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Kern v. Arlington Ridge Pathology, S.C.: An unsound decision illustrating a lack of awareness of basic corporate law principles

By Jason W. Mosleyand Charles W. Murdock

A recent Illinois Appellate decision, *Kern v. Arlington Ridge Pathology*, S.C., 384 Ill.App.3d 528 (1st Dist. 2008), illustrates the necessity for lawyers and judges to have a mastery of corporate law, in general, and the Illinois Business Corporation Act ("BCA"), in particular. The attorney who drafted Arlington's corporate documents inserted greater than majority voting requirements at the shareholder level in the bylaws instead of in the articles, as required by the BCA, while counsel at trial could have broadened several arguments that might have swayed the trial and the appellate court. Moreover, the Appellate Court ignored several bases that would have been sufficient to reverse the trial court's order granting summary judgment. Specifically, Plaintiff's counsel could have bottle worked his argument that the bylaws constituted a contract, by also positioning the bylaws as a shareholders agreement of the type recognized by *Galler v. Galler.* The court mistakenly failed to recognize that the majority shareholders breached their fiduciary duty to the minority shareholder by threatening to terminate her, that the conduct of those in control was oppressive, and that the cumulative voting provisions of the BCA precluded defendant's from removing Plaintiff as a director. In addition, the Court relied upon a questionable abrogation of bylaws theory to uphold summary judgment, failed to recognize that the meeting in question was not held pursuant to proper notice, and misapplied Illinois fiduciary duty law.

Kern v. Arlington involved three pathologists (Plaintiff, Dr. Manglani, and Dr. Regan) who were the sole directors and shareholders of a corporation that maintained an exclusive services agreement with Northwest Community Hospital. Plaintiff and Dr. Manglani were both original founders of the corporation in 1994 and Dr. Regan was admitted as a shareholder and elected as a director years later. In 2001 a dispute arose between Plaintiff and Bruce Crowther, chief executive officer of Northwest. This animosity continued until 2005 and culminated with an accusation that Plaintiff acted unprofessionally when addressing an Arlington employee. As a result, Mr. Crowther issued a letter to Dr. Regan in August 2005 stating that plaintiff created a hostile work environment, and pursuant to the agreement between the hospital and Arlington, Crowther threatened to terminate Arlington's exclusive services agreement if Plaintiff was not sent to professional counseling or terminated.

Approximately two months later, Dr. Regan and Dr. Manglani voted to amend the articles of incorporation to allow the bylaws to be amended by a two-thirds shareholder vote instead of the eighty percent required under the bylaws. However, Plaintiff was not present because the meeting occurred and ended before the noticed time. Subsequently, the same two directors voted to change the voting requirements for removing directors, terminating physician employment, and board action for major decisions from 67 percent of outstanding shares to two-thirds. The slight difference between the foregoing two percentages was significant because the two defendants and shareholders held 66.93 percent of the shares, more than two thirds but less than 67 percent.

The first, and most costly, mistake occurred when Arlington's corporate documents were drafted. Even though the founders of Arlington intended to preclude a majority of shareholders from ganging up on a minority of shareholders, which is clearly evidenced by a bylaw provision which requires an 80 percent vote to remove a director or to alter the bylaws, this provision was not placed in Arlington's articles of incorporation, which was statutorily required. Section 7.60 of the BCA requires a greater than majority quorum or voting requirements with respect to shareholders meetings must be set forth in the articles. In the case at bar, these provisions were inserted in the bylaws.

Moreover, there should also have been a provision that the articles themselves could not be amended except by an 80 percent shareholder vote. Otherwise, it could be determined that a mere majority vote could eliminate the other 80 percent voting provisions. Since initially there were five shareholders, the clear intent of the provision was that it took more than a mere majority of the shareholders to disadvantage another shareholder. Once the number of shareholders dropped below five, it would have been prudent to amend the articles to provide for a unanimity requirement, so as to preclude a court from interpreting such provision as permitting majority action. The oversight in failing to put these provisions in the articles of incorporation ultimately caused the present litigation.

In an attempt to rectify the incorporating attorney's mistake, Plaintiff's counsel argued that the bylaws constituted an enforceable contract between the shareholders. This is a valid argument, based upon *Crotty v. Peoria Law Library, Ass'n*, 76 N.E. 707 (1906); however, while the court recognized this rule of law, it then ignored it in formulating its opinion. This argument could have been reinforced by citing *Galler v. Galler*, 203 N.E.2d 577 (1964), where the Illinois Supreme Court upheld the right of shareholders in close corporations to create agreements concerning the management of the corporation, even if such agreement is counter to statutory language, as long as there is no complaining minority interest, fraud, or injury to the public or creditors.

In reaching this conclusion, the *Galler* Court stressed the need to protect the financial interests of minority shareholders in close corporations because of the inability to readily sell their shares on the open market. Id. Instead of merely claiming that the bylaws constituted an enforceable contract, it would have been desirable to argue that the bylaws constituted a shareholders agreement to protect the interest of minority shareholders. If this argument were made, an inquiry into the intent of the parties would have been necessary. At the very least, this would have precluded summary judgment.

The court rejected Plaintiff's breach of fiduciary duty argument. However, this was not phrased in terms of the duty of majority shareholders to minority shareholders. If this were done, Dr. Manglani and Dr. Regan would have had the burden of showing a legitimate business purpose in seeking to terminate Plaintiff's employment. If defendant satisfied this burden, Plaintiff would have had the opportunity to show that, even if terminating her employment were a legitimate business purpose, the same purpose could have been achieved through an alternative course of action less harmful to Plaintiff's minority's interest.

This argument would have been supported by one of the seminal cases on controlling shareholder fiduciary duty, *Wilkes v. Springside Nursing Home*, 353 N.E.2d 657, 665 (1976), where the court held that terminating the minority shareholder's employment breached the majority's fiduciary duty, because employment in the corporation is one of the basic reasons for investing in a close corporation, especially when the earnings of that close corporation are distributed primarily through salaries. Id. at 662. Therefore, because the business purpose for Plaintiff's termination was her strained relationship with Northwest's CEO, Plaintiff's counsel could have at least argued that eliminating Plaintiff's contacts with Northwest's CEO, or some other arrangement, could have satisfied the same business purpose as termination, without destroying the value of Plaintiff's minority interest.

The facts would also seem to support an allegation of oppressive conduct on the part of the majority shareholders. After the 1995 amendments to the BCA Illinois Supreme Court has made it clear that courts are encouraged to use the numerous alternative remedies in section 12.56 of the BCA. See *Schirmer v. Bear*, 271 Ill.App.3d 778, 786 (1995). Plaintiff counsel could have argued that seeking to remove Plaintiff as a director, terminating her employment, and conducting a board meeting before the noticed time, constituted "heavy-handed treatment," which has been historically sufficient to satisfy a claim for oppression under 12.56. See *Compton v. Paul K. Harding Realty Co.*, 285 N.E.2d 574 (1972); *Notzke v. Art Gallery, Inc.*, 405 N. E.2d 839 (1980); and *Hager-Freeman v. Spircoff*, 593 N.E.2d 821 (1992). It could also have been argued that the "reasonable expectations test" was the appropriate standard in determining whether oppression existed. Under this test, Plaintiff could have claimed that she, as one of the founders of the corporation, made her investment on the expectation that she would be employed as a pathologist with an exclusive services agreement with Northwest, not terminated a few years later because of a personal disagreement.

The next issue that was not dealt with by the court was that Plaintiff could not have been removed as a director because section 8.35 of the BCA, which is the default rule if the articles do not provide otherwise, prevents a director from being removed if the votes against removal would have been sufficient to elect the director. Plaintiff owned 166 shares out of 502. Applying the cumulative voting formula, even if there were only three directors, Plaintiff needed only 126 shares to elect herself as a director. Therefore, Plaintiff could not have been removed as a director under section 8.35 of the BCA. See 7 Charles W. Murdock, *Illinois Practice -- Business Organizations, §9.14.*

The Court also incorrectly focused on whether Arlington's bylaws were abrogated by nonuse. In reaching its conclusion that Arlington's bylaws were abrogated, the court relied upon the fact that the only three directors have acted for the corporation in the past couple of years when the bylaws required a minimum of four directors. However, a quorum is still possible if all three directors show up. This is exactly what happened. Every decision of the board of directors was unanimous. Thus, the argument that the directors were acting in accordance with the bylaws is at least as consistent as the argument that they had abrogated the bylaws.

Even if you accept that the bylaws were abrogated, the issue of what the requisite vote was still remained. The unanimous votes over the years and the 80 percent voting requirement in the bylaws reflected an intent not to allow majority shareholders to disadvantage minority shareholders. If the directors impliedly had determined that there were only three directors, it could also be argued that they had impliedly determined to act by unanimous consent. The Court should have determined the intent of the parties at a hearing, not on a motion for summary judgment.

What is absolutely clear is that the meeting the two directors held was not in accordance with the notice, since the two defendant directors met prior to the noticed time of the meeting. Thus, the meeting was invalid for failing to comply with proper notice. While this could have been cured by the defendants, reversing the trial court might have provided the opportunity for the parties to negotiate a settlement in lieu of continuing to litigate.

Finally, the appellate court rejected the breach of fiduciary duty count on the basis that there was no unlawful underlying act. This is an improper statement of what is necessary to constitute a fiduciary duty. Failure to meet the reasonable expectations of a shareholder can constitute a breach of fiduciary duty even though the actions of the majority are not specifically unlawful. Note the cases cited above.

The net effect of the decision of the trial court, as affirmed by the appellate court, has been to oust plaintiff from a lucrative position in a corporation which she helped form about a decade earlier. This is particularly sad when the legal bases relied upon by the court are at best suspect.

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