AFTER THE BELL
THE NEWSLETTER OF CLEVELAND FINANCE
MARCH 2014

INSIDE THIS ISSUE

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CFA Society Cleveland
24199 Lyman Blvd.
Shaker Heights, Ohio 44122
216-696-8066

Dear fellow members and stakeholders,

A Crisis of Culture: Valuing Ethics and Knowledge in Financial Services was conducted to take the temperature as the financial services industry starts to emerge from the financial crisis. It shows that although executives overwhelmingly recognize the importance of ethical behavior in the industry, there is still a significant gap between that belief and the industry's practices. The study also shows that while building a culture based on integrity and financial knowledge across firms helps mitigate risk and makes for a more resilient business, a silo culture remains pervasive and integrated functional and management approaches to risk-proof organizations remains weak.

Excerpt from CFA Institute Website, **Download full report from The Economist**

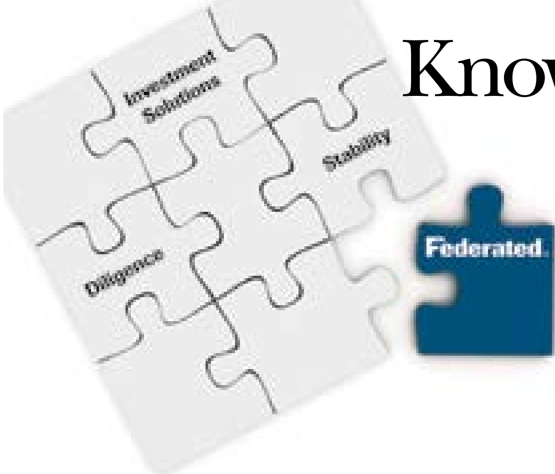
I highlight this report because it describes a continuing challenge for our industry – a challenge that the CFA Institute and by extension, its member societies, have put in center stage of strategy through its Future of Finance program. While green shoots exist when examining sentiment and investor perception toward our industry, the bridge to success is still being constructed. I encourage you to read the report and get involved. The future of finance starts with you.

Wayne Chamberlain, Program Chair, and I will attend the regional meeting in Denver on April 3-5. The regional meetings bring society leaders together to exchange ideas on best practices. We are excited to gain insights into advocacy programs, in particular Investor First efforts, percolating here locally at the grass roots level throughout the country. Our advocacy program dovetails well under the Future of Finance umbrella and the Cleveland Society will take a leadership role through support of this initiative. As I've talked about in previous newsletters, we plan to hold our inaugural Investors First day in the spring and will look to our membership for support for the kickoff. As part of our focus here, at the end of February we hosted a well-attended lunch with Bob Luck, Director of Society Advocacy Engagement for the Institute. Thank you Bob for a great presentation about Market Integrity Forecast!

In other areas of our Society, we are in the early stages of planning our Q3 mentor program and career day. Our spring planning calendar is full and we are already adding events to the fall calendar. Check the calendar for some strong international oriented lunches we have planned in March -we hope to see you at one (or all) of them.

Respectfully Submitted,

Craig Cimoroni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Board Member Nonimation for 2014-2015

We are in the process of soliciting board and committee nominations. Our Society continues to grow and there are opportunities for members to volunteer on a committee or on the board of directors. Please let us know if you are interested via email at cfa@cleveland.cfasociety.org in serving on the board or on a committee. We thank you for your interest.

MEMBERSHIP

David C. Fulton, Jr., CFA

Hartland & Company

President and Chief Executive Officer

Education: Graduate of Amherst College and The Tuck School of Business at Dartmouth

Family: David and his wife Claudia reside in Cleveland Heights, Ohio.

Hobbies: Golf, squash, skiing, and reading

Community Activities: Trustee and former Chairman of the Board of University School. Trustee of The Lake View Cemetery Association, Urban Squash Cleveland, and The Shaker Lakes Nature Center Foundation.

MEMBERSHIP SPOTLIGHT

Interview conducted by Bradley Knapp, Membership Chair

Q: As the President & CEO of an independent investment counsel firm, how did you first get involved within the investment management field? Share with us some of your professional background?

A: After business school, I was fortunate to join Stein Roe & Farnham, a leading investment firm. I worked as a portfolio manager and eventually became a principal. In the early 1990s a fellow principal at Stein Roe and I decided to start our own firm, focusing on private clients and small institutions. After about a decade of building the firm, we decided to sell to Mellon. I stayed with Mellon for a few years before moving on. I learned a great deal through these early years.

In the mid-2000s I was asked to lead Sterling, the multi-family office and wealth management practice that was part of National City Bank. Sterling integrated tax, estate, and financial counsel with investment management. When National City was sold, I decided to seek another new entrepreneurial opportunity, just as I had earlier in my career.

My search led to Hartland, an institutional consulting firm founded in 1989. Hartland had an excellent core business and was looking to expand into other areas. In 2010 we entered the private client business, and in 2011 merged with Chess Financial, a large Cleveland-based multi-family office firm. The merger with Chess has been a success. We added important new clients and capabilities to our firm, and picked up talented people, many of whom have become partners in Hartland.

Today Hartland is an independent institutional and wealth advisory firm with 53 employees, 18 partners, a strong Board of Directors, and over 300 institutional and private clients. Our clients are located across the US and internationally. We offer a broad range of services and implement a rigorous institutional-style approach to our clients' financial affairs.

Q: How did the CFA designation and the CFA Society of Cleveland become part of your professional development? Have these been helpful for you over time?

A: The partners of Stein Roe insisted that associates earn the CFA designation. Pressure was high, as no one at Stein Roe had ever failed any part of the CFA exam – ever. Fortunately I was successful.

Earning the CFA requires discipline and the sacrifice of at least three springs. The CFA provides a framework for solving complex investment issues, and the emphasis on ethics is especially valuable. The curriculum goes way beyond what is learned in business school, and rounds out an investment professional's qualifications.

Continued on page 5

MEMBERSHIP

Interview with David Fulton, CFA, Hartland & Co. Continued

Q: Now that the "Great Recession" is nearly five years behind us, what significant changes have you seen in the investment management business and how do you think they will continue to evolve over the next several years?

A: There are several trends that have emerged. The first is toward independent advisory firms that do not make or sell products. Both institutions and private clients felt bushwhacked after 2008, and became wary of firms that offer advice and recommend their own products, or products they are paid to recommend. The value of independent, objective advice is higher than ever.

The second is toward understanding investment risk. There are lots of ways to define and measure risk, but most importantly, clients want to understand how they will be affected by extreme adverse market conditions.

The third trend is toward higher levels of service. After the downturn, client demands went up; permanently, I think. Firms must invest in the best reporting platforms, and make sure they are communicating with clients constantly.

The fourth trend is toward heightened compliance. Compliance is no longer a sideline for investment firms; it is central to an effective investment process and client service.

There are other trends, but the last I would mention is increased skepticism of active investment approaches. Professionals must prove that active approaches can add value after turnover, taxes and fees; especially in efficient asset classes.

Q: Can you share with us your views on what the current business climate is like in Northeastern Ohio for a growing firm? Have conditions improved over the past several years and how does the region's talent pool stack up with those you have seen elsewhere?

A: Cleveland is a fabulous place to locate a growing investment firm. Our move downtown shows our love for the city and our commitment to be part of its fabric.

We have had great luck recruiting from business schools such as Weatherhead and Ohio State. We get young people who are committed to Cleveland and want to dig in and do well. We've also had great luck recruiting ambitious people locally. I would stack up the quality of these people with any, anywhere.

Q: As an experienced investment executive, do you have any guidance or important professional lessons that you can share with some of our CFA candidates, new charterholders, and young CFA Society Cleveland members as they develop their careers?

A: The first is to listen and learn. The managing partner of Stein Roe told me to "listen and not say a word for five years." These were harsh words for a 27-year-old, but great advice. I've been fortunate to learn from top practitioners, even if I haven't always been able to keep my mouth shut.

The second is to get involved with organizations in which you have a deep interest. Serving on boards and investment committees teaches valuable lessons. In the long run the relationships you build will be personally gratifying and help your career.

The third is "shined shoes and cautious ties." You are working with people's money; there is a required formality in that. Be sure you look and act the part.

PROGRAMMING

CALENDAR OF EVENTS

March 5th
Jeremy Schwartz, CFA,
Director Of Research,
Wisdom TreeMarch 12th

March 12th
Paul Rogers,
Director, Portfolio Manager/Analyst,
Lazard Asset Management, LLC

Jeremy Schwartz, CFA, Director of Research, WisdomTree, The Global Dividend Stream and Outlook, Wednesday, March 5th, 2014

As Director of Research, Jeremy Schwartz is responsible for the WisdomTree Equity Index construction process and oversees research across the WisdomTree equity family. Prior to joining WisdomTree, Jeremy was Professor Jeremy Siegel's Head Research Assistant and helped with the research and writing of Stocks for the Long Run and The Future for Investors. He is also the co-author of the Financial Analysts Journal paper "What Happened to the Original Stocks in the S&P 500?" and the Wall Street Journal article "The Great American Bond Bubble." Jeremy is a graduate of The Wharton School at the University of Pennsylvania and a member of the CFA Society of Philadelphia.

Luncheon Sponsored by Wisdom Tree Asset Management

Click Here To Register For This Event

Paul Rogers, Director, Portfolio Manager/Analyst, Lazard Asset Management LLC, Emerging Markets - Volatility, Valuations and Investment Strategy, Wednesday, March 12th, 2014

Paul Rogers is a Portfolio Manager/Analyst on the Emerging Markets Core Equity and Latin American Equity teams, focusing primarily on emerging markets investments within Latin America. He began his career at Chemical Bank in 1985. Prior to joining Lazard in 2011, Paul served as the Managing Director of Emerging Markets Research at Fidelity Management & Research Company. Before that, Paul spent 14 years at Deutsche Asset Management where he was at first an Analyst and later a Portfolio Manager on the Scudder Latin America Fund, the Brazil Fund, the Scudder Latin America UK Trust, the Argentina Fund and a number of institutional accounts. Paul has an MBA in Finance from New York University and a BA in Political Science from the University of Vermont. He is fluent in Spanish.

Luncheon Sponsored By Lazard Asset Management

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PROGRAMMING

CALENDAR OF EVENTS

March 31st
Jack Kleinhenz
Kleinhenz & Assoc
The City Club

April 9th
Elizabeth Allen
Federal Express
The City Club

April 16th
Dennis Folllmer
F-Squared
The City Club

Joint Lunch Event with CFA Cleveland and CABE, Jack Kleinhenz, Kleinhenz & Assoc., Principal and Chief Economist, Emerging Markets, March 31st, 2014

Jack Kleinhenz, Ph.D. serves as chief economist for the National Retail Federation headquartered in Washington, D.C. He is principal and chief economist of Kleinhenz & Associates, a registered investment advisory firm specializing in financial consulting and wealth management headquartered in Cleveland, Ohio and he is an adjunct professor of economics at Case Western Reserve University's Weatherhead School of Management. Formerly with the Federal Reserve Bank of Cleveland and the Federal Home Loan Bank of Pittsburgh, Jack also served as chief economist and planning officer the Greater Cleveland Growth Association, the nation's largest chamber of commerce

Upcoming CFA Society Cleveland Events, The City Club;

March 5th, Jeremy Schwartz, Wisdom Tree, *Global Valuations and The Dividend*

March 12th, Paul Rogers, Lazard Asset Management, LLC, *Emerging Markets*

March 31st, Joint Lunch with CABE, Jack Kleinhenz, Kleinhenz & Assoc., *Emerging Markets*

April 9th, Elizabeth Allen, Federal Express, *Company Update*

April 16th, Dennis Follmer, F-Squared

April 23rd, Joe Becker, Invesco Powershares, *Fixed Income Market Strategy*

April 30th, Robert Doll, Nuveen Asset Management

May 7th Martin Schulz, PNC Capital Advisors

May 14th, John Escario, Vanguard,

May 22nd, Matt Moran, Chicago Board Options, *Options for Enhanced Yield & Risk*

May 28th, Stephen Malinak, Thomson Reuters

June 4th, Brian Wesbury, First Trust, *Macroeconomic Outlook*

FEATURE ARTICLE

THE ECONOMICS OF OBAMACARE (PART 3): UNDERSTANDING THE LESSONS OF MEDICARE

By Ron Rimkus, CFA

I This post explores Medicare, its role in the U.S. health insurance landscape and the lessons it holds for the future of health care and for investors in the wake of the U.S. Supreme Court's historic decision to uphold the Patient Protection and Affordable Care Act (PPACA), more popularly known as ObamaCare.

What exactly is Medicare, and how does it work? Medicare is a government-run health insurance plan that provides coverage of medical-related costs for people over the age of 65. It is funded through income taxes on the tax-paying public. In contrast to the standard insurance model, Medicare is funded through taxes on persons A, B, and C, which are then used to pay the health care claims of other persons X and Y (i.e., the over-65 crowd). This is what makes Medicare a socialized model and not an insurance model per se. Moreover, an insurance model is able to estimate the cost of each policy reasonably well based on each person's age, demographics, driving distance to work, and other factors — and hence prices its products accordingly. In the socialized model, the beneficiaries receive payments for claims, but do not pay for the policies themselves, so there is no practical way to link their contributions with their subsequent claims. As it stands now, persons A, B, and C pay into Medicare for many years through taxes and hope that the government will allow them to receive the unfettered coverage that their parents and grandparents received.

Medicare's finances are further strained by the aging of the population. While the population has been aging steadily for some time, the population over age 65 is now exploding (see following exhibit of the increasing elderly population).

As illustrated in the estimate from U.S. Administration on Aging, people in the 65+ age cohort will grow from about 13% of the population in 2010 to about 20% of the population by 2030. This change is happening right now. Moreover, people in the age 65+ cohort spend about four times as much on health care as everyone else spends on average. As of 2004, those over age 65 spent $14,788 per year as compared to about $3,850 for everyone else. So, as the numbers of people in the 65+ age cohort swell, there will continue to be massive upward pressure on total costs.

Like any organization, Medicare tries to curtail its costs. And this is where it gets tricky: bureaucrats can only set limits on the prices they are willing to pay or limit the services they are willing to cover. While this does, in fact, help curtail costs to Medicare as a program, it doesn't do much to curtail costs in the entire health care system. All of the underlying health care products and services must be produced by somebody — nurses, doctors, medical technology manufacturers, biologists, technicians, researchers, and so forth. Therefore, these things have their own costs for labor, materials, and research, to name just a few factors. So, doctors and hospitals treating Medicare patients are frequently left with partially unpaid bills. Consequently, doctors and hospitals raise their prices for everyone else (non-Medicare patients). Naturally, these more expensive price tags ultimately flow through to higher premiums on the private insurance policies covering these patients. In effect, the rest of the country picks up an increasing share of the tab for the Medicare crowd each year. So, persons A, B, and C pay for Medicare through taxes that pay claims for persons X and Y — and then these same persons A, B, and C simultaneously pay into a private insurance pool that pays claims for persons A, B, and C, as well as the disallowed portions of persons X and Y's claims in Medicare. Got it?

Impact of the Insurance Mandate

As of today, the elderly comprise about 13% of the population in the United States (about 40 million people) and spend about 30% of all health care dollars. With 30 million additional people covered by PPACA, the role of government in health care will almost double overnight. The important lesson from Medicare is that this same exact framework of price mandates and cost shifting will also apply to the government-run plans that will become available on health care exchanges through PPACA. And by emulating the cost shifting of Medicare, the PPACA will see to it that more and more people migrate to government plans, only now it will apply to all age groups.

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FEATURE ARTICLE

THE ECONOMICS OF OBAMACARE (PART 3): UNDERSTANDING THE LESSONS OF MEDICARE CONTINUED

Private insurers like Aetna (AET), United Health Group (UNH), and WellPoint (WLP) receive the near-term trade-off of gaining millions of healthy, young, and currently uninsured customers to "join" their plans through the insurance mandate. The longer-term trade-off is that they must now compete with government-run insurance plans that can shift costs much like Medicare.

Looking at medical costs before and after the implementation of Medicare also helps to improve our perspective on the coming growth in bureaucracy from the PPACA. Medicare was passed in 1965 and implemented in 1966. The compound average growth rate in cost per patient day (adjusted for inflation) was 6% in the 10 years before Medicare and immediately and persistently escalated to 11% in the 10 years following implementation of Medicare — to the tune of a 5% premium to growth in real costs.

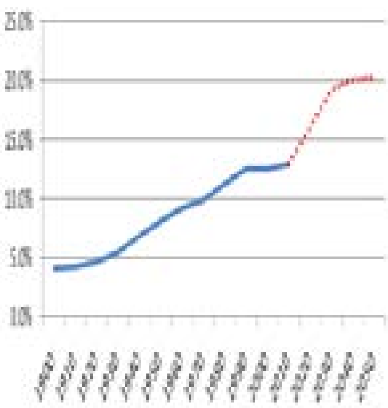
In fact, the real cost per patient day in 2010 is $187, nearly 29 times as much as the cost per patient day of $6.50 in 1965. In combination, Medicare suffers from the triple whammy of no coinsurance (which encourages overconsumption), cost shifting to the private sector, and strong growth in the elderly population. However, over the ten years ending in 2010 (before PPACA was passed), the compound annual growth in real costs per patient day were only 4.7% per year (despite ongoing advances in medical technology, downward movements in out-of-pocket spending, and other trends already well underway). At the time Medicare was implemented, it covered a maximum of only 9.5% of the population. In contrast, the PPACA will immediately take on 30 million new people — about 10% of today's population and, through the insurance exchanges, will take on many, many more with the potential to take on 100% of the population. Under PPACA, it is likely to create an even greater premium in cost growth due to the accommodation of larger percentages of the population. My estimate is that real cost growth accelerates from 4.7% to about 11.7% (about a 7% premium in cost growth) for the foreseeable future due solely to the passage of Obamacare.

In response to all these cost pressures over the years, hospitals and physicians have continually adapted the ways they do business. Shorter hospital stays and greater at-home recovery are just two outcomes. Perhaps critics might argue that the trend toward outpatient programs is a trend toward greater bureaucratic efficiency. Shorter stays mean higher throughput in hospitals and more patients being cared for by a single hospital. If there are in fact fewer patients staying in a hospital while more patients are processed through that hospital, isn't that a sign of efficiency? Sounds plausible, until you consider cost on a per patient basis. If it were true that greater outpatient numbers meant greater efficiency, shouldn't we expect the bureaucratic cost in hospitals to decline on a per patient basis? In fact, the opposite is true. Bureaucratic costs per patient increase materially. Note how the number of staff per occupied bed is moving like a runaway train. Note well the pivotal moment in the data: 1966, the year Medicare was enacted. In the ten years ending in 1965, hospital staff grew at a rate of 3.8% per year. In the ten years following implementation of Medicare, hospital staff grew at a rate of 6.8% per year.

The number of staff per bed in 2010 exhibits a more than 11-fold increase over the corresponding figure in 1946. Note also that this increase in staff occured while the number of occupied beds declined. As Milton Friedman explained, technological innovations typically drive unit costs downward. It's true in every other industry, but not health care. Why? Innovation and efficiency may explain the decline in occupied beds, but it does not explain the explosion in costs.

Likewise, as we look forward from today, we should expect hospital staff per occupied bed to accelerate and occupied beds to decline at an accelerated pace. Using Medicare implementation as a benchmark, growth in hospital staff should accelerate from 1.9% to approximately 4.9% per year, while occupied beds should decelerate from –0.4% to –2.8% per year as illustrated below.

Continued on page 10



United-States-Population-Aged-65-and-Over-as-a-Percent-of-the-Total-Population.png (657×264)

THE ECONOMICS OF OBAMACARE (PART 3): UNDERSTANDING THE LESSONS OF MEDICARE CONTINUED

Isn't it also possible that a surge in innovation created new treatment regimens and new therapy classes including pharmaceutical products, medical devices, and diagnostic technologies? This can be a complex topic, to be sure. For example, even if a new therapy (A) is statistically proven to reduce costs when swapped out for a traditional therapy (B) in isolation, that savings can get lost across the entire system. For instance, many

doctors may prescribe both therapy A and B, or they may prescribe therapy B to supplement therapies A, B, and C. In any event, in the aggregate, it is never clear just how much a new therapy is utilized as a substitute versus a supplement.

Another important driver of U.S. health spending is the fact that U.S. research effectively subsidizes the rest of the world. Because many other countries are already willing to limit access to care, they are also willing to demand lower prices from medical suppliers. So, if they don't get the prices they want, they are willing to walk away from providing the product to their citizens at all. Moreover, because of the disincentives and difficulties of earning returns on R&D investments, many of these countries typically abstain from significant research, letting the U.S. market bear a disproportionate share of development. Consequently, health care manufacturers charge U.S. consumers higher prices than they charge in other markets for the very same products.

So, the U.S. health consumer has played a special role in the world by paying these higher prices. As other countries have increasingly socialized their health care systems, the United States has increasingly played the role of developer. Thus persons A, B, and C pay for the health claims of persons X and Y through Medicare AND pay for their own insurance (which person E buys for them), which pays claims for persons A, B, and C — as well as persons X and Y — and for persons H, I, J, and K, who live in foreign lands. And this, my friends, is how the cost of health insurance has become so expensive here in America. Unfortunately, the passage of PPACA will see to it that the government bureaucracy will be amplified many times over, greatly increasing the cost of US heath care and accelerating all current cost trends. By design, the government can not match the program's costs with corresponding revenues. So, the great irony of Obamacare – whose advocates want free and equal access for all – is that the Government must eventually resort to its only real defense: limiting access to care in order to control costs.

But in the words of P.J. O'Rourke, "If you think it's expensive now, just wait until it's free!"

Download the full report

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CFA INSTITUTE RESEARCH CHALLENGE 2014

Challenge Winner

Case Western Reserve University

Research Challenge Team

Congratulations go out to Case Western Reserve University, which on February 22, 2014, ably presented their case as equity research analysts for their recommendation on the shares of Nordson Corporation (NDSN – NASDAQ). CWRU's team consisted of Snow Chen, Nicholas Dayton, Adil Haider, Sergio De Ilzarbe and Naiwen Zhang directed by Faculty Advisor Professor Scott Fine and Industry Mentor Warren Coleman, CFA. The CFA Society Cleveland would like to extend our best wishes for Good Luck to the participants from Case Western at the Americas Regionals to be held in Denver on March 18 & 19, 2014.

On behalf of CFA Society Cleveland, a sincere thank you goes out to the volunteers who assisted with the 2014 CFA Institute Research Challenge. This is the fifth year local Colleges and Universities have participated in the event. Report graders included Mark Douglass, Scott Kamenir, Mary Lau and Jason Rodgers. Presentation Judges included Linda Fousek, Brett Hillard and Nick Perini. Without your help, this worthwhile educational event could not proceed. Teams from Ashland University, Baldwin Wallace University, Case Western Reserve University, Cleveland State University and the University of Findlay competed for the opportunity to travel to Denver for the Americas Regional Finals. The winner of the Americas Regional will next compete in Singapore for the overall title in the Global Final on April 25, going against the winners from the Asia-Pacific and EMEA Regions.

CFA Mock Exam

The CFA Society Cleveland is hosting a Mock Exam for all levels of the CFA Exam in May on the 3rd floor of the Monte Ahuja College of Business via the walk through to the Law Building. Details will be available later in March.

Access Scholarship Program

Access Scholarships are needs-based scholarships allocated to societies for applicants applying for the 2015 CFA Program.

- *The 2015 Access Scholarship application period will open on March 1, 2014 and run through September 15, 2014. Stay tuned for further details.*
- *A record high of 5,630 applications were submitted for 2014 (vs 3,921 in 2013).*
- *CFAI awarded 2,652 Access Scholarships to individuals in 91 countries in 2014.*

LEGAL PERSPECTIVES

Tony Rospert, Thompson Hine

Tony Rospert is a partner in Thompson Hine's business litigation group in the firm's Cleveland office. He focuses his practice on complex business and corporate litigation involving public and private companies, including commercial and contract disputes, indemnification claims, shareholder actions, business transactions, class actions and taxcontroversies.

Rob Powell Thompson Hine

Rob Powell is an associate in the firm's corporate transactions & securities group in the Columbus, Ohio, office. He represents privately held, middle market and public companies on issues relating to entity formation, organization and governance, and the acquisitionand disposition of assets.

[Download the Full Article]

The Closely Held Business: To Squeeze Or Not To Squeeze?

By Tony Rospert and Rob Powell

Indeed, the closely held corporation structure itself often leads to the abuse of minority shareholders. This is primarily due to the fact that owners of a closely held business are often its primary decision-makers, but thebackgrounds and qualifications of ownership in a closely held business rarely reflect the depth of knowledge and expertise that a large corporation's elected board of directors possess. Owners may include early investors, old friends, family members and/or long-standing employees, and frequently the owners are also the executives. As a consequence, the owner of a closely held business typically has more vested, personally and financially, than the traditional corporate decision-maker.

Yet, the balance of decision-making authority in a closely held business commonly rests in the hands of a majority owner, or a few acting in concert, leaving those with a noncontrolling interest — minority owners — subject to the discretion of the controlling majority. This can result in shareholder oppression, which is rooted in several different legal theories, and more broadly addresses the evolving concern that majority shareholders in a corporation should not use their control to oppress a minority by employing mechanisms that disrupt the minority shareholders' reasonable expectation in the value of their shares.

Minority Shareholder Oppression

Minority shareholder oppression can take many forms. Two terms — squeeze-out and freeze-out — are often used interchangeably to describe the tactics most commonly employed by majority shareholders. These tactics may involve efforts by the majority to diminish the value of a minority shareholder's interest in the business.

This can include terminating the minority shareholder's employment, voting the minority off the governing board, voting to divert resources to prevent dividends, and diverting resources toward the salaries and benefits of those shareholders still under the employ of the business. Controlling shareholders may also attempt to eliminate a minority shareholder's interest altogether, typically through mechanisms established by statute, such as dissolution and reacquisition of the business, reverse stock splits and cash-out mergers.

If these minority shareholder oppression issues arise, it is essential for both majority and minority owners to evaluate the risks and consequences of any action before taking it. Navigating the options requires an understanding of established common law and governing statutes.

Common Law Remedies

Filing suit against the majority is difficult, expensive and lacks certainty, but offers one option in combating oppressive conduct by majority shareholders. Courts in many states impose

Continued on page 14

LEGAL PERSPECTIVES

The Closely Held Business: To Squeeze Or Not To Squeeze? Continued

a heightened fiduciary duty on majority shareholders. This duty owed to the minority by the controlling majority is similar to duties owed in a partnership or joint venture: duties of loyalty, care and good faith.

A breach of a fiduciary duty arises when the majority leverages control to its ownadvantage without providing the minority with the opportunity to benefit, absent a legitimate business purpose. Such a breach, in turn, gives rise to a cause of action by the individual minority shareholder. See, e.g. Crosby v. Beam, 47 Ohio St. 3d 105, 109 (Ohio 1989) (holding that majority shareholders have a fiduciary duty to minority shareholders, and noting that when majority shareholders in a closely held corporation utilize their majority control to their own advantage, without providing minority shareholders an equal opportunity to benefit, such breach, absent legitimate business purpose, is actionable).

In alleging a breach of fiduciary duty claim against the controlling majority, the minority shareholder must overcome the business judgment rule. That rule is a presumption that the majority shareholders acted in good faith and had a legitimate business purpose for their actions. Minority shareholders have the burden of rebutting this presumption byshowing that the majority shareholders lacked good faith, were engaged in self-dealing,i.e., were not disinterested, or failed to make a decision on an informed basis.

If a minority shareholder is unable to make such a showing, a court will not substitute its judgment for that of the majority shareholders. In re Toys "R" Us Inc. Shareholder Litigation., 877 A.2d 975 (Del. Ch. 2005). Thus, in order for a shareholder oppression action to succeed, the minority shareholder must first demonstrate that the majority breached a fiduciary duty of loyalty, care and/or good faith.

Most courts have adopted two approaches in resolving shareholder oppression issues within the context of a breach of fiduciary duty claim: 1) the fairness approach, and 2) the reasonable expectations approach.

The Fairness Approach

The "entire fairness" or "intrinsic fairness" approach shifts the burden to the majority shareholders to show that their actions and decisions were fair. Nixon v. Blackwell, 626 A.2d 1366 (Del. 1993). "The requirement of fairness is unflinching" and requires "careful scrutiny by the courts" which analyze two related concepts — fair dealing and fair price.

Weinberger v. UOP Inc., 457 A.2d 701 (Del. 1983).

"Fair dealing" looks at issues relating to process and "fair price" addresses issues of substance, such as economic and financial considerations. Courts, however, narrowly construe fairness. Indeed, minority shareholders are only "entitled to be treated fairly but not necessarily to be treated equally." Nixon, 626 A.2d 1379. Accordingly, courts determine entire fairness based on all aspects of the transaction to determine whether themajority's tactics are oppressive and, therefore, actionable.

The Reasonable Expectations Approach

A minority shareholder who reasonably expects that ownership in the closely held business entitles them to a job, a dividend payment, an opportunity to participate in governance issues, or some other return on their investment, could be oppressed when the majority seeks to disregard those expectations. The reasonable expectations approach finds oppression where "the majority conduct substantially defeats expectations that, objectively viewed, were both reasonable under the circumstances and were central to the [minority shareholder's] decision to join the venture." In re Kemp & Beatley Inc., 473 N.E.2d 1173 (N.Y. 1984)

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LEGAL PERSPECTIVES

The Closely Held Business: To Squeeze Or Not To Squeeze? Continued

Demonstrating a minority shareholder's reasonable expectations will require both proof of specific facts giving rise to the expectation and a showing that the expectation was reasonable. Thus, this approach looks not on whether the majority's actions were fair or reasonable, but rather shifts the focus to how the majority shareholders have affected the minority shareholder's interest in the business.

The application of these two approaches is usually only triggered after the minority shareholder rebuts the presumption underlying the business judgment rule. If a minority shareholder is unsuccessful, they will have no opportunity to argue unfairness or that their expectations have been frustrated as a result of squeeze-out tactics employed by the majority. Instead, the courts will presume that the majority shareholders made an informed decision which was in the best interests of the business, and in good faith.

The Closely Held Business: To Squeeze Or Not To Squeeze?

By Robin D. Powell and Anthony J. Rospert, Thompson Hine LLP

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