these issues should try to disclaim, to the maximum extent possible, the existence of duties to shareholders in these circumstances. Such disclaimers tend to be strongest when set forth in a company’s charter documents. They may be more effective in some types of entities, such as limited liability companies, than in others, such as more traditional corporations, though the law also varies from state to state and is still evolving. As with other steps noted above, such disclaimers also can affect the perceived value of the shares.