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Re: *Horbal, et al. v. Three Rivers Holdings, Inc., et al.*
Civil Action No. 1273-N

Dear Counsel:

Before the Court is defendants' motion to dismiss. Plaintiff Anthony Horbal[1] was the founder of a Health Management Organization ("HMO") servicing residents of Pennsylvania. Horbal was eventually forced out of his management position at the HMO by his co-investors. The complaint alleges that these co-investors then abused their positions by siphoning off

[1] Plaintiff Anthony Horbal is bringing this suit together with John Horbal, a shareholder of Three Rivers Holdings, Inc., and together with Donna Horbal, who is the custodian for Apryle Horbal, also a shareholder of Three Rivers Holdings, Inc.

tens of millions of dollars from the HMO in the form of disguised salaries, bonuses and corporate perquisites or, as the plaintiffs prefer to call them, "*de facto* dividends."[2] In connection with these "*de facto* dividends," plaintiffs allege breaches of the defendants' fiduciary duties.[3] Plaintiffs also allege they were improperly denied their right to a Section 220 inspection of the corporate books and records.

I. FACTS

In March 1995, Horbal and Warren Carmichael founded Three Rivers Health Plan ("TRHP"), a Medicaid HMO serving residents of Pennsylvania.[4] Carmichael was designated TRHP's Chairman and CEO while Horbal was the company's President, Secretary, and Treasurer.[5] Shortly after organizing TRHP, Horbal and Carmichael sought an investor who could provide capital to fund TRHP's continued development and growth.[6] In May 1995, Carmichael identified defendant John H. Dobbs and the Dobbs Family as possible early-stage investors who might be interested in purchasing equity in TRHP.[7] The Dobbs family was willing to invest in THRP if TRHP could

[2] Pls.' Opposing Br. at 23.
[3] The individual defendants are Warren Carmichael, John H. Dobbs, William H. Lawson, Jr. Three Rivers Holdings, Inc., is also a defendant.
[4] Compl. ¶ 21.
[5] *Id.* at ¶ 22.
[6] *Id.* at ¶ 24.
[7] *Id.* at ¶ 24.

be restructured so that its operations were divided among multiple companies.[8]

In June 1995, the Dobbs Family executed a stock purchase agreement with TRHP, purchasing a non-controlling interest in the company for $2 million.[9] Following the Dobbs Family investment, Horbal owned 17% of TRHP's voting stock, Carmichael 34%, and the Dobbs Family the remaining 49%.[10] Following the Dobbs Family investment, the TRHP board of directors consisted of Carmichael, Horbal and Lawson.[11]

The parties agreed on a complex restructuring of TRHP.[12] The restructuring had two parts. First, Horbal and Carmichael formed Three Rivers Health Management Company, Inc. ("TRHM").[13] TRHM was created to provide operational, management and administrative services to TRHP.[14] TRHP agreed to pay 10% of its net profits to TRHM in return for these management services.[15] The "management agreement" between TRHM and TRHP provided that TRHM would determine the amount and nature of the compensation of its employees, Horbal and Carmichael, and

[8] Compl. ¶ 27.
[9] Compl. ¶ 28.
[10] *Id.*
[11] Compl. ¶ 29.
[12] Compl. ¶ 30.
[13] *Id.*
[14] *Id.*
[15] Defs.' Opening Br. Ex. 1.

would pay their compensation.[16] Horbal signed a copy of the agreement dated June 12, 1995.[17]

Dobbs Management Service, LLC ("DMS"), a company controlled by the Dobbs family, also entered into a management services agreement with TRHP. DMS agreed to assist TRHP in managing its business and in return TRHP agreed to pay DMS a monthly consulting fee of 5% of TRHP's net profits.[18] Plaintiffs allege that DMS never provided any services to TRHP.[19]

After June 1995, the health of TRHP's business began to improve dramatically.[20] In April 1996, TRHP obtained a contract from Pennsylvania's Department of Public Welfare to operate and administer a managed care program for Pennsylvania's Medicaid population.[21] By the end of 2002, TRHP had enrolled 190,703 members.[22] This number has continued to increase; at the time the complaint was filed, TRHP had over 250,000 participants enrolled.[23] Revenues and profits also have increased dramatically. Between 1998 and 2004, TRHP's revenues increased from

[16] Defs.' Opening Br. Ex. 1 at 3.
[17] Defs.' Opening Br. Ex. 1.
[18] Compl. ¶ 31.
[19] Compl. ¶ 64.
[20] Compl. ¶ 32.
[21] Compl. ¶ 32.
[22] Compl. ¶ 33.
[23] Compl. ¶ 33.

around $192 million to approximately $500 million annually.[24] During the same period, annual net profits have increased from around $8 million to over $25 million, and TRHP has become Pennsylvania's largest Medicaid HMO.[25]

As the HMO's business began to improve, relations among the investors soured. In late July 1998, William Lawson, the Dobbs' Family attorney and the vice-president of DMS, presented Horbal with a partial buy-out proposal whereby roughly a third of Horbal's stock in TRHP and TRHM would be bought out.[26] At the same time, Carmichael, Lawson, and Dobbs took steps to end Horbal's tenure as an officer and director of TRHP and TRHM.[27] Sometime in August 1998, the board of directors of TRHP removed Horbal as an officer and director of TRHP and TRHM.[28] In January 1999, following extensive negotiations, the Dobbs family bought-out a large part of Horbal's TRHP-stock.[29] In connection with the buy-back of Horbal's stock, the company was again restructured.[30]

Pursuant to this second restructuring, all of TRHP's and TRHM's outstanding stock was transferred to a new holding company called Three

[24] Compl. ¶ 34.
[25] Compl. ¶ 34.
[26] Compl. ¶ 41.
[27] Compl. ¶ 44.
[28] Compl. ¶ 46.
[29] Compl. ¶ 49.
[30] Compl. ¶ 53.

Rivers Holdings, Inc. ("TR Holdings") in exchange for newly issued shares in TR Holdings and promissory notes from TR Holdings.[31] Plaintiffs were left owning 11% of TR Holdings and the Dobbs family became the holder of 60% of TR Holdings.[32] The reorganization also affected the ownership of TRHM and DMS: These companies became wholly-owned subsidiaries of TR Holdings.[33] After the reorganization, Carmichael and the Dobbs Family continued to receive compensation from the two subsidiaries, but Horbal, who no longer provided management services to TRHP, was no longer entitled to compensation per the management agreement signed between TRHP and TRHM.[34]

In connection with the partial buy-out of Horbal and the subsequent reorganization of TRHP, defendants set up a company called Three Rivers Administrative Services, LLC ("TRAS").[35] While TRAS was initially a subsidiary of TRHP, in 2001 TRAS became a wholly-owned subsidiary of TR Holdings.[36] TRAS was organized in order to provide administrative services to TRHP, and later to TR Holdings.[37] TRAS entered into compensation agreements with defendants whereby millions of dollars in

[31] Compl. ¶ 49.
[32] Compl. ¶¶ 50-51.
[33] Compl. ¶ 55.
[34] Compl. ¶¶ 53-56; Defs.' Opening Br. Ex. 1.
[35] Compl. ¶ 57.
[36] Compl. ¶¶ 58-59.
[37] Compl. ¶ 57.

compensation were allegedly paid to Carmichael and Lawson for services that plaintiffs allege were never rendered.[38]

Plaintiffs allege that they have been improperly denied access to the corporation's books and records.[39] Some of the corporate books and records were given to Horbal for his inspection on September 25, 2002.[40] Horbal alleges that these books and records were insufficient. On October 3, 2002, Horbal sent a letter to TR Holdings demanding access to more information.[41] When he received what he considered to be an inadequate response from TR Holdings, Horbal sent two follow-up letters on August 21, 2003, and December 7, 2004.[42] Plaintiffs allege that no response has been given with regards to these two requests.[43]

II. LEGAL STANDARD

To survive a motion to dismiss, a complaint must allege facts that, if true, would establish the elements of a claim.[44] In analyzing this question, I am required to assume the truthfulness of all well-pled allegations of the complaint. In addition, I am required to extend to plaintiffs the benefit of all reasonable inferences that can be drawn from the complaint. I cannot order

[38] Compl. ¶ 58.
[39] Compl. ¶ 3.
[40] Compl. Ex. A.
[41] Compl. Ex. A.
[42] Compl. Ex. B and Ex. C.
[43] Compl. ¶¶ 76-77.
[44] *See, e.g.*, *Lewis v. Honeywell, Inc.*, 1987 WL 14747, at *4 (Del. Ch. July 28, 1987).

a dismissal unless it is reasonably certain that the plaintiffs could not prevail under any set of facts that can be inferred from the complaint. However, any conclusory allegations unsupported by factual averments will not be accepted as true for purposes of this motion.[45]

III. DISCUSSION

A. Plaintiffs' De Facto Dividend Claim

Plaintiffs' *de facto* dividend claim centers on allegations of director self-dealing. Plaintiffs allege the director defendants used wholly-owned subsidiaries under their control to siphon off millions of dollars in the form of excessive salaries, bonuses and corporate perquisites.[46] Plaintiffs ask the Court to treat this excessive compensation as constructive or "*de facto*" dividends to which plaintiffs, as shareholders, have a right to share in equally.[47] With their *de facto* dividends theory, plaintiffs attempt to apply to corporate law a concept borrowed from tax law.[48] No Delaware court has ever recast executive compensation as a constructive dividend nor (to my

[45] *Grimes v. Donald*, 673 A.2d 1207, 1214 (Del. 1996).
[46] Compl. ¶ 53.
[47] Plaintiffs argue that these dividends were discriminatory, in the sense that they were paid out to some shareholders to the exclusion of others. According to plaintiffs, this violates the rule that "the board of directors cannot pay dividends only to certain shareholders to the exclusion of others of the same class," Fletcher, *Cyclopedia of the Law of Private Corporations*, § 5352. Of course, it is axiomatic that the declaration of dividends is necessary to trigger any such obligation.
[48] *See, e.g., Sam Kong Fashions, Inc. v. Comm'r*, 2005 WL 1516084 (U.S. Tax Ct. June 28, 2005); *Neonatology Assocs., P.A. v. Comm'r*, 299 F.3d 221, 232 (3d Cir. 2002.)

knowledge) has any Delaware court recognized such a cause of action to exist for the benefit of shareholders of a corporation.

This case, however, is remarkably similar to the facts of *Wilderman v. Wilderman.*[49] The plaintiff in *Wilderman*, a 50% shareholder in a close corporation, alleged that the corporation's other 50% shareholder, the company's president and the plaintiff's ex-husband, was using his control over the corporation to pay himself excessive compensation.[50] As relief, the plaintiff requested that the excessive compensation be returned to the corporation, "as corporate profits and required to be distributed as dividends, thereby opening the way to plaintiff to share in the net corporate profits as a stockholder with 50% equity in her corporation."[51] On the basis of the plaintiff's well-pled fraud allegations, the Court did order that the excessive portion of the compensation be returned to the company's treasury.[52] Nevertheless, the Court declined to recast the compensation as a disguised dividend to which plaintiffs would be allowed to share as a matter of right.[53]

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[49] *Wilderman v. Wilderman,* 315 A.2d 610, 612-13 (Del. Ch. Jan. 10, 1974)
[50] *Wilderman,* 315 A.2d at 612-13.
[51] *Wilderman,* 315 A.2d at 613.
[52] *Wilderman,* 315 A.2d at 616 (The Court noted in passing that the excessive compensation had come to light as a result of an investigation by the United States Internal Revenue Service ("IRS") which had concluded that, for tax purposes, some of the compensation would be treated as a "de facto dividend," *i.e.*, would be subject to tax as dividend income.)
[53] *Wilderman,* 315 A.2d at 616. *See also Gabelli & Co v. Liggett Group, Inc.,* 479 A.2d 276, 280 (Del. 1984) ("It is settled law in this State that the declaration and payment of a

The Court concluded that the decision whether to pay a dividend is a matter for the board of directors, absent an allegation of fraud.[54] Plaintiffs in this case make the same mistake as the plaintiffs in *Wilderman*, and they also fail to do what the plaintiffs in *Wilderman* did correctly. First, plaintiffs do not contend the management agreements with TRHP were improper. Plaintiffs clearly state that they "are *not* contending that the payments made pursuant to the Management Agreements are improper but that they are nonetheless entitled to their 'cut.'"[55] Indeed, plaintiffs are not alleging that the management agreements are improper at all; nor do they seek to invalidate the distributions made under those agreements.[56] Second, plaintiffs make clear they are *not* alleging fraud and, indeed, their complaint lacks the particularized allegations required by Chancery Court Rule 9 to plead a fraud claim.

Another case similar to this one is *Keenan v. Eshleman*.[57] *Keenan* was a derivative action challenging the payment of management fees to another company by interested directors who stood to benefit from the

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dividend rests in the discretion of the corporation's board of directors in the exercise of its business judgment; that, before the courts will interfere with the judgment of the board of directors in such matter, fraud or gross abuse of discretion must be shown.")

[54] *Wilderman*, 315 A.2d at 616.

[55] Pls.' Opposing Br. at 24 and 30.

[56] Pls.' Opposing Br. at 24.

[57] 2 A.2d 904 (Del. 1938).

payments.[58] The Delaware Supreme Court refused to regard the misappropriated fees "as a fund for a dividend in which the dissenting shareholders are to share.…"[59] On the contrary, based on the well-plead allegations of fraud in *Keenan*, the Court ordered the entire recoverable amount to be repaid to the corporation.[60] Again, in this case, the plaintiffs have consciously avoided pleading any allegations of fraud, presumably because plaintiff Horbal was intimately involved in the creation of the management agreements and, in the case of the management agreement with TRHM, he was even a signatory.

Ultimately, plaintiffs' claim in this case implicates, if anything, a classic allegation of self-dealing or waste. But plaintiffs have not directly challenged the management agreements, or the payments thereunder, on duty of loyalty grounds.[61] Because plaintiffs have not adequately pled a duty of loyalty claim, I am dismissing, without prejudice, plaintiffs' purported claim for breach of fiduciary duty; they may seek leave to amend their complaint to assert such a claim if they believe facts can be alleged adequately regarding it. With respect to plaintiffs' *de facto* dividends claim, I dismiss such claim with prejudice.

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[58] *Id.* at 909.
[59] *Id.* at 912.
[60] *Id.* at 912-13.
[61] Pls.' Opposing Br. at 23.

B. Plaintiffs' 8 Del. C. § 220 Claim

Based on my review of the briefs, I conclude that plaintiffs were improperly denied their right to a § 220 inspection of TR Holdings' books and records. Plaintiffs have requested information necessary to carry out an audit of Holdings and its subsidiaries' pursuant to 8 *Del. C.* § 220. Defendants' responses to the plaintiffs' demands have been inadequate. I therefore direct defendants to permit a thorough books and records inspection by plaintiffs so that plaintiffs can determine the fair value of their stock. In addition, I direct TR Holdings to provide plaintiffs with an accounting that shows exactly what money has been paid to defendants in the form of salaries, bonuses and corporate perquisites.

IT IS SO ORDERED.

Very truly yours,

William B. Chandler III

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