APPLICATION OF ANDREW R. HISSONG, DENNIS R. HISSONG, IVAN D. HISSONG, KIRBY L. HISSONG, AND LARRY W. HISSONG, Individually, and on Behalf of HISSONG FARMSTEAD, INC., C.P. Franklin County Branch, Civil Action - Equity, Eq. Doc. Vol. 8, Page 229

Hissong Application

Application under the Business Corporation Law of 1988 as amended, 15 Pa.C.S. section 1103 et seq, to adjudicate the proper composition of the board of directors of a closely-held corporation operating as a family-owned dairy farm; shareholder agreement; business judgment rule; votability of newly-issued shares at a shareholder meeting to elect a board of directors.

1) Under the Business Corporation Law (BCL), a board of directors' power to issue authorized but unissued shares of corporate stock can be restricted by an article of incorporation or a bylaw, but not by a shareholders' agreement.

2) Where the terms of a shareholders' agreement are ambiguous, the court must consider parole evidence to discern the shareholders' intentions at the time of its execution.

3) The board of directors was not restricted from issuing unissued shares of authorized stock by the provisions of a shareholder agreement, and those shares were legal, where such provisions were not intended by the shareholders to be restrictions when they signed the agreement, but were concerned instead with the consequences of the early withdrawal from the corporation of a second-generation family shareholder whose shares had to be purchased by the corporation, and the agreement was intended to prevent members of the third generation who had received gifted shares from the older generations from leaving the corporation, cashing in their shares at full value and leaving the older generations to do the farm work, and was designed to achieve that end by keeping control of the corporation within the family, controlling the price of the shares, and permitting family members to acquire shares if they remained employees of the corporation, with an eye toward allowing a shareholder who had worked at the corporation for twenty-five years to automatically receive the full value of his shares as a source of retirement income without having to negotiate the terms of his withdrawal with the other shareholders.

4) Where a trial court order enjoining the board from issuing shares while an appeal was pending as to prior litigation between the shareholder groups, but the board did not issue the shares until after the appellate court had ruled in its favor, the board did not violate the injunction even though the shares

were issued before the appellate court denied the losing group's motion for reconsideration.

5) The business judgment rule is a common law doctrine, finding expression in the BCL, which protects corporate officers from liability for their business decisions under certain conditions.

6) It is presumed 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 corporation; the burden is on the party challenging the decision to establish facts rebutting the presumption.

7) If the decision being challenged was within the scope of the director's authority, if he exercised reasonable diligence, and if he honestly and rationally believed his decision was in the corporation's best interests, his actions are beyond the court's scope of review unless the challenger can show fraud, self-dealing, violation of statutory duties and the like; if a court makes a preliminary determination that a business decision was made under proper circumstances, the court is prohibited from going further and examining the merits of the underlying business decision.

8) In considering the corporation's best interests, a board of directors may consider a range of issues, including the impact of its decisions on shareholders, employees and other persons or entities associated with the corporation; it may also consider the long-term and short-term interests of the corporation, the intent and conduct of any person or entity seeking to acquire control of the corporation, and all other pertinent factors; the board may pursue a course of action which it considers in the best interests of the corporation even if that course of action does not serve the short-term interests of a particular group of shareholders.

9) A corporate director's fiduciary duty to the corporation demands that he act in a disinterested manner; however, a director may own stock in a corporation, may seek to retain his position as director, and may be a participant in a corporate retirement plan and nevertheless remain "disinterested."

10) The board did not violate the business judgment rule or the BCL when it issued shares under a stock plan designed to encourage shareholder employees to work for the corporation on a long-term basis; a board may set up incentive stock plans and other similar employee and management compensation programs, and, absent a restriction in the articles of incorporation or the bylaws, the board may set the share price.

11) Although the incentive plan allows employees to purchase shares at a price substantially below the share price established by the board and/or

shareholder consensus, the plan does not "reclassify" the stock or trigger formal dissenters' rights under the BCL because both the preexisting, authorized shares and the newly issued shares have the same voting rights; the newly issued shares do not constitute a different class or series of stock from those originally created and issued upon the corporation's founding.

12) The board did not violate the business judgment rule when, in a dispute with the opposing shareholder group over the proper share price of the stock, it refused that group's demand to have the corporation pay for the cost of appraising corporate assets where the board set a share price above, not below, the price previously set by shareholder consensus, the corporation itself would not benefit from such appraisals, and the two groups were then locked in contentious litigation concerning whether the corporation should be involuntarily dissolved, with the group demanding the appraisals seeking the dissolution and the group comprising the board opposed to dissolution.

13) The board did not violate the business judgment rule when its officers who were also employee shareholders swapped debt owed to them by the corporation under promissory notes for shares of stock in the corporation where the purpose of the swap was to reduce the corporation's debt load, making bank financing for upgrading farm facilities more tenable, and where the swap entailed no risk to the corporation but only to the employee shareholders who would no longer be guaranteed to receive from the corporation annual interest on the notes.

14) The board did not violate the business judgment rule or engage in oppressive conduct toward the opposing non-employee shareholder group in issuing shares of stock under the incentive plan and the debt for stock swap because these plans benefited the corporation in two ways: by improving cash flow for farm operations, and by giving the committed employee shareholders a personal stake in the long-term health of the farm.

15) The newly-issued shares, in addition to having been legally issued, were also votable at the shareholders' meeting where the stock ledger book and the voting list indicating how many shares each shareholder owned were updated by or before the record date fixed by the board.

16) An election will not be automatically invalidated simply because some shareholders did not see the voting list in advance of the meeting because the BCL gives prima facie validity to the list presented at the meeting up through the moment a shareholder demands to see it and objects to it; the objection is then preserved and the objector can seek whatever relief may be available under the articles, bylaws or BCL.

J. McDowell Sharpe, Esquire, Attorney for Plaintiffs
Thomas J. Finucane, Esquire. Attorney for Participant, Greg Hissong

OPINION AND DECREE NISI

HERMAN, J., December 23. 1998:

INTRODUCTION

This case involves a dispute between two shareholder groups in a closely-held family corporation known as Hissong Farmstead, Inc.[1] This matter comes before the court pursuant to an application for relief under the Pennsylvania Business Corporation Law filed by members of one of the groups as individuals and on the behalf of the Farmstead. The corporation was founded in 1974 by Marvin D. Hissong and his wife Romaine who have five sons: Dennis, Larry, Jere, Sr., Gregory and Marvin E. Hissong.[2] Larry's sons are Kirby and Andrew. Dennis has a son named Ivan. Jere, Sr. also has sons Jere, Jr., Shawn and Spencer. The founder of the corporation, Marvin D. Hissong, was its President and a member of the board of directors until a shareholder election held on December 15, 1994. Dennis, Larry and Gregory were elected to the board of directors at that meeting.

Dennis, Larry, Andrew, Kirby and Ivan (the applicants) seek to confirm the results of a later election held at a shareholder meeting on February 21, 1998 during which the respondents sought to elect a new board of directors. The respondents are Marvin D., Jere, Sr., Jere, Jr., Gregory, Shawn and Spencer individually and on behalf of the Farmstead. Both groups claim to be in control of the board of directors as a result of at least two elections held at the shareholder meeting on February 21, 1998.

Previous litigation has occurred in this court between the two shareholder groups. In 1995 the now-respondents filed an application

[1]A closely-held corporation is a corporation which has no more than 30 shareholders. The Business Corporation Law of 1988 as amended, 15 Pa.C.S. section 1103.

[2]Marvin E. Hissong has not been a shareholder since February 20, 1988.

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requesting involuntary dissolution of the corporation alleging minority shareholder oppression and the wasting of corporate assets. They sought to have a receiver appointed for the purpose of dissolving the corporation. The Honorable John R. Walker denied the application after a bench trial by Order dated September 10, 1996. That ruling was appealed to the Superior Court and on April 14, 1997 Judge Walker issued an injunction precluding the issuance of new stock and barring the expenditure of corporate funds for the purchase and installation of a new cow care facility pending appeal.[3] The injunction was to remain in effect until the matter was decided by Superior Court. The Superior Court affirmed Judge Walker's ruling on February 18, 1998. A motion for reconsideration was denied on April 30, 1998.

As previously mentioned, a shareholder meeting was held on February 21, 1998 at the respondents' request during which a dispute erupted as to whether authorized but unissued shares of stock issued by the board of directors to Andrew, Kirby and Ivan were issued in violation of a 1991 shareholder agreement and whether those shares could properly be voted. As an additional challenge to the issuance of these shares, the respondents claims those shares were issued in violation of the April 14, 1997 injunction.

The parties disagree as to whether two or three elections were conducted and which should be considered the valid election. The applicants contend the second election should be upheld. That election placed Dennis, Larry, Andrew, Shawn and Jere, Sr. on the board and if valid gives the applicants control of the board of directors. The respondents contend the third election which awards them all five seats on the board is the valid election. If respondents prevail, the board would consist of Marvin D., Jere, Sr., Jere, Jr.,

[3]Judge Walker's initial Opinion denying the petition for a receiver was filed on February 6, 1996. An appeal was taken which was later discontinued on May 22, 1996 by Order of Superior Court. Following additional proceedings, Judge Walker issued a second Opinion denying the petition on September 10, 1996. Another appeal was filed on February 19, 1997 on which Superior Court ruled on February 18, 1998.

Shawn and Spencer. The respondents considered themselves the legitimate board of directors following the meeting and assumed control of the corporate payroll, bank accounts, lines of credit and other assets. The litigation has caused serious disruption of normal dairy farm operations such as the receipt of milk checks and the payment of bills.

At the center of this dispute over control of the corporation is a shareholders' agreement executed on February 20, 1991 between the corporation and Marvin D., Jere, Sr., Larry, Dennis, Gregory, Jere, Jr., Shawn, Spencer and Andrew.[4] Paragraph 3 provides: "Share Certificates. The sale or transfer of this certificate is subject to the approval of all shareholders." Paragraph 7 provides: "Disbursement of Shares. Prior to twenty-five (25) years of full-time employment by the corporation, value of shares and payment plan to be negotiated by all Shareholders."[5]

The disputed new shares were issued under two stock plans conceived and implemented by the applicants before the February 21, 1998 meeting. These plans are known as the "Debt for Stock Swap" and the "Employee Incentive Stock Plan."[6] The plans increased the number of shares held by certain applicant shareholders and, according to the respondents, the new issue of stock diluted the voting power of the respondents' shares.

The stock incentive plan was adopted at the January 13, 1998 regular board meeting attended by Dennis, Larry, Andrew, Kirby, Ivan and Gregory. According to the minutes of that meeting, the purpose of the incentive plan was to encourage younger family members who have been full-time Farmstead employees for at least five consecutive years to continue long-term employment at the

[4]This Agreement was also referred to as the "Buy-Sell Agreement" in some of the pleadings and testimony.

[5]Respondents' exhibit #1. The applicants' exhibits are designated as "petitioners' exhibits."

[6]The formal name of the latter plan is the "Employee Stock Purchase Plan." (Petitioners' exhibit #12).

Farmstead. Paragraph 2 of the incentive plan states that the plan shall be administered by the board of directors. The board of directors at that time consisted of Dennis, Larry, Andrew, Kirby, Ivan and Gregory. Gregory had resigned his full-time employment at the Farmstead on December 20, 1997. He was still on the board of directors but abstained from voting on the stock incentive plan.

The respondents claim that both the incentive stock plans and the debt for stock swap, neither of which were approved by all shareholders, were designed to place more shares in the hands of the applicants for the purpose of diluting the voting power of the respondents' shares, thereby enabling the applicants to remain in control of the board of directors and the corporation.

A key matter for decision is whether the 1991 shareholders' agreement (updated in 1995) precludes the board of directors from issuing authorized but unissued shares of stock from the preexisting pool of authorized shares absent the agreement of all shareholders. The applicants argue that, according to the Business Corporation Law, a board of director's power to issue such shares can be restricted only through the articles of incorporation or the bylaws and not through a shareholder agreement. Alternatively they argue that even if a shareholders' agreement is an acceptable mechanism for restricting the board from issuing those shares, the particular agreement the parties signed does not, and was not intended, to impose such restrictions.

The respondents maintain the 1991 agreement required that authorized but unissued shares could be issued only by agreement of all the shareholders and not just the board of directors. Respondents further maintain that allowing the board to issue these shares without shareholder consensus subjected them as minority shareholders to fundamental unfairness under the Business Corporation Law. This fundamental unfairness is allegedly found in the dilution of the voting power of the respondents' shares. The respondents claim that the sole aim of the stock issue was to allow the applicants to retain control of the corporation in a manner which constituted self-dealing.

FINDINGS AND DISCUSSION

I Does the 1991 shareholders' agreement restrict the power of the board of directors to issue authorized but unissued shares from the pool of authorized shares without the agreement of all shareholders?

A. Under the Business Corporation Law, can a shareholders' agreement, rather than an article of incorporation or a bylaw, restrict a corporate board's power to issue authorized but as yet unissued shares of stock?

Five-thousand (5,000) shares of stock were authorized when the corporation was founded. One-thousand (1,000) of those were originally issued. Founder Marvin D. received 600 shares and 100 shares each were issued to Jere, Sr., Marvin E., Dennis and Larry. Gregory was considered too young at that time to be issued any shares. A practice developed by which Marvin D. periodically gifted some of his shares to his sons once they began working full-time for the Farmstead. Jere, Sr., Dennis and Larry would in turn gift some of their shares to their own sons. By February 23, 1994, Marvin D. owned 169 shares and Jere, Sr., Larry, Dennis and Gregory each owned 187 shares. Jere, Jr., Shawn, Spencer and Andrew owned 63, 33, 25 and 12 shares respectively.[7]

Neither the articles of incorporation nor the bylaws contain any provisions which limit the corporation through its board of directors from issuing shares of authorized stock. The applicants maintain that under section 1521(c) any restriction of the board's power to issue shares from the pool of authorized shares must be done either through the articles of incorporation or a bylaw, and since neither was utilized here, the shareholder agreement which purports to achieve the same end is irrelevant and should not operate to restrict the board from issuing the shares from the existing pool of authorized shares.[8]

[7]Respondents' exhibit #25.

[8]Under *Chrisman et al. v. Avil's Inc., et al.*, 80 D. & C. 395 (1952), restricting a board's powers as to authorized but as yet unissued shares can be done only through the articles of incorporation and not through the bylaws; this holding predates the 1988 amendments to the BCL which also allow for board restrictions using bylaws.

The following sections of the Business Corporation Law (BCL) pertain to powers of a corporation's board of directors

> 1521(a): Every business corporation shall have power to create and issue the number of shares stated in its articles.
>
> 1521(c): Additional provisions regulating or restricting the exercise of corporate powers...may be specified in a bylaw adopted by the shareholders.
>
> 1525(d): ...[Stock rights] and options may be issued to representatives of the corporation...as an incentive to service or continued service with the corporation...or for such other purpose and upon such other terms as its directors, who may benefit by their action, deem advantageous to the corporation.
>
> 1529(b): A restriction on the transfer...of securities of a business corporation may be imposed by the bylaws or by an agreement among any number of security holders or among them and the corporation...

Corporate powers are vested in a corporation's board of directors. Section 1721. The 1988 BCL provides expressly that the bylaws rather than the articles may also contain provisions on certain voting rights of the corporation's shares. 1504(c); the Amended Committee Comment-1990.

The respondents counter that section 1529(b) allows for this type of restriction on the board by way of a shareholder agreement. They maintain that "transfer" under that section is a broad term which includes the transfer of shares from the corporation to its shareholders and does not refer only to the transfer of shares between shareholders. "Transfer" according to this view would be synonymous with "issue." This interpretation has little if any support in the language of the BCL. However, under section 1530(a), the board acting for the corporation may issue authorized, but as yet unissued shares, without first offering them to shareholders of any class or classes where there is no article of incorporation restricting the board from so doing. Amended Committee Comment-1990.

We agree with the applicants that a shareholder agreement is not a proper vehicle to restrict a corporation's power to issue shares from a pool of authorized shares. However, we will not declare the shares issued on February 19, 1998 to be valid on that basis alone.

B. What is the purpose of the 1991 shareholders' agreement? Is it to prevent the board of directors from issuing shares of authorized stock or was it simply a device for the control of formerly held shares with retirement features?

This argument also has two parts: First, does the language of the agreement clearly limit the powers of the board, or are the provisions so ambiguous as to require the court to consider parole evidence in order to interpret their meaning? Second, does examination of the circumstances of its execution indicate the parties intended to preclude the board from issuing new shares without the consent of all the shareholders?

As to the first part, the agreement's key provisions are paragraphs 3 and 7:

> 3. Share Certificates. The sale or transfer of this certificate is subject to the approval of all shareholders.
>
> 7. Disbursement of Shares. Prior to twenty-five (25) years of full-time employment by the corporation, value of shares and payment plan to be negotiated by all Shareholders.[9]

The agreement was made "by and between Hissong Farmstead, Inc." and the shareholders. The respondents maintain that the board's issuance of authorized but previously unissued shares to Andrew, Kirby and Ivan before the election without the consent of all shareholders was, in the respondents' view, an improper "transfer" under paragraph 3.

It is undisputed that Larry acting as secretary drafted and included these provisions with the consent of all shareholders. They were not drafted by legal counsel and when read in a vacuum their purpose is

[9]Respondents' exhibit #3.

not entirely clear. Therefore, in addition to incorporating our prior discussion of the word "transfer" in the context of the BCL, we will consider parole evidence to discern the meaning of the agreement's provisions.

Wayne Brubaker is employed by the Pennsylvania Farm Bureau and has been the Farmstead's accountant since 1980. He has attended Farmstead annual meetings since February of 1980 and assists in maintaining its financial records and advising the corporation on all matters relevant to its operation. Shortly before he became the Farmstead accountant, Farm Bureau attorney S. Paul Mazza drafted an agreement which was signed by all the Farmstead shareholders. Paragraph 6 barred any shareholder from disposing of his shares during his lifetime without first offering to sell his shares to the corporation. If the corporation decided not to purchase the shares, they could be purchased by the shareholders. Valuation of the shares was to be set by consensus at annual shareholder meetings held each February. According to Mr. Brubaker, the 1980 agreement was designed to protect a closely held corporation in the event of the death, retirement and withdrawal of member shareholders.[10]

Marvin E. Hissong (known as Marvy) withdrew from the corporation on February 20, 1988. By shareholder consensus, he was allowed to sell his 175 shares at a price of $1,000 per share with a fixed amount to be paid annually. His shares were distributed equally among Marvin D., Jere (Sr.), Larry, Dennis and Gregory who each then had 210 shares for a total number of shares issued of 1,050.[11] After Marvy left the corporation, members of the third generation, Jere, Jr., Shawn, Spencer and Andrew, began receiving stock as gifts from the older generations. Jere, Jr. had worked at the farm since 1982 and began receiving stock in 1988. Shawn, Spencer

[10]Respondents' exhibit #2.

[11]Respondents' exhibit #7, Agreement signed by Marvin D., Jere, Sr., Larry, Dennis, Marvin E., and Gregory.

and Andrew began receiving stock in 1990, 1991 and 1993, respectively.[12]

A 1990 tax audit revealed although the agreement provided for the corporation to receive shares, in reality it was the shareholders who were receiving them. A new shareholder agreement was drafted and signed on February 20, 1991 clarifying this matter.[13] Paragraphs 3 and 7 set forth above were added at that time. As mentioned above, these paragraphs were not drafted by an attorney but were included by Larry acting as corporate secretary with the approval of all shareholders. A third version of the shareholder agreement was signed on February 20, 1995 which was identical to the 1991 agreement but for the shareholder signatures which now included Andrew. Again, no attorney reviewed paragraphs 3 and 7 which remained unchanged. According to the respondents, all the parties understood that all shareholders, not only the board of directors, had to agree to share transfers and the issuance of the 3,950 authorized but unissued shares.

The shareholders held an annual meeting on February 20, 1995 at which they signed the revised version of the 1991 agreement. According to Wayne Brubaker's credible testimony and the respondents' admissions, all shareholders agreed to value the stock at $1,400 per share.[14] At the February 19, 1996 annual shareholder meeting, Jere, Jr. expressed his belief that the assets of the corporation should be formally appraised before any consensus was possible as to the proper share price of the stock. The board of directors refused to have the corporation underwrite an appraisal and suggested that any shareholder who wished could do his own appraisal.[15] The shareholders could not reach a consensus at that meeting as to a new share price so it remained at $1,400 as agreed on February 20, 1995.

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[12]Respondents' exhibit #25

[13]Respondents' exhibit #3.

[14]Petitioners' exhibits #52 and #53.

[15]Respondents' exhibits #15, 32; petitioners' exhibits #50, 51.

The respondents, with the exception of Gregory, did not attend the next shareholder meeting held on February 11, 1997. The board of directors therefore set the value of the stock at $1,450 per share.[16] The respondents maintained that attending shareholder meetings for the purpose of agreeing upon a share price would have been futile unless a formal, independent appraisal of corporate assets was conducted beforehand.

We conclude from the credible evidence that the early withdrawal of Marvy from the corporation caused the remaining shareholders to be concerned about protecting the corporation. The 1991 agreement was intended achieve several related objectives: 1) to keep control of the corporation within the family; 2) to permit family members to acquire shares if they remained employees of the corporation; 3) to control the price of the shares, and 4) to serve as a retirement plan. The idea was to prevent the younger shareholders from prematurely leaving Farmstead employment and cashing in their gifted shares at full value, thereby removing capital from the corporation and leaving the older shareholders to do the actual farm work. The agreement would also allow a shareholder with 25 years of Farmstead employment to automatically receive the full value of his shares as a source of retirement income without having to negotiate the terms of their withdrawal with the other shareholders.

The evidence showed the older generations were gradually divesting themselves of shares by transferring them to the younger generation between 1974 and 1994.[17] At the same time, the value of the stock steadily increased every year between 1984 and 1995 from $800 to $1,400 per share at regular increments of $50-$100 by consent of all shareholders.[18] This pattern of divestment while

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[16]Petitioners' exhibits #2 and 3: Minutes of February 10, 1997 shareholders meeting and minutes of February 11, 1997 board of directors' meeting, respectively.

[17]Respondents' exhibit #25.

[18]Respondents' exhibit #3.

elevating the shares' value is consistent with funding the retirement of older shareholders who would receive the full value of their shares with those shares then being distributed among the other shareholders. We agree with the applicants that the agreement was intended to restrict transfers of stock that had already been issued and were outstanding and to provide for their purchase by other shareholders or the corporation in the event of the death or other withdrawal from the corporation.

A thorough review of the extensive testimony and documentary evidence shows the idea of precluding the board from issuing shares of unissued but authorized stock without unanimous shareholder consensus was not in the parties' minds when they signed the agreement. Only after Dennis was elected president on December 15, 1994 did the shareholders split into two groups. Jere, Jr. was terminated in October 1995 and then Jere, Sr., Shawn and Spencer left Farmstead employment and commenced the involuntary dissolution action addressed by Judge Walker. The notion that the buy-sell agreement restricts the board's power to issue shares of authorized stock did not emerge until after the applicants filed this action to rule on the outcome of the February 21, 1998 election.[19]

[19]The parties each contend the other party should be estopped from advancing an argument about the enforceability of the 1991 (and 1995) agreement opposite to that which it advanced in the prior litigation. The respondents, then petitioning for involuntary dissolution of the corporation, contended the agreement was ineffective to protect them from oppression. The applicants, then opposing dissolution, claimed the agreement was indeed an effective mechanism by which a shareholder desiring to withdraw from the corporation could retrieve his investment back from the corporation. Judge Walker indicated in his Opinion of February 6, 1996 that the buy-sell agreement did, generally speaking, provide such a mechanism if the parties can agree upon a share price. (Respondents' exhibit #16, pp. 16-17). The argument now raised by the applicants is that by failing to attend annual meetings in 1996, 1997 and 1998 the respondents have nullified the agreement. This is the applicants' alternate argument: i.e., even if the agreement does preclude the board from issuing new shares, it can no longer have that effect because it has been nullified.

Even Gregory, the youngest son of founder Marvin D. and the family member most distressed by the family conflict, conceded the shareholders never discussed the notion that the agreement restricted the board's power to issue shares of authorized but unissued shares of stock. This concession is wholly consistent with Wayne Brubaker's credible testimony.

The respondents may be correct in commenting that "[i]t is prudent that shareholders in a closely held corporation restrict the issuance of new shares - to fail to do so allows a board to determine the issue of corporate control without input from shareholders. To allow complete shareholder control on 1,050 shares and none on 3,950 shares is not reasonable or prudent." (Respondents' Post Trial Memorandum, p. 8). We may agree with this statement. However, in the context of this closely held corporation, the agreement simply does not speak to the 3,950 unissued shares. We will not now read back into the agreement a purpose which was not part of the shareholders' intentions when they signed it.

II Did the applicants violate the injunction by issuing shares before the Superior Court had ruled on the respondents' motion for reconsideration on April 30, 1998?

Collateral estoppel applies where 1) the issue is identical to one previously litigated; 2) final judgment on the issue was rendered on the merits in the previous litigation; 3) the party against whom the estoppel is asserted was a party to the previous action or in privity with such a party, and 4) the party against whom the estoppel is asserted had a full and fair opportunity to litigate the issue in the previous action. *Shaffer v. Smith*, 673 A.2d 872 (Pa. 1996). We decline to apply collateral estoppel. One of the problems currently before the court is what can be done when the parties cannot agree upon a share price. This issue was not before Judge Walker; there is no identity of issues, and the parties have not previously had the opportunity to litigate that issue. Also, as a practical matter, the parties' respective assertions of collateral estoppel tend to effectively cancel each other out and prove of little help to the court's efforts to adjudicate this matter.

The respondents moved for an injunction to preclude the issuance of new stock pending the outcome of the appeal to Superior Court. The April 14, 1997 injunction order stated: "The Court orders that no new stock be issued by the corporation until the Superior Court of Pennsylvania decides on appeal the Court's opinion resolving this matter. [The applicants] may proceed with their investigation of milking parlor equipment and freshening barn, but the Court directs that they not enter into a contract or start construction unless specifically given permission by the Court through an order..."[20] The board continued to discuss the upgrading plans and the need to compensate employees with Wayne Brubaker and at monthly board meetings. In compliance with the injunction, however, the board refrained from issuing new shares and new stock certificates until February 19, 1998, one day after the Superior Court affirmed Judge Walker's ruling and two days before the disputed February 21, 1998 election.

With this background we now turn to the respondents' challenge to the issuance of stock under the debt for stock swap and the employee incentive plan as being violative of the injunction issued by Judge Walker. The respondents argue that the resolution of this issue lies in the interpretation of the order issuing the injunction. We disagree. The order is very precise "...until the Superior Court decides on appeal the Court's opinion resolving the matter." A "decision on appeal" is defined by the Pennsylvania Rule of Appellate Procedure, Rule 1112(b) as a final order. A final order of the Superior Court is "...any order that concludes an appeal..." Pa.R.A.P. 1112(b). The matter having been concluded by entry of the final order of the Superior Court, the respondents were placed in the position of requesting a stay or supersedeas as required by Pa.R.A.P. 1732(a) in order to maintain the status quo. There is no automatic supersedeas pursuant to Rule 1731(a) except under specific circumstances which were not applicable at the time of the Superior Court's decision. The respondents filed a motion for reargument but did not request any further relief pursuant to Rule 1732 such as "...modifying, restoring

[20]Petitioners' exhibit #24.

or granting an injunction during the pendency of an appeal..." The respondents claim that with the injunction already in place it was reasonable for them to rely on it. However, the court cannot agree with this position in light of the specific requirements for stays and injunctions found in Pa.R.A.P. 1731 et seq.

Curiously, the respondents have cited the case of *Kuriakose v. W.C.A.B.(J.F. Kennedy Hospital)*, 681 A.2d 1389 (Commwlth. Ct.1996) as support for their position. They seem to argue that they should have been able to avoid the holding of the Commonwealth Court in *Kuriakose* because there was a statutorily created procedural step in that case which allowed the parties to proceed in the lower court even though the decision of the governmental unit had been appealed and was pending before the Commonwealth Court. The Superior Court in *Kuriakose* confirmed the practical effect of a final order as divesting the lower court of authority to act any further as to those issues decided by the court. The respondents seem to say that because they were not pursuing further action in the lower court, the holding in *Kuriakose* does not apply to this case. This is a distinction without substance. We believe the holding to the Commonwealth Court precisely describes the effect of a final order issued by an intermediate appellate court in this Commonwealth. It cuts off the power of the lower court to act any further, if indeed any remains at that point, but more importantly it concludes the matters raised in the appeal as to both the lower court and the intermediate appellate court. To hold otherwise "...would restrict our jurisdiction by denying a final order of this Court its res judicata effect." *Id.* at 1391. Therefore we conclude that not only did Judge Walker intend to limit the relief provided by the injunction to the time of entry of the final order of the Superior Court on February 18, 1998, but also the entry of the final order set the limit of the lower court's authority to provide or continue injunctive relief. The stock issued by the applicants subsequent to that date was not constrained by Judge Walker's injunction.

III Did the applicants, in implementing the debt for stock swap and the incentive stock plan, violate the business judgment rule?

BACKGROUND

After Dennis's election as board president on December 15, 1994, it appears that personality conflicts and disagreements about business matters emerged between the two shareholder groups. During the following two years, Jere, Sr., Jere, Jr., Shawn and Spencer left Farmstead employment or were terminated.[21] The workload was assumed by Dennis, Larry, Andrew, Kirby and Ivan and to a lesser extent by part-time employees who were not family members. Credible testimony showed the three younger men in particular worked relentlessly long hours on the farm and were critical to the corporation's viability.

There was credible testimony that paying Farmstead employees a fair hourly wage placed strains on the corporation's cash flow. Beginning in early 1996, the board frequently discussed various methods of encouraging the younger men to remain working on the farm on a long-term basis. Each employee with one year or more of experience received bonuses in 1996 and 1997 but the bonus approach had drawbacks, particularly its effect on cash flow. The board also began investigating the viability of an employee incentive stock plan.[22] In addition, the board believed the milking facility needed upgrading which would cut labor costs and ease the burden on remaining employees as well as improve efficiency and profitability. It began planning this facility in February 1997.[23]

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[21] Jere, Jr.'s employment at the Farmstead was terminated by the board of directors in September or October 1995. Spencer and Shawn resigned sometime in 1996. The particular circumstances of the resignation and termination of Jere, Sr. and Jere, Jr. were discussed in the Opinion issued by Judge Walker on February 6, 1996 and are not at issue here. (Respondents' exhibit #16).

[22] Petitioners' exhibits #1, 5, 6, 8: Minutes of board of directors meeting from December 11, 1996, April 8, 1997, July 8, 1997 and October 14, 1997.

[23] Petitioners' exhibit #3: Minutes of February 11, 1997 board of directors meeting.

The respondents requested a special shareholder meeting on December 16, 1997 pursuant to the bylaws. According to the request, the purpose of the meeting was "to designate a board of directors and to discuss the status of Hissong Farmstead, Inc."[24] Larry as secretary issued a notice setting the meeting for February 21, 1998.[25]

Gregory resigned his employment at the farm on or about December 20, 1997. Both shareholder groups realized that Gregory was the "swing" shareholder and attempted to induce him to vote their way at the upcoming meeting. Gregory, the youngest of Marvin D.'s sons, had been part of the group led by Dennis during the previous litigation but his support for that group wavered in late 1997 and early 1998. In addition, he was in the process of getting a divorce and was having financial problems. The respondents, led by Jere, Sr., offered to buy his property, which is situated around the Farmstead, if he voted their way at the upcoming meeting.[26]

The incentive stock plan was approved by the Board at a board meeting held on January 13, 1998.[27] Dennis and Larry voted in favor of the plan. Andrew and Kirby acknowledged the plan but did not participate in the vote and Greg abstained. The plan eliminated the need for employee bonuses, resulting in a decrease of salaries. The board registered the plan with the Pennsylvania Securities Commission on January 27, 1998. It was not to become effective until the Superior Court ruled on the appeal from the previous litigation.[28] The board also took steps to implement the debt for stock swap discussed below. The Superior Court ruled on the appeal on February 18, 1998. The applicants immediately put both stock plans

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[24] Petitioners' exhibit #16.

[25] Petitioners' exhibit #17.

[26] Petitioners' exhibit #47.

[27] Petitioners' exhibit #11.

[28] Petitioners' exhibits #25 and # 26.

into effect on February 19, 1998. Issuing the new shares under both plans gave the applicants voting control of the stock. The applicants, now the majority shareholders, have 691 shares and the respondents have 664 shares. The total number of shares was therefore increased to 1,355 from 1,050.[29]

A. The business judgment rule and the incentive stock plan.

A common law doctrine known as the business judgment rule has developed which protects corporate officers from liability for business decisions under certain conditions. The rule finds expression in sections 1712, 1715, 1716 and 1717 of the BCL which pertain to directors' and officers' conduct as corporate operatives. Section 1712 provides that a director or officer owes a fiduciary duty to the corporation to act "in good faith, in a manner he reasonably believes to be in the best interests of the corporation and with such care, including reasonable inquiry, skill and diligence, as a person of ordinary prudence would use under similar circumstances..." Under section 1717, "the duty of the board of directors under section 1712...is solely to the business corporation..." In considering the corporation's best interests, a board of directors and individual directors may consider a range of issues, including the impact of their decisions on shareholders, employees and other persons or entities associated with the corporation. It may also consider the long-term and short-term interests of the corporation, the intent and conduct of any person seeking to acquire control of the corporation, and all other pertinent factors. Section 1715(a). The board may in its discretion pursue a course of action which it considers in the best interests of the corporation even if that course of action does not serve the short-term interests of a particular group of shareholders. Section 1715(b). A board of directors is presumed to have acted in the best interests of the corporation absent proof by clear and convincing evidence of a breach of fiduciary duty, a lack of good faith or self-dealing. Section 1715(d).

[29]Petitioners' exhibits #23 and #19.

Section 1715(e) refers to the need for directors and officers to act in a disinterested manner, particularly under scenarios involving the potential or actual acquisition of control over the corporation. In general, however, a director may own stock in the corporation, may seek to retain his position as director and may be a participant in a corporate retirement plan and nevertheless remain "disinterested." Section 1715(e); Sell and Clark, *Pennsylvania Business Corporations,* vol. 3, section 1715:3.[30]

The business judgment rule takes different forms in different jurisdictions. Pennsylvania courts have adopted the rule formulated as follows:

> 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 court. The burden is on the party challenging the decision to establish facts rebutting the presumption.

Cuker v. Mikalauskas, 692 A.2d 1042,1045-1046 (1997), citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del.1984). If the decision being challenged was within the scope of the directors' authority, if the director exercised reasonable diligence, and if he honestly and

[30]The business judgment rule has also been discussed at length in the American Law Institute's Principles of Corporate Governance: Analysis and Recommendations and has been formulated as follows: "A director or officer who makes a business judgment in good faith fulfills the duty under this Section if the director or officer: (1) is not interested in the subject of the business judgment; (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and (3) rationally believes that the business judgment is in the best interests of the corporation." A.L.I. volume 1, section 4.01(c); 5.02; 5.04; 5.11. The term "interested" is also discussed at length in section 1.23.

rationally believed his decision was in the corporation's best interests, the actions of the board are beyond the court's scope of review unless the respondents can show fraud, self-dealing, violation of statutory duties and the like. "...[I]f a court makes a preliminary determination that a business decision was made under proper circumstances...then the business judgment rule prohibits the court from going further and examining the merits of the underlying business decision." *Id.* 1047. The court must examine the circumstances of the decision in a narrowly focused manner and minimize or forego judicial intervention where it is not warranted.[31] With this understanding of the rule, we must now review the challenged actions of the Farmstead's board of directors as to the incentive stock plan.

The incentive stock plan provides that employees who have worked for the corporation for five consecutive years have the option to purchase 67 shares at a discount from fair market value or established corporate value. "The price for a share of stock subject to this Plan shall be purchased at a sum of $1,300.00 less than the higher value established by the Board of Directors for the Corporation or by the shareholders of the Corporation under a Buy/Sell Agreement." (paragraph 6).[32] "Commencing on January 1, of the year after the purchase of initial stock under this plan, each employee shall be entitled to purchase an additional ten shares of stock for a period of 12 consecutive years." [paragraph 13(b)]. The board had set a new share price for the stock at $1,450.00 at the February 10, 1997 annual shareholder meeting, reasoning that members of the other shareholder group (who did not attend) "would not be hurt because the price is higher than on the [February 20, 1995] Buy/Sell Agreement."[33]

By January 1998, Andrew, Kirby and Ivan had all worked full-time on the farm for at least five years. They each bought 67 shares at $150.00 per share as per paragraph 6 and each paid $10,050.00 for the shares once the Superior Court issued its ruling on February 18, 1998. As was the usual practice, the old stock certificates were turned in and new ones written up to reflect that 201 new shares had been issued.[34]

The respondents assert the incentive stock plan constituted a "reclassification" of the stock and resulted in fundamental unfairness. Specifically, the respondents assert the plan diluted the voting power of their shares and ensured that Dennis, Larry and their sons would retain control of the corporation for their own personal benefit.

Section 1105 of the BCL provides:

> A shareholder of a business corporation shall not have any rights to obtain, in the absence of fraud or fundamental unfairness, an injunction against any proposed plan or amendment of articles authorized under any provision of this subpart, nor any right to claim the right to valuation and payment of the fair value of his shares because of the plan or amendment, except that he may

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[31]The doctrine also serves other related purposes. It "reflects a policy of judicial noninterference with business decisions of corporate managers, presuming that they pursue the best interests of their corporations, insulating such managers from second-guessing or liability for their business decisions in the absence of fraud or self-dealing or other misconduct or malfeasance." *Id.* at 1406. "It encourages competent individuals to become directors by insulating them from liability for errors in judgment...[B]usiness decisions frequently entail some degree of risk and consequently [the doctrine] provides directors broad discretion in setting policies without judicial or shareholder second-guessing..." *Id.*

[32]Paragraph 15 of the incentive stock plan sets forth the values of an employee's stock purchased during the course of his employment with the corporation. During the first five years, the value of the stock will be $1,300.00 less than the higher value set by the Corporation and/or shareholders under a buy/sell agreement; in years five through ten - $1,100.00 less; in year ten through fifteen - $900.00 less; in year fifteen through twenty - $600 less; and in year twenty through twenty-five - $300.00 less. "After 25 years, full value as set by the Board of Directors and/or shareholders."

[33]Petitioners' exhibit #13.

[34]Petitioners' exhibit #21.

dissent and claim such payment if and to the extent provided in Subchapter D of Chapter 15 (relating to dissenters rights) where this subpart expressly provides that dissenting shareholders shall have the rights and remedies provided in that subchapter. Absent fraud or fundamental unfairness, the rights and remedies so provided shall be exclusive. *Structuring a plan or transaction for the purpose or with the effect of eliminating or avoiding the application of dissenters rights is not fraud or fundamental unfairness within the meaning of this section.*

(Italics added). "Dissenters rights" are triggered only under circumstances involving an amendment to the articles of incorporation or a "plan" as defined by section 1103: "A plan of reclassification, merger, consolidation, exchange, asset transfer, division or conversion." Reclassification is defined as a "change in the number, voting rights, designations, preferences, limitations, special rights or par value of shares, or a conversion or exchange of one class or series of shares into or for another class or series of shares, other securities or obligations of the same corporation, or the cancellation of shares."

Andrew, Kirby and Ivan each bought 67 shares at $150.00 per share - $1,300.00 less than the set value of $1,450.00. Although the plan allows for purchase of the stock at substantially discounted rates, we cannot agree this gives the applicants an advantage which is impermissble under the BCL. The plan does not "reclassify" the stock because both the preexisting, authorized shares and the newly issued shares have exactly the same voting rights. The newly issued shares do not constitute a different class or series of stock from those originally created and issued upon the corporation's founding in 1974. Insofar as the stock has not been reclassified under section 1103, the matter of dissenters rights is not triggered and there is no basis to enter into a fundamental fairness analysis. Parenthetically we also note that the mere creation of a plan which avoids the triggering of dissenters rights does not in itself constitute fundamental unfairness under section 1105.

A corollary argument the respondents make to support a claim of fundamental unfairness is that the articles of incorporation were not amended to include the incentive stock plan by the consent of all

shareholders. The respondents cite section 1911(a)(4) which provides that a corporation may amend its articles to "effect a reclassification of or otherwise affect the substantial rights of the holders of any shares, including, without limitation, by providing special treatment of shares held by any shareholder or group of shareholders as authorized by, and subject to the provisions of, section 1906 (relating to special treatment of holders of shares of same class or series)." First, this section does not mandate that the articles be amended under such a situation. Second, it merely begs the question of whether the incentive stock plan "reclassifies" the stock or gives "special treatment" to the applicants. Even aside from the fact that dissenters rights are not triggered here because there was no reclassification of the stock, we also find that the board did not violate the business judgment rule.

Although there is a dearth of recent case law interpreting the business judgment rule under the 1988 BCL, it is fair to say that in closely-held corporations involving disputes between family members, the conduct of majority shareholders should be carefully scrutinized where minority shareholders allege fraud, gross negligence or self-dealing. In such family-owned closely-held corporations, self-dealing is an especially ambiguous concept to define and apply because the best interests of the corporation may also sometimes serve the personal interests of the directors, officers or shareholders. *Orchard v. Covelli,* 590 F.Supp. 1548 (1984). A careful examination of the board's conduct in this case reveals no persuasive evidence of the kind of personal benefit at the expense of the corporation alleged by the respondents.

It is well-settled that a corporation through its board of directors has the authority to set up incentive stock plans and other similar employee and management compensation programs. Section 1502(a)(14). Section 1523 provides that "except as otherwise restricted in the bylaws, shares of a business corporation may be issued at a price determined by the board of directors, or the board may set a minimum price or establish a formula or method by which

BAR NEWS ITEM

To: All Attorneys of the 39th Judicial District

From: John R. Walker, President Judge

Date: June 4, 1999

SUBJECT: Application for the position of Conciliator in custody actions

Due to the resignation of Courtney J. Graham, Esquire, as one of the court's two custody conciliators, a position is now open for interested applicants. the conciliator shall be a member of the bar of this court and who along with any other members of his or her professional practice shall not be engaged in the practice of law in the field of domestic relations.

It is anticipated that the position will require three days each month. the current procedure provides a rate of compensation of $100 per case. However, the current structure and compensation schedule are being reviewed with modification expected.

Interested applicants for the position of conciliator should submit a resume detailing the applicant's educational and professional background to Carol L. Van Horn, Chairperson of the Custody Subcommittee at 247 Lincoln Way East, Chambersburg, Pennsylvania 17201. The deadline for the submission of applications is June 15, 1999. Any questions regarding this matter should be directed to Attorney Van Horn.

* * *

the price may be determined."[35] The incentive stock plan was indeed designed to offer employees a substantial discount in the valuation of the stock. However, the stock will appreciate in a controlled manner, not reaching full value until 25 years after purchase. This controlled appreciation is designed to encourage employees to remain working at the Farmstead until retirement age. Until an employee shareholder has worked for the corporation for twenty-five years, he cannot simply cash in his shares for their full value. The plan does represent a benefit to Farmstead employee shareholders as opposed to non-employee shareholders, but that benefit is contingent upon a demonstrated committment to working on the farm for a long period of time. We fail to see how an employee who purchases shares under this plan gains an unfair advantage in relation to non-employee shareholders who contribute no labor to making the farm a profitable enterprise.

The respondents further argue in connection with the incentive stock plan that the issuance of stock under these plans was a violation of the board's fiduciary duty because the board refused to pay for an appraisal of the corporation's stock. The background to this claim is as follows: All the shareholders agreed to a per share valuation of $1,400.00 at the February 20, 1995 annual shareholder meeting. Jere, Jr. expressed the view at the next annual meeting on February 19, 1996 that $1,400.00 was too low a valuation and insisted that appraisals would have to be done of all corporate assets before any agreement could be reached on a new share price. The board was amenable to appraisals but disagreed that the corporation should pay for them because they were of no benefit to the corporation. The respondent shareholders did not attend the next annual shareholder meeting held on February 10, 1997 at which the board set the share price at $1,450.00.[36] The respondents believed that attending the annual meetings for the purpose of agreeing to a new share price

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[35]The restrictions may also be set forth in the articles of incorporation. Section 1504(c).

[36]Petitioners' exhibit #18.

would have been futile insofar as accurate valuation first required formal appraisals and the board continued to refuse to have the corporation underwrite the cost. The board set the new share price at $1,450.00 on February 10, 1997, reasoning that members of the other shareholder group "would not be hurt because the price is higher than on the [February 20, 1995] Buy/Sell Agreement." The inability of the two shareholder groups to work out a payment arrangement created an impasse.[37]

As grounds for the respondents' allegation that the $1,450.00 per share valuation is too low, Jere, Jr. testified that "if a shareholder is forced out of the corporation, he should get a higher price per share." There are several problems with this position. First, it presumes a shareholder has been "forced out" in some unreasonable manner, a claim which Judge Walker specifically rejected and which is not before this court now in any event. The respondents still have the opportunity to seek a fair price for their shares. Second, it is directly contrary to what the respondents themselves admitted in their pleadings: that all shareholders unanimously consented to the $1,400.00 per share price on February 20, 1995.[38] Third, the evidence shows the value of the stock had been steadily increasing since 1984 from $800.00 to $1,400.00 per share at regular increments of $50.00-$100.00 with mutual consent. The $1,450.00

[37]Respondents' exhibit #15, #32; petitioners' exhibits #2, #13.

[38]The last time share price was set by written agreement of all the shareholders was February 15, 1994. The value at that time was established at $1,350.00 per share. Although all shareholders signed the 1995 agreement, the value of $1,400.00 per share was not signed to by all shareholders: Marvin D., Dennis, Larry, Andrew and Gregory; the others did not sign Schedule A which sets forth the price per share. We rely on the applicants' second request for admission and the respondents' answers thereto, appearing in the record as petitioners' exhibits #52 and #53 respectively which without question establish that all shareholders did in fact agree to the $1,400.00 per share valuation.

price is certainly in line with that pattern.[39] Finally, the applicants' fiduciary duty is not to guarantee a particular share price, and the price they resolve upon is not inappropriate simply because it may conflict with the short-term interests of a shareholder group within the corporation. Sections 1715, 1717.

We cannot agree with the respondents that the board's refusal to have the corporation pay for appraisals demonstrated a lack of good faith and fair dealing. At the time the request was first made in February 1996, the two shareholder groups were locked in contentious litigation, with the respondents seeking to dissolve the corporation and the applicants strongly opposed to dissolution. It was not unreasonable under those circumstances for the applicants to offer only minimal cooperation with a request which they could reasonably perceive as being contrary to the best interests of the corporation. The evidence does not establish that the applicants' conduct on this matter constituted a violation of the business judgment rule.

B. The business judgment rule and the debt for stock swap.

Since the corporation's inception in 1974, a practice had developed whereby individual shareholders would lend the corporation money for farm operations. The corporation would then repay the shareholders with interest in accordance with promissory notes. At the February 3, 1998 board meeting, the applicants discussed their long-standing plan to upgrade the cow care and milking facilities. Wayne Brubaker's accounting records indicated the corporate debt owed to shareholders under the promissory notes was very high - $400,000.00.[40] The board decided that shareholders who were owed money by the corporation would exchange that debt for shares of stock. The result would be to reduce the amount of debt carried by the corporation and improve the corporation's prospects of

[39]Respondents' exhibit #2: Schedule A of the 1980 shareholders' agreement; Respondents' exhibit #3: Schedule A of the 1991 shareholders' agreement.

[40]Petitioners' exhibit #27.

obtaining bank financing to build the new facilities. The corporation took no risk under this swap; the only risk was to the holders of the notes who would no longer be guaranteed to receive 10% annual interest from the corporation. The swap also posed other risks for these shareholders in the event of an involuntary dissolution of the corporation.[41] Andrew received 34 shares, Larry received 44 shares, and Dennis received 26 shares.[42] A total of 104 new shares were issued at $1,450.00 per share.

As with the incentive stock plan, the respondents have not shown that the board violated the business judgment rule in implementing the debt for stock swap. The applicants did not appropriate corporate assets for their own personal benefit in a manner incompatible with the best interests of the corporation. In fact, the evidence showed exactly the opposite. In agreeing to swap debt for stock, the applicants, particularly Dennis, Larry and Andrew, sacrificed a short-term financial benefit in the form of annual interest income in favor of the best long-term interests of the corporation. The swap improved the corporation's balance sheet to allow for the upgrading of farm facilities. The applicants also took a risk that the corporation would be involuntarily dissolved, jeopardizing their ability to get their

[41]Petitioners' exhibits #13 and #27.

[42]Petitioners' exhibit #31. Andrew's loan to the corporation was $59,000. His promissory note signed December 26, 1995 was amended on February 19, 1998 as follows: "$49,300 of this note converted for 34 shares of stock for debt reduction for capital improvement." Larry signed a promissory note on December 26, 1995 which was also amended on February 19, 1998. The corporation owed him $85,000. The note was amended: "$63,000 of this note was converted for 44 shares of stock for debt reduction for capital improvement." Dennis's note dates from July 12, 1996 and indicates the corporation owed him $38,000: "$37,700 of this note was converted for 26 shares of stock for debt reduction for capital improvement." Kirby did not participate in the debt for stock swap because he plans to build a house on a piece of land he purchased from the corporation and requires cash to do so. He testified he may swap debt for stock in the future.

monies out of the corporation. Their actions cannot be characterized as a breach of fiduciary duty to the corporation, fraud or self-dealing.

C. Other conduct alleged to be in violation of the business judgment rule.

Certain allegations in the context of a closely-held family-owned corporation deserve careful examination. *Orchard v. Covelli*, supra. One such allegation is that of oppressive conduct by the majority shareholders against the minority shareholders and disparate treatment of employee shareholders. As previously discussed, the matter of oppressive conduct and termination of employees was decided by Judge Walker and affirmed by the Superior Court in the prior litigation and is not before us here.

The respondents also claim that Andrew, Kirby and Ivan were paid excessive salaries and bonuses. These applicants were paid approximately $29,000.00 in 1997. Wayne Brubaker acknowledged this salary level is somewhat higher than average for farm labor. However, the credible evidence showed the salaries and bonuses were necessary to compensate the younger men for their tireless work and to give them a long-term stake in the business. The younger applicants knew their pay would decrease once the two stock plans were implemented. Over the years, the incentive to remain at the farm had taken the form of gifted shares from Marvin D. to the second generation, and particularly to his son Dennis and Larry. The gifting stopped with the onset of the prior litigation. Andrew had received 12 shares of gifted stock, but Kirby and Ivan had never received any gifted stock. These salaries with bonuses strained cash flow, causing the board to explore other methods of compensation. The board's decision to implement the stock plans was meant to accomplish two things: to improve cash flow for farm operations and to give the committed employee shareholders a personal stake in the long-term health of the farm. Both aims are consistent with the board's fiduciary duty to the corporation.

The respondents make much of the fact that Dennis candidly admitted that one of his goals in issuing the shares was to have his group of shareholders retain control of the corporation and to protect

the corporation from being controlled by the respondents. Despite the respondents' urgings, we cannot characterize his statement as "self-dealing" contemplated in *Cuker v. Mikalauskas*, supra, and sections 1712 and 1715 of the BCL. Simply because the applicants may benefit from employment with the corporation does not mean they have violated their fiduciary duty to the corporation. The applicants viewed their personal futures to be inextricably linked with the long-term viability of the farm. They did not divert assets from the corporation, dissipate them on luxuries or personal expenditures at the expense or to the detriment of the farm. On the contrary, all their efforts have been directed towards doing whatever was necessary to preserve the corporation as a profitable enterprise. Their sincere concern with increasing the corporation's profitability is clear from the minutes of board meetings, as well as correspondence, ledger books and other documents indicating the board approached running this corporation in a careful and professional manner. The respondents have failed to prove the board violated the business judgment rule when it implemented the debt for stock swap and the incentive stock plan.[43]

The respondents did not allege a violation of the business judgment rule in their pleadings and therefore evidence as to why the applicants believed the farm's physical plant required updating was

[43]We have also considered *In the Matter of Reading Co.*, 711 F. 2d 509 (3rd Cir. 1983) (applying Delaware law). The burden under Delaware law is on those asserting the validity of corporate action under an intrinsic fairness test as to minority shareholders. This approach has been specifically rejected by the standards and presumptions adopted in Pennsylvania' s BCL. Even so we note that even under that stricter level of scrutiny, the majority shareholders in that case were found to have not committed self-dealing when they initiated policies to benefit employee shareholders. We have also reviewed *Coleman v. Taub*, 638 F. 2d 628 (3rd Cir. 1981)(applying Delaware law); *Dower v. Mosser Industries, Inc.*, 648 F.2d 183

(1981)(applying Delaware law), and *Coggins v. New England Patriots Football Club*, 492 N.E.2d 1112 (Mass. 1986).

not presented in great detail at trial. However, we need not reach the merits of the board's decision because the respondents have not met their threshhold burden of showing breach of fiduciary duty to the corporation through fraud, gross negligence or self-dealing

IV Were the shares issued pursuant to the two stock plans votable at the February 21, 1998 shareholder meeting?

The respondents, with the exception of Gregory, sent a letter to Larry on December 16, 1997 in his capacity as secretary of the corporation to request a special shareholder meeting to designate a board of directors.[44] After discussions with Dennis and Larry, Gregory informed the respondents that the board was preparing to issue shares of stock. The respondents' counsel sent a letter to the board's counsel to remind it that the April 14, 1997 injunction barred such issuances.[45] The board held a meeting on January 13, 1998 at which the employee incentive stock plan was approved.[46] Larry issued a notice the next day that a special shareholders' meeting would be held on February 21, 1998 per the respondents' request.[47] Based on erroneous information from Gregory that new shares had already been issued, the respondents by letter dated January 21, 1998, objected to any transfer, issuance or opening of new stock without all shareholders first discussing the matter.[48] At the February 3, 1998 board meeting, Larry, on advice of counsel, set February 20, 1998 as the record date for voting shares at the February 21, 1998 special

[44]Petitioners' exhibit #16.

[45]Petitioners' exhibit #28.

[46]Petitioners' exhibit #11.

[47]Petitioners' exhibit #17.

[48]Petitioners' exhibit #29.

meeting. The board's understanding was that any stock issued on or before February 20 could be voted at the meeting.[49]

As discussed earlier, the gifting of shares from the older generation to the younger generations had occurred since the corporation's founding. The pace of gifting accelerated when the third generation came of age and began full-time work at the farm. The period of greatest fluctuation in shareholders' share transfers began with Marvy's withdrawal from the corporation in February 1988 and lasted until February 23, 1994.[50] Each year Larry prepared a voting list which showed each shareholder how many shares he owned which could be voted at meeting. Because gifting of shares ceased after February 1994, the 1995 voting list remained unchanged up through February 19, 1998 when the board issued shares under the incentive stock plan and the debt for stock swap. That list reflected that 1,050 shares had been issued from the total authorized pool of 5,000 in 1974.[51] Larry prepared a new voting list which reflected the shares issued under the stock plans on February 19, 1998. That list reflected a new total of 1,355 shares.[52] The new voting list reflected the stock transfer ledger book as of February 20, 1998, the record date for voting the stock at the next day's meeting. Even though the respondents believed the board had already issued new shares in violation of the injunction, they did not ask to see the voting list or the ledger at any time before the meeting.

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[49]Petitioners' exhibit #13.

[50]Petitioners' exhibit #20: stock transfer ledger.

[51]Petitioners' exhibit #23; the 1995 voting list indicates that the shareholders each owned the following number of shares: Andrew-12; Dennis-187;. Gregory-187; Jere D.-187; Jere, Jr.-63; Larry-187; Marvin D.-169; Shawn-33; Spencer-25.

[52]Petitioners' exhibit #19; the new list reflects the following ownership of shares: Andrew-113; Dennis-213; Gregory-187; Ivan-67; Jere D.-187; Jere, Jr.-63; Kirby-67; Larry-231; Marvin D.-169; Shawn-33; Spencer-25.

All shareholders attended the February 21 meeting which was confused and highly contentious.[53] The respondents asked to see the voting list and Dennis produced it. The respondents thereafter objected that the 305 newly-issued shares were illegal and not votable. Voting took place after much discussion and two possible election results emerged. According to one vote taken using the 1,355 shares, the board of directors consists of Andrew, Dennis, Larry, and the respondents' choice of two of the following shareholders: Jere, Sr., Jere, Jr. and Shawn. The parties do not dispute that this is one possible outcome. According to the other votes taken using only 1,050 shares, however, there is a dispute as to the make-up of the board of directors. The board consists of either Marvin D., Jere, Sr., Jere, Jr., Shawn and Spencer, or Jere, Sr., Jere, Jr., Shawn, and the applicants' choice of Andrew, Dennis or Larry.[54]

It is not necessary for the court to decide the precise ballot counts using only 1,050 shares because we find that the newly-issued shares were votable. The new shares being votable, the election at which they were included in the voting will be confirmed and the applicants will retain their majority position on the Farmstead's board of directors.

Our analysis focuses on the corporation's bylaws, specifically Article III, section 8, and Article VIII, section 3, as well as sections 1763 and 1764 of the BCL.

<u>ARTICLE III - SHAREHOLDERS' MEETING</u>

> 8. VOTING LIST. The officer of agent having charge of the share transfer book shall make, at least five days before each meeting of shareholders, a complete list of the shareholders entitled

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[53]Kirby, who was out of town, appeared by proxy by which he authorized Dennis to act as his agent. Petitioners' exhibit #22; respondents' exhibit #5.

[54]Petitioners' exhibits #33-35; respondents' exhibits #11-14, 27, 29. See also petitioners' exhibit #36 and respondents' exhibit #31.

to vote at the meeting...with...the number of shares held by each. The list shall be kept on file at the registered office of the corporation...and shall also be produced and kept open at the time and place of the meeting, and shall be subject to the inspection of any shareholder during the whole time of the meeting. The original share ledger or transfer book, or a duplicate thereof kept in this Commonwealth, shall be prima facie evidence as to who are the shareholders entitled...to vote...at any meeting of shareholders.[55]

ARTICLE VIII - SHARES

3. CLOSING SHARE TRANSFER BOOKS OR CLOSING RECORD DATE. The Board of Directors may fix a time, not more than fifty days prior to the date of any meeting of shareholders...as a record date for the determination of the shareholders entitled...to vote at any such meeting...In such cases, only such shareholders as shall be shareholders of record on the date so fixed shall be entitled...to vote at such meeting...If no record date is fixed...transferees of shares which are transferred on the books of the corporation within ten days next preceding the date of such meeting shall not be entitled to...vote at such meeting.[56]

The 1995 voting list was still an accurate reflection of the shareholders' shares of stock five days before the February 21 meeting. No shares had been gifted, issued or transferred since February 1994. The new shares were not issued until February 19, the day after the Superior Court ruled, two days before the meeting, and one day before the fixed record date. The voting list was updated, as was the stock transfer ledger, on February 19. The respondents argue that Larry as secretary violated Article III, section 8 because he did not make the updated voting list available to all shareholders five days before the meeting.

The key to voting rights under the bylaws is the whether a record date has been fixed. Under Article VIII, section 3, if the board does

[55]Article III, section 8 is completely consistent with section 1764(a) and the second sentence of 1764(b) of the BCL.

[56]Petitioners' exhibit #15; respondents' exhibit #10.

not fix a record date, stock transfers must be accomplished ten days before a shareholders meeting in order to be votable at that meeting. This section is consistent with section 1763 of the BCL.[57]

There is nothing in the BCL or the bylaws which prevented this board of directors from fixing the record date at the day before the meeting day. Neither the BCL nor the bylaws require the board to fix the record date as any particular date preceding the meeting day. In those situations where the board does not fix a record date, section 1763(b)(1) serves as a default mechanism and allows for the record date to be the day preceding the meeting day. The Farmstead bylaws provide for a ten-day default record date, but that date is not controlling when the board of directors fixes a record date. Larry acting as secretary fixed February 20 as the record date during the February 3 board of directors meeting and that date was permissible under both the BCL and the bylaws.

As the applicants correctly point out, neither in Article VIII, section 3 nor elsewhere in the bylaws is there a requirement that the record date be fixed at five days in advance of a shareholder meeting nor does the five-day voting list provision govern when the record

[57] (a) **Fixing record date.**-- Unless otherwise restricted in the bylaws, the board of directors of a business corporation may fix a time prior to the date of any meeting of shareholders as a record date for the determination of the shareholders entitled...to vote at the meeting...Only shareholders of record on the date fixed shall be so entitled notwithstanding any transfer of shares on the books of the corporation after any record date fixed as provided in this subsection...

(b) **Determination when a record date is not fixed.**-- Unless otherwise provided in the bylaws, if a record date is not fixed:

(1) The record date for determining shareholders entitled to notice of or to vote at a meeting of shareholders shall be at the close of business on the day next preceding the day on which notice is given or, if notice is waived, at the close of business on the day immediately preceding the day on which the meeting is held.

date should be fixed. Because the bylaws do not specify that the record date must be fixed five days before a meeting in order to give the secretary the opportunity to prepare and make available the voting list five days before a meeting, we must defer to the board's discretion in fixing the record date. This is consistent with section 1763 of the BCL. Under this reasoning, the shares issued February 19, 1998 were votable at the February 21 special shareholder meeting.

Also relevant to the respondents' argument is Section 1764(b) which provides:

> Effect of [voting] list.- Failure to comply with the requirements of this section shall not affect the validity of any action taken at a meeting prior to a demand at the meeting by any shareholder entitled to vote thereat to examine the list. The original share register, or transfer book, or a duplicat thereof kept in this Commonwealth, shall be prima facie evidence as to who are the shareholders entitled to examine the list or share register or transfer book or to vote at any meeting of shareholders.

The respondents were not prejudiced by the fact that the list was not prepared until two days before the meeting for several reasons. The respondents knew the record date had been fixed as February 20, one day before the meeting. They also knew the board was preparing to issue shares but did not demand the updated voting list which would have been available to them. Most importantly, section 1764(b) is not designed to automatically invalidate an election simply because some shareholders did not see the list in advance of the meeting. That secticn gives prima facie validity to the voting list presented at the meeting up through the moment a shareholder demands to see it and makes an objection to it. The respondents had the opportunity to see and object to the updated list and did so before any voting occurred. The purpose of that section is to preserve the objection and allow the objector to seek whatever relief may be permissible under the articles, bylaws or the BCL. Section 1764(b) served its purpose under the circumstances of this case.

In this connection note our disagreement with the applicants' assertion that section 1764(b) nullifies the requirement under Article III, section 8 of the bylaws that the list be available for inspection five

days before a meeting. While 1764(b) does not require the voting list to be presented at the corporation's principal place of business five days in advance of a meeting as did the prior law, we do not agree that section nullifies Article III, section 8 for two reasons. First, it is the general BCL policy to defer to procedures adopted in a corporation's articles and bylaws where these are reasonable, and second, section 1764(b) is a procedural and not a substantive provision. It allows a shareholder who objects to a voting list the remedy of bringing his objection before the court but is not meant to be used to invalidate a corporation's articles and bylaws. *Fletcher Cyclopedia of the Law of Private Corporations*, volume 5, sections 2028, 2033.

The board violated neither the bylaws nor the BCL and therefore the shares issued under the two stock plans were votable at the February 21, 1998 meeting. The shares being legal and votable at that meeting, application to confirm the election placing the applicants in control of the board of directors will be granted. An appropriate decree nisi will be entered as part of this adjudication.

DECREE NISI

NOW this 23rd day of December 1998, this matter having come before the court pursuant to an application under the Business Corporation Law to confirm the results of an election of a board of directors of Hissong Farmstead, Inc. held on February 21, 1998, and the court, having held a non-jury trial and considered all the testimony, exhibits and other evidence, as well as arguments of counsel and the applicable law, hereby finds that the shares of stock of Hissong Farmstead, Inc. issued under the employee stock purchase plan and the debt for stock swap were legal and votable at the time of the shareholder meeting. This court retains jurisdiction to rule on any ancillary issues germane to this matter should they arise.

IT IS FURTHER ORDERED that the Prothonotary is directed to notify the attorneys of record of the filing of this adjudication pursuant to Pennsylvania Rule of Civil Procedure 1517 and if post trial motions are not filed within ten (10) days after such notice in accordance with Pennsylvania Rule of Civil Procedure 227.1, to enter

the decree nisi on praecipe as the final decree in accordance with Pennsylvania Rule of Civil Procedure 227.4.

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