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Minority Shareholder Protection

Practical Implications for Business Planning

By Brett M. Larson

Small businesses are the foundation of our economy. They are often formed by friends, relatives, and business associates in a spirit of optimism and mutual trust. Partly because of that optimism and trust, many small businesses are informally organized and managed. All too often relationships among shareholders degrade over time or there are disagreements about the preferred direction of the company. Minority shareholders may become casualties of these disagreements and are often disregarded, marginalized, or "squeezed out" completely. In the absence of an agreed-upon plan for dealing with dissension among shareholders, the statutory default applies and the results of that statutory default will surprise many shareholders, majority and minority alike. Given the harsh economic climate for small businesses and their owners, it is now more important than ever to engage in thoughtful business planning because the ability to plan for future events is paramount to the stability and long-term success of any business.

The most common minority shareholder actions include claims under Minn. Stat. §302A.751, dissenter's rights under Minn. Stat. §§302A.471-.473, equitable remedies under Minn. Stat. §302A.467, and a common-law claim for breach of the fiduciary duty owed between shareholders in a close corporation. The broadest protection for minority shareholders is provided by Minn. Stat. §302A.751.

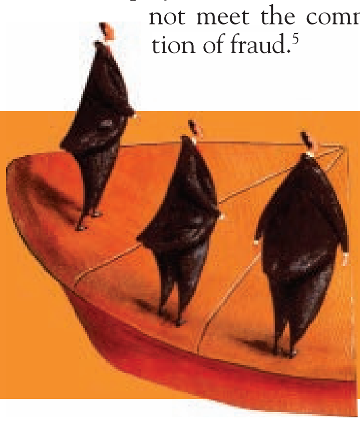
Liability Triggers

Minority shareholder protection under §302A.751 is liberally construed to protect against a wide range of conduct and provide a wide range of damages to address this conduct. Where the directors or those in control of the corporation acted: (1) fraudulently; (2) illegally; or (3) in an unfairly prejudicial manner toward the shareholder in his capacity as a shareholder, director, officer, or employee of the closely held corporation, the aggrieved shareholder has a right to be bought out for fair value.[1]

Fraud under §302A.471 has generally been held to encompass "deception, misrepresentation, actual fraud, or [a] violation of applicable statutes or articles of incorporation, or [a] violation of a fiduciary duty."[2] The Minnesota Court of Appeals in *Sifferle v. Micom Corporation* concluded that "the Minnesota legislature intended the term 'fraudulent' in §302A.471, subd. 4, [is] to be construed more broadly than strict common-law fraud."[3]

However, this is not true for claims under §302A.751. Specifically, in *U.S. Bank NA v. Cold Spring Granite Co.*, the Minnesota Supreme Court clarified that this broader definition of fraud that is applicable to dissenters' rights actions under §302A.471 does not apply in the context of a claim under §302A.751. Instead under §302A.751 the standard of proof for fraud is the same as for common law-fraud.[4]

This may be a distinction without a practical difference because the type of dishonest conduct that would constitute "*Sifferle* fraud" would likely also trigger protection under §302A.751 as unfairly prejudicial conduct even if it does not meet the common law definition of fraud.[5]



The only way that companies and shareholders can hope to avoid these pitfalls and possibly unfair results is through thoughtful business planning.

Conduct is "unfairly prejudicial" if it frustrates the reasonable expectations of a shareholder in his capacity as a shareholder.[6] Even a single instance of such conduct can justify relief to a minority shareholder.[7] Such relief can include a court-ordered buyout of the minority shareholder. In deciding whether to order a buy-out, the courts should consider "the reasonable expectations of the shareholders" with respect to each other and the corporation.[8] This is an objective standard.

Generally, any conduct that would constitute a breach of fiduciary duty will also serve as the basis for a claim under Minn. Stat. §302A.751.[9] This is especially applicable to negotiations among shareholders.[10] Minority shareholders have a reasonable expectation that their fellow shareholders will not withhold corporate records and other information necessary for a shareholder to evaluate his or her investment.[11] This does not include all corporate records. Only the withholding of "material" information will trigger a claim under §302A.751.[12]

Another expectation is voice in corporate affairs. "Oftentimes, a shareholder's reasonable expectations include a significant voice in management and an opportunity to work."[13] This expectation is a reflection of the essence of entrepreneurship and small business ownership: the opportunity to control one's own destiny. Even where a shareholder was properly terminated as an employee for assaulting customers of the corporation, removal of the shareholder from the Board violated the shareholder's reasonable expectation to participate in the management of the business.[14] This expectation exists regardless of whether the shareholder is an employee. As Judge Lansing stated in her concurrence in *U.S. Bank v. Cold Springs Granite Co.*,

> No part of our decision today should be read to dilute the broad equitable powers afforded to the district courts under section 302A.751. Appellants alleged unfairly prejudicial conduct and sought the equitable remedy of a buy-out under section 302A.751, subdivision 2, with the fair value of their shares determined by the court under that section. Although the prototypical minority shareholder claim is asserted by a terminated employee-shareholder, *see, e.g., Pedro*, 463 N.W.2d at 287, the protections afforded by section 302A.751 are sufficiently broad to bring within its ambit non-employee minority shareholders whose shares are involuntarily redeemed.[15]

If the shareholder is an employee, the expectation of a voice in corporate affairs may exist despite an "at-will" employment agreement.[16] In reaching this holding, the *Gunderson* court reasoned,

> … the doctrine of employment-based shareholder oppression is distinct from the wrongful-termination doctrine, and the analysis under the separate doctrines should attempt to protect close-corporation employment and, at the same time, respect the legitimate sphere of the at-will rule … . The threshold question in wrongful-termination cases, therefore, is whether a contractual agreement or a promise inducing reliance existed. The oppression doctrine, on the other hand, affords closely-held-corporation shareholders relief when the controlling shareholders frustrate their reasonable expectations as shareholder-employees. Accordingly, the threshold question in the context of a claim of shareholder oppression based on the termination of employment is whether a minority shareholder's expectation of continuing employment is reasonable.[17]

The expectation of a voice in corporate affairs does not have to be extinguished in order to trigger relief for the minority shareholder. The expectation of continued input into management decisions need not be tied to or hinge upon a position of employment, a directorship, or officer position. Rather, relief is triggered even when management responsibilities and input into company decisions are only reduced and not taken away completely.[18]

The reasonableness of such an expectation is a corollary issue. Minnesota courts have articulated several principles in assessing the reasonableness of a claimed expectation to continued input in management or company decisions. An expectation of continuing input is reasonable in the first instance if continued input was a significant reason for investing in the business.[19] Second, to be reasonable, an expectation of continued input must be known and accepted by other shareholders. Subjective hopes and desires alone are insufficient.[20] Third, in assessing the reasonableness of an expectation, courts look to a course of dealing between the shareholders that implies an understanding or agreement among shareholders.[21] Fourth, courts will consider "whether a shareholder's salary and benefits constitute de facto dividends and whether procuring employment with the corporation was a significant reason for investing in the business.[22] Finally, "expectations of continuing employment must also be balanced against the controlling shareholder's need for flexibility to run the business in a productive manner."[23]

In *Gunderson*, the court considered whether the plaintiff had a reasonable expectation of continuing employment by virtue of his shareholder status, a business plan, and another shareholder's alleged promises of job security. The court reasoned that any expectation based on the business plan was unreasonable because the shareholders never adopted it or learned of it. The court did say that the promises of an alleged shareholder "may be probative" of an expectation of continued employment even though the promise was insufficiently definite to create a contract. The court further noted that the buy-sell agreement failed to address the shareholder's right to continued employment.[24] The court remanded the case to the trial court to address issues of fact that remained relating to the reasonable expectations of the shareholder.

The *McCallum* court required the individual and corporate defendants to buy-out the shareholder's shares under §302A.751 for terminating him from his position as CEO, removing him from the board of directors, and attempting to buy his equity at an unfairly low price.[25] The court reasoned that on his termination, the plaintiff was divested of his primary expectations as a minority shareholder, including an active role in management.[26]

What's Recoverable

If reasonable expectations are established and it is shown the expectations were frustrated, the next question is damages. Under *Pedro v. Pedro* and its progeny, the damages under §302A.751 and a breach of fiduciary duty claim include two separate but related components of share value; return on equity and return on labor.[27]

The former is generally the value of an equity stake after subtracting the value of continued employment. The latter is often defined as the value of "lifetime employment." As indicated above, damages for an expectation of lifetime employment are available regardless of an "at-will employment agreement" and regardless of gross misconduct of a shareholder.[28] The defendant corporation can also be liable for attorney fees, costs, and interest under §302A.751.

The equity stake is defined as "fair value." Although it can be confused with "fair market value," it is not the same and the distinction can be the single most important variable in a case from an economic standpoint.

Fair market value is defined under generally accepted accounting principles as the "price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts."[29] It includes a discount for "lack of marketability." That is, a discount is applied to stock in a close corporation to reflect the fact that these shares are not freely alienable like publicly traded shares.

In 1994 the American Law Institute (ALI) set forth standards for determining fair value, which are used under Chapter 302A. The ALI recommended that fair value should equal the shareholder's proportionate ownership interest in the corporation, not the specific shares, without a discount for lack of marketability, except in extraordinary circumstances.[30] The ALI further recommended that the "extraordinary circumstances" exception exists only where to not apply a marketability discount would result in "an unfair wealth transfer from the remaining shareholders to the dissenting shareholder."[31]

The Minnesota Supreme Court adopted the ALI standard for court-ordered buy-outs pursuant to §302A.751 and held "absent extraordinary circumstances, fair value in a court-ordered buy-out pursuant to §302A.751 means a pro rata share of the value of the corporation as a going concern, without discount for lack of marketability."[32]

In applying the extraordinary circumstances exception the courts have further held that "maximum flexibility can be achieved by taking into account factors relevant to fair value, including: (1) whether the buying or selling shareholder has acted in a manner that is unfairly oppressive to the other or has reduced the value of the corporation; (2) whether the oppressed shareholder has additional remedies such as those available pursuant to Minn. Stat. §302A.467; or (3) whether any condition of the buy-out, including price, would be unfair to the remaining shareholders because it would be unduly burdensome on the corporation. The overarching policy however, is to ensure fair value, and in exceptional circumstances, to ensure the buy-out is 'fair and equitable to all parties.'"[33]

In *Follett*, the court applied this analysis by remanding with instructions that the trial court determine fair value by applying a marketability discount of 35 percent to 55 percent to the appraised value. The court reasoned that rejecting the marketability discount would result in a one-third ownership interest valued at almost seven times the average operating cash flow for the company's preceding five years and more than eight times its average net income over the same period "and in all probability strip" ACD of necessary cash flow and earnings for future growth."[34]

The court has wide discretion in determining the appropriate level and type of relief under §302A.751. This relief can include the value of lifetime employment and the fair value of the separate, but overlapping equity interests. Fair value is a concept that provides maximum protection for shareholders in a close corporation and will only be diminished by a marketability discount in extraordinary circumstances where such a buyout, even one paid over time, would obliterate the business out of fairness to the other shareholders of that business who did no wrong.

Special Litigation Committees

The statutory default can be equally unpredictable for a shareholder. For example, in the event a controlling shareholder engages in self-dealing such as dilution of stock value, the common law and statutory structure can be manipulated in the course of litigation to ostensibly provide a sort of *carte blanche* to shield abusive shareholders.

If majority shareholders are accused of wrongdoing by minority shareholders, the majority-controlled board of directors can appoint a committee to "investigate" the claim. Specifically, in the event the damages caused by the defendants' misconduct give rise to a derivative claim only, a board of directors can appoint a special litigation committee (SLC) to determine whether it is in the best interests of the company to pursue litigation, regardless of the merits of a particular claim. A claim is derivative if the damages are a function of reduction in share value and are common to all shareholders.[35]

Corporations may appoint SLCs consisting of one or more independent directors or other independent persons to consider the legal rights or remedies of the corporation and whether those rights and remedies will be pursued. Not surprisingly, the SLC can and often will recommend that the corporation not pursue the claim against the board of directors that appointed it. Regardless of the merits of a claim, a decision by an SLC will serve as the basis for a motion to dismiss the claims if the corporation can establish: (1) that the committee was sufficiently independent from the board of directors that appointed it, and (2) that the committee's investigation procedures were adequate, appropriate and pursued in good faith.[36] In making this determination, a court is supposed to conduct "a robust review of the SLC and its investigative procedures.[37]

An SLC is sufficiently independent "[i]f the board properly delegates its authority to act to the [SLC]."[38] "[A] mere advisory role of the Special Litigation Committee fails to bestow sufficient legitimacy on the Board's decision to warrant deference to the committee's decision by a court."[39] The board of directors may properly appoint an SLC by resolution, which must delegate all of the board's authority regarding the litigation including all power and authority to direct the corporation's actions going forward.

If the board merely asks the SLC for a recommendation, this delegation falls short of the independence requirement.

Importantly, if the SLC is not initially independent or its investigation is not adequate, neither the corporation nor the SLC will be allowed an opportunity to cure the defect and the SLC will be rendered powerless and its directive ineffective. On this point, the supreme court stated, "If the courts allow corporate boards to continually improve their investigation to bolster their business decision, the rights of shareholders and members will be effectively nullified."[40] Consequently, "if the initial SLC investigation and recommendation fail to satisfy [the business-judgment] standard, 'the derivative suit proceeds on its merits' with no opportunity to rectify any deficiencies."[41]

Practical Implications

The only way that companies and shareholders can hope to avoid these pitfalls and possibly unfair results is through thoughtful business planning. In 1994 the legislature amended §302A.751 to make clear that it intended for reasonable expectations to be shaped by agreements between corporations and their shareholders. In relevant part, the statute states:

> In determining whether to order equitable relief, dissolution, or a buy-out, the court shall take into consideration the duty which all shareholders in a closely held corporation owe one another to act in an honest, fair, and reasonable manner in the operation of the corporation and the reasonable expectations of all shareholders as they exist at the inception and develop during the course of the shareholders' relationship with the corporation and with each other. For purposes of this Section, any written agreements, including employment agreements and buy-sell agreements, between or among shareholders or between or among one or more shareholders and the corporation are presumed to reflect the parties' reasonable expectations concerning matters dealt with in the agreements.[42]

Interpreting this subdivision, the *Gunderson* court held "courts may rely on written or oral agreements among shareholders or between shareholders and the corporation in determining whether shareholder expectations are reasonable."[43]

The court further held "we recognize that written agreements are not dispositive of shareholder expectations in all circumstances."[44] …

> But written agreements should, nonetheless, be honored to the extent they specifically state the terms of the parties' bargain. The written (buy-sell) agreement in this case specifically provided for the involuntary removal of shareholders with or without cause. It also set forth a method for valuing a departing shareholder's stock, which *Gunderson* proposed to"protect ACP if a partner [left] in a more or less hostile manner."[45]

In deciding whether to substitute the buy-sell agreement for the expectations of the shareholders, the court will consider whether the buy-sell agreement was an arms length transaction and the relative input that the plaintiff shareholder had in the drafting of the agreement.[45]

A well-drafted buy-sell agreement can obviate the need for what is otherwise a very complex and often contentious battle over defining the "fair value" of equity holdings.

The buy-sell agreement in *Gunderson* failed to address the expectation of continued employment and input in management decisions. Since this opinion was written based on an appeal from a summary judgment motion, the court remanded the case to the trial court without determining whether the expectation was frustrated; the court did note:

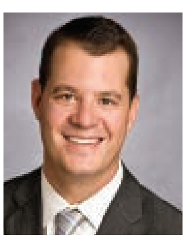
> because the buy-sell agreement does not address the parties' expectations on employment matters and the record is insufficiently developed, we conclude that genuine issues of material fact remain on whether Gunderson reasonably expected that his investment in ACP would entitle him to continuing employment with the corporation and whether any expectation of employment he may have had was altered by the parties' subsequent dealings or by Gunderson's alleged misconduct.[4]

The Gunderson buy-sell agreement addressed the general circumstances of the typical breakup that leads to a claim under §302A.751 and seemingly provided a minimum level of specificity to shape a shareholder's expectations regarding removal generally. However, best practices post-*Gunderson* now require that a buy-sell agreement and employment agreement specifically set out the understanding and agreement regarding the right to continued input in management and continued employment in the event of the triggering events referenced in the buy-sell agreement.[47] In any event, no written agreement will be upheld to contract around the expectation of fair and honest treatment among shareholders, which is protected under §302A.751.

Another potential issue for agreement is purchase price. The shareholder and corporation may also agree on the issue of purchase price in the event of a buy-out, which is helpful to the shareholder and the corporation in planning for and financing the buy-out. "Minnesota courts are required to honor shareholder agreements setting the purchase price of shares, unless the court determines that the price is unreasonable under all the circumstances."[48] If there are a small number of shareholders, the buy-sell agreement could first give the shareholders an opportunity to meet and agree upon a value. If they do not meet or cannot agree, the buy-sell agreement should provide a procedure by which an accountant or multiple accountants determine either fair value or fair market value of the shares, depending upon the preference of the company and shareholders.

All of this avoids costly and protracted litigation and the uncertainty associated with such litigation. A well-drafted buy-sell agreement can obviate the need for what is otherwise a very complex and often contentious battle over defining the "fair value" of equity holdings. The agreement will set forth a specific procedure for valuing the company and the shares by a formula or a procedure by which multiple experts will arrive at a value. As stated above, a shareholder may also be entitled to the value of lifetime employment ("return on labor") in addition to his or her "return on equity." The company and shareholder can control this issue by reaching an agreement as to a long-term expectation of employment and or input into management decisions. This agreement is most appropriately included in an employment agreement, shareholder agreement, or both.

A buy-sell agreement will also set the parameters for when a buyout is required, avoiding the need to litigate the equitable and often factually intensive issue of whether reasonable expectations were frustrated under §302A.751, and whether dissenters' rights were triggered under §302A.471 and .473. In this way, a well-drafted buy-sell agreement can help companies and shareholders avoid protracted litigation and predict the terms and cost of a separation. A shareholder agreement can also be used to limit or avoid the misuse of special litigation committees. Such an agreement will impose specific criteria for selecting a special litigation committee to avoid the common problem of bias and set specific objective criteria for its analysis. ▲



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Notes

[1] Minn. Stat. §302A.751, subd. 1(b)(2)-(3).

[2] *Sifferle v. Micom Corp.*, 384 N.W.2d 503, 507 (Minn. App. 1986),*review denied* (Minn. 06/13/1986); *see also*, R. Saliterman and R. Magnuson, *Advising Minnesota Corporations and Other Business Organizations*, §43.01 (Juris Publishing 2011.

[3] *Sifferle*, 384 N.W.2d at 507.

[4] 802 N.W. 2d 363, 372-73 (Minn. 2011).

[5] *See e.g.*, *Berreman v. West Pub. Co.*, 615 N.W.2d 362, 371 (Minn. App. 2000); *Pedro v. Pedro (Pedro II)*, 489 N.W.2d 798, 802-03 (Minn. App. 1992); *Pedro v. Pedro (Pedro I)*, 463 N.W.2d 285, 288-89 (Minn. App. 1990); *Swanson v. Upper Midwest Industries, Inc.*, 2002 WL 857744, *11. (Minn. App. 2002; *McCallum v. Rosen's Diversified, Inc.*, 153 F.3d 701, 703 (8th Cir. 1998).

[6] *Gunderson v. Alliance of Computer Professionals, Inc.*, 628 N.W.2d 173, 184 (Minn. App. 2001).

[7] *Sawyer v. Curt & Company, Inc.*, 1991 WL 65320 (Minn. App. 02/12/1991).

[8] Minn. Stat. §302A.751, subd. 3a (amended 1994.

[9] *Pedro II*, 489 N.W.2d at 802-03; *Pedro I*, 463 N.W.2d at 288-89.

[10] *Swanson*, 2002 WL at *11.

[11] *Berreman*, 615 N.W.2d at 371; *McCallum*, 153 F.3d at 703; *Swanson*, 2002 WL at *11.

[12] *U.S. Bank N.A. v. Cold Spring Granite Co.*, 788 N.W. 2d 160 (Minn. App. 2010).

[13] *McCallum*, 153 F.3d at 703; *Pooley v. Mankato Iron & Metal*, 513 N.W.2d 834, 836 (Minn. App. 1994.

[14] *Pooley*, 513 N.W.2d at 836. *Compare Gunderson*, 628 N.W. 2d at 192.

[15] *U. S. Bank N.A. v. Cold Springs Granite Co.*, 788 N.W.2d 160, 170 (Minn. App. 2010) (Lansing, J., concurring).

[16] *Gunderson*, 628 N.W. 2d at 181; *Pedro I*, 463 N.W.2d at 289-90.

[17] *Gunderson*, 628 N.W. 2d at 190.

[18] *O'Neil v. U.S. Spring Specialties, Inc.*, 1998 WL 128756 (Minn. App. 1998).

[19] *Gunderson*, 628 N.W.2d at 191.

[20] *Id.*

[21] *Id.* at 185.

[22] *Id.* at 191.

[23] *Id.*

[24] *Gunderson*, 628 N.W. 2d at 186.

[25] 153 F.3d at 704.

[26] *Id.*

[27] *Pedro II*, 489 N.W.2d at 802-03; *Pedro I*, 463 N.W.2d at 288-89.

[28] *Pooley*, 513 N.W.2d at 837-38.

[29] Internal Revenue Service Treasury Regulations §20.2031-1(b).

[30] *See* 2 A.L.I., *Principles of Corporate Governance: Analysis and Recommendations* §7.22(a) (1994).

[31] *Id.*

[32] *Advanced Communication Design v. Follett*, 615 N.W. 2d 285 (Minn. 2000).

[33] *Id.* at 292-293 (citing Minn. Stat. §302A.751, subd. 2).

[34] *Advanced Communication Design*, at 293.

[35] *Westlund Capital Corp. v. Lucht Engineering, Inc.*, 303 N.W.2d 709, 712 (Minn. 1981).

[36] *Janssen v. Best & Flanagan*, 662 N.W.2d 876, 888 (Minn. 2003).

[37] *In re UnitedHealth Group Inc. Shareholder Derivative Litigation*, 754 N.W.2d 544, 551 (Minn. 2008).

[38] *Id.*

[39] *Janssen*, 662 N.W.2d at 888.

[40] *Id.* at 890.

[41] *In re UnitedHealth Group*, 754 N.W.2d at 559 (quoting *Janssen*, 662 N.W.2d at 889).

[42] Minn. Stat. §302A.751, subd. 3a.

[43] *Gunderson*, 628 N.W. 2d at 185.

[44] *Id.* (citing, *Berreman*, 615 N.W.2d at 374).

[45] *Id.* at 187.

[46] *Id.*

[47] *Id.*at 192.

[48] *Id.* at 190.

[49] *Id.* (citing, Minn. Stat. §302A.751, subd. 2).