

Special Issues Involving Executives In Privately Held Companies: The Impact of Minority Shareholder Disputes

Randy G. Gullickson
Anthony Ostlund & Baer PA
Minneapolis

TABLE OF CONTENTS

Special Issues Involving Executives in Privately Held Companies: The Impact of Minority Shareholder Disputes

I.	Fiduciary Duties and Relationships	1
II.	Court's Broad Equitable Authority to Remedy Shareholder Oppression	3
	A. The Key Statutes	4
	B. Enforcing Reasonable Expectations	5
	C. The Rights of Employee-Shareholders	7
III.	Potential Remedies	9
	A. Dissolution	9
	B. "Fair Value" Buy-Out	10
	1. Procedure	10
	2. Valuation Methods/Factors	11
	3. What is "Fair Value?"	12
	4. Valuation Date	15
	5. Terms/Security Interest	16
	6. The Effect of a Valuation Formula Under an Existing Buy-Sell Agreement	16
	C. Sale of Company	17
	D. Breach of Fiduciary Duty "Damages"	17
	E. Injunctive Relief	18
	F. Appointment of Receiver, Custodian, or Provisional Director	19
	G. Other Equitable Relief	20
	H. Attorneys' Fees	21
	I. Punitive Damages	21
	J. Joint and Several Liability	22
	K. Equitable Remedies Against Minority Shareholders	22
	L. Indemnification Under Minn. Stat. § 302A.521	23

RIGHTS AND REMEDIES OF THE SHAREHOLDER – EMPLOYEE IN CLOSELY HELD CORPORATIONS

Executives in closely held¹ private corporations are often shareholders in the companies employing them, and may serve on the Board of Directors and/or in officer positions. As such, they may have rights and obligations under Minnesota law beyond the four corners of their executive employment contract or employment relationship. Issues regarding these rights and obligations often arise when the executive's relationship with the company is terminated, particularly when the termination is involuntary. However, executives (and their legal counsel) should understand and consider these issues when negotiating the terms of their relationship and carrying out their duties as employees, officers, directors, and/or shareholders of closely held companies.

I. Fiduciary Duties and Relationships

An executive employee who wears the hat of shareholder, officer and/or director has the benefit and burden of important rights and obligations relating to his or her relationship to the corporation and shareholders. These fiduciary relationships lie at the heart of the law governing the relationship among close corporation shareholders.

Under Minnesota law, the legal relationship between and among shareholders in a closely held corporation is similar to that of partners in a partnership. Such shareholders owe one another a fiduciary duty, which “imposes on them the highest standard of integrity and good faith in their dealings with each other.” Pedro v. Pedro, 489 N.W.2d 798 (Minn. Ct. App. 1992). See

¹ Under the Minnesota Business Corporation Act, a closely held corporation is defined somewhat arbitrarily as one with 35 or fewer shareholders. Minn. Stat. § 302A.011, subd. 6a. However, common law principles governing relationships within closely held companies can apply in corporations that, despite having more than 35 shareholders, have the attributes of closely held companies. These include: (1) a small number of shareholders; (2) no ready market for corporate stock; and (3) active shareholder participation in the business. Berreman v. West Publishing Co., 615 N.W.2d 362, 367-68 (Minn. Ct. App. 2000).

Minn. Stat. § 302A.751, subd. 3a (identifying “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”). This duty includes both substantive obligations that focus on the outcomes of shareholder conduct and procedural obligations that focus on process. Gunderson v. Alliance of Computer Professionals, Inc., 628 N.W.2d 173, 185 (Minn. Ct. App. 2001).

In addition, shareholders who serve in director or officer positions have further statutory and common law duties.

- Minn. Stat. § 302A.251, subd. 1: A director shall discharge the duties of the position of director in good faith, in a manner the director reasonably believes to be in the best interests of the corporation, and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.
- Minn. Stat. § 302A.361: An officer shall discharge the duties of an office in good faith, in a manner the officer reasonably believes to be in the best interests of the corporation, and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.

A director’s personal liability to the corporation or its shareholders for monetary damages for breach of fiduciary duty as a director may be eliminated or limited by specific provision in the articles of incorporation. However, the articles cannot limit liability for several categories of conduct, including: breach of the duty of loyalty; acts or omissions not in good faith; intentional misconduct or knowing violations of law; transactions involving an improper personal benefit; securities violations; and illegal distributions. Minn. Stat. § 302A.551, subd. 4.

- Under common law, directors and officers owe a fiduciary duty to the corporation. Matter of Villa Maria, Inc., 312 N.W. 921 (Minn. 1981) (one entrusted with the active management of a corporation, such as an officer or director, occupies a fiduciary relationship to the corporation).

Share ownership alone does not always mean that a minority shareholder is subject to the benefit or burden of fiduciary duties. For example, the Minnesota Court of Appeals has held that partnership fiduciary principles do not apply to the benefit of an employee who was not a founder and did not invest in the company, but only acquired a small percentage of stock as a part of his employment compensation package. Harris v. Mardan Business Systems, Inc., 421

N.W.2d 350 (Minn. Ct. App. 1988); see also, Brennan v. Chestnut, 973 F.2d 644 (8th Cir. 1992) (a majority shareholder does not owe a fiduciary to an employee minority shareholder who acquires a small percentage of stock as part of his or her employment compensation). But see, McCallum v. Rosen's Diversified, Inc., 153 F.3d 701 (8th Cir. 1998) (granting shareholder relief to CEO who had received shares as compensation for outstanding service and as an inducement to remain at the company and foster continued growth).

Moreover, the Minnesota Supreme Court has stated that, generally, only a majority or controlling shareholder owes a fiduciary duty to the corporation or the other shareholders. Advanced Communication Design, Inc. v. Follett, 615 N.W.2d 285, 293-94 (Minn. 2000). At least where the minority shareholder has no significant ability to control corporate decision-making, the Court held that the minority shareholder did not owe a fiduciary duty to the company or the other shareholders. Id. (The facts of Follett on which this holding was based were fairly unique. The minority shareholder was a corporate employee, but had never served as a director or officer. Moreover, he owned only non-voting shares, and thus played no meaningful role in company decisions.)

II. Court's Broad Equitable Authority to Remedy Shareholder Oppression.

Minority shareholders in closely held corporations often occupy a vulnerable position. As minority owners, they are subject to the will of the controlling shareholders on important matters affecting their business, their role in the company, and their investment return. Yet, since there is no ready market for the stock, as there is with public companies, a minority shareholder cannot simply go out and sell his or her shares and move on. Because of this vulnerable position, Minnesota law is designed to protect minority shareholders from what is often referred to as

shareholder “oppression.” In short, courts have been granted broad equitable power to remedy unfair treatment of minority shareholders.²

A. The Key Statutes

The key statutes governing minority shareholder rights reflect the broad discretion granted to judges to consider all of the facts and circumstances to determine whether relief is appropriate and, if so, to fashion relief that is “just and reasonable” in light of the facts and circumstances.

Minn. Stat. § 302A.751 (“Section 751”)³ expressly authorizes the Court to grant “any equitable relief it deems just or reasonable in the circumstances” in any one of several circumstances, including:

- the directors or those in control of the corporation have acted in a manner “unfairly prejudicial” toward a shareholder.
- the directors or those in control of the corporation have acted fraudulently or illegally toward a shareholder.
- the directors are deadlocked and the shareholders cannot break the deadlock.
- corporate assets are being misapplied or wasted.

Most minority shareholder litigation focuses on whether the controlling owners have engaged in “unfairly prejudicial” conduct toward a minority shareholder. Courts have held that even a

² The primary focus of this outline is on direct claims brought by shareholders in closely held corporations. Some shareholder lawsuits are based on shareholder derivative claims – that is, claims by a shareholder asserting a right that really belongs to the corporation. When asserting such claims, which involve direct injury to the corporation, the pleading requirements for derivative claims under Minn. R. Civ. P. 23.06 must be followed. Wessin v. Archives Corp., 592 N.W.2d 460 (Minn. 1999).

³ This outline deals specifically with closely held corporations, which are governed by Minn. Stat. Ch. 302A. The key statutes have parallel provisions in the Minnesota Limited Liability Company Act, Minn. Stat. Ch. 322B. The LLC provision similar to Section 751 is Minn. Stat. § 322B.833.

single instance of such conduct may justify relief to a minority shareholder. Sawyer v. Curt & Company, Inc., 1991 WL 65320 (Minn. Ct. App. Feb. 12, 1991).

Minn. Stat. § 302A.467⁴ similarly provides the Court with broad equitable authority to remedy a violation of the Business Corporations Act:

If a corporation or an officer or director violates a provision of this chapter, a court in this state may in an action brought by a shareholder of the corporation, grant any equitable relief it deems just and reasonable in the circumstances and award expenses, including attorneys' fees and disbursements, to the shareholder.

B. Enforcing Reasonable Expectations

In determining whether to order relief, Courts are directed to consider “the reasonable expectations of all shareholders” as they existed at the inception of the relationship and developed during the course of the parties’ relationship. Section 751, subd. 3a. In light of this statutory direction, “unfairly prejudicial” conduct has been interpreted to mean conduct that frustrates the reasonable expectations of shareholders. Berremman, 615 N.W.2s at 374; Gunderson v. Alliance of Computer Professionals, Inc., 628 N.W.2d 173, 184 (Minn. Ct. App. 2001). While what constitutes “reasonable expectations” will depend upon the facts and circumstances of each case, a shareholder’s reasonable expectations may often include a job, a salary, and a significant place in management. Sawyer, 1991 WL 65320; McCallum v. Rosen’s Diversified, Inc., 153 F.2d 701 (8th Cir. 1998) (reasonable expectations often include a “significant voice in management and an opportunity to work”); Haley v. Forcelle, 669 N.W.2d 48, 59 (Minn. Ct. App. 2003) (shareholders in closely held corporations typically have an expectation of continuing employment).

⁴ The parallel provision of the LLC Act is Minn. Stat. § 322B.38.

Courts will consider a number of factors in determining whether a shareholder's "reasonable expectations" have been violated. First, under the express terms of Section 751, written agreements are presumed to reflect the parties' reasonable expectations.

For the purpose of this section, any written agreements, including employment agreements and buy-sell agreements, between or among shareholders or between one or more shareholders and the corporation are presumed to reflect the parties' reasonable expectations concerning matters dealt with in the agreements.

Section 751, subd. 3a (emphasis added). Note that even as to matters expressly addressed in a written agreement, the agreement is only presumed to reflect reasonable expectations. Such agreements are not always dispositive in determining shareholder expectations. Haley v. Forcelle, 669 N.W.2d at 58; Gunderson, 628 N.W.2d at 186. There may be expectations that contradict a written agreement. Or, the written agreements may not expressly apply to the circumstances giving rise to the dispute.

Shareholder expectations often arise from understandings that are not expressly stated in the corporation's agreements or governance documents. Therefore, courts may look to other factors or touchstones in determining the parties' reasonable expectations, including:

- a course of dealing that implies an agreement. Gunderson, 628 N.W.2d at 185;
- an assessment of the understandings that would be expected to result from "associative bargaining." Gunderson, 628 N.W.2d at 185; Berreman, 615 N.W.2d at 374. In other words, what would the parties have agreed to had they bargained over how their investment would be protected?;
- the fiduciary duties owed by shareholders to one another – including substantive obligations, such as withholding dividends or using corporate assets preferentially, and procedural obligations, such as refraining from engaging in oppressive or unfair negotiation tactics or arbitrarily exercising discretion or veto power. Gunderson, 628 N.W.2d at 185-86.

Corporate governance rules can also form the basis for reasonable expectations, the violation of which can give rise to minority shareholder relief. Violations of Chapter 302A can

give rise to a remedy under Section 467 and can also be a triggering events for relief under Section 751. See, Henrickson v. Big League Game Co., 1995 WL 550935 (Minn. Ct. App. Sep. 19, 1995) (violation of Minn. Stat. § 302A.401, involving issuance of stock without authority, and § 302A.551, involving distribution of corporate funds without authorization of the Board, constituted breach of fiduciary duty and justified buy-out under Section 751). However, the Court of Appeals has held that breach of a company's bylaws, as opposed to a violation of Chapter 302A, does not trigger relief, at least under Section 302A.467. Isaacs v. American Iron, 690 N.W.2d 373 (Minn. Ct. App. 2004).

C. The Rights of Employee-Shareholders.

The rights and remedies of a shareholder-employee are often based both on their contractual relationship with the company and/or other shareholders and the statutory and common law protections afforded shareholders in closely held corporations. As a result, the analysis of the rights and remedies available to an executive may depend upon which hat he or she is wearing – employee or shareholder. Where an employee (in his capacity as employee) claims wrongful termination, the threshold question is whether a contractual agreement or promise inducing reliance existed which is breached by the termination. Gunderson, 628 N.W.2d at 190. However, a shareholder-employee also has the protections of the shareholder oppression doctrine. The threshold question in the context of a shareholder oppression claim based on termination of employment is whether a minority expectation of continuing employment is reasonable. Id.

The employment relationship is often governed by a written employment contract, which is governed by contract principles. The employment contract may be for a definite term or may set forth limited bases on which the executive may be terminated. It may also expressly allow

termination on an “at-will” basis. Moreover, where there is no written contract, Minnesota law will presume that the employment is at-will. *Id.*, at 181-82. A terminated executive employee subject to an at-will employment relationship may be unable to successfully pursue a claim for breach of an employment contract.

Courts will engage in a separate analysis, however, where the employee is a close corporation shareholder to determine whether the shareholder-employee had a reasonable expectation to continuing employment that was violated. *Id.* Factors courts will consider in assessing this issue include the following:

- whether there is a buy-out agreement permitting termination of employment for any reason and obligating shareholders to sell their shares upon termination.
- whether the employee has made a capital investment.
- whether the expectation of continuing employment is known and accepted by the other shareholder.
- whether the termination of employment is caused by the shareholder-employee’s own conduct or incompetence.

Id., at 190-91. Courts will also balance expectations of continuing employment against the need of the controlling shareholder need for flexibility in running the business. *Id.*, at 191-92.

Employment termination can often be accompanied by other conduct that adversely affects a shareholder-employee. Examples include: removal from the Board and/or other management role; cutting off dividends and/or refusing to make a good faith attempt to buy-out the shareholder at a fair price or to alter the income distribution mechanism following termination to provide the terminated shareholder-employee a fair investment; using a buy-sell agreement manipulatively to force the sale of the shareholders stock at a low price; cutting off the shareholder from access to company information. See generally, Gunderson; Sawyer; Pedro; Pooley v. Mankato Iron & Metal, Inc., 513 N.W.2d 834 (Minn. Ct. App. 1994) (although

termination of employment was appropriate for bad-acting shareholder-employee, removal of shareholder from the Board and freezing him out of a business in which he reasonably expected to participate violated shareholder's reasonable expectations). These examples and others can be the basis for claims of unfairly prejudicial conduct. In evaluating such claims, courts will engage in an assessment of the "reasonable expectations" of the shareholders.

III. Potential Remedies.

Disputes involving executive employees (who are also shareholders) often involve breach of contract claims for alleged violations of employment agreements and/or other contracts. But Minnesota law provides for an extensive array of other potential remedies to remedy oppressive conduct toward a minority shareholder. As reflected by the broad language of Section 751 and Section 467 – providing for "any equitable relief" the court finds to be "just and reasonable" under the circumstances – the range of potential remedies available to a court to resolve shareholder oppression claims and other shareholder disputes is exceedingly broad. While a "fair value" buy-out is often the remedy sought in Section 751 cases, courts can (and do) grant other relief instead of or in addition to a buy-out remedy.

A. Dissolution.

Historically, the Minnesota corporate code provided for dissolution as the primary remedy for resolving disputes involving serious oppression of minority shareholders or irreconcilable deadlock. See, Minn. Stat. § 301.49 (repealed 1981). But even before the adoption of Section 751, courts recognized that involuntary dissolution was a drastic remedy to be used with great caution. In re Lakeland Development Corp., 152 N.W.2d 758, 764 (Minn. 1967). Most typically, decisions to dissolve a corporation were based on deadlock that was irreconcilable, under circumstances that made continuation of the business no longer advantageous to the shareholders. E.g., In re Lakeland, 152 N.W.2d at 764; In re Villa Maria,

Inc., 312 N.W.2d 921, 923 (Minn. 1981); In re Hedberg-Freidheim & Co., 47 N.W.2d 424, 427 (Minn. 1951).

Since the adoption of Section 751 in the early 1980s, courts have been directed that they “shall” consider whether lesser relief, such as a buy-out, would be adequate to permanently relieve the unfair treatment of the plaintiff shareholder. Section 751, subd. 3b.

While involuntary dissolution is not a common remedy, courts will still order dissolution in some cases, generally in cases involving deadlock. Johnson v. Dolphin, 1990 WL 194991 (Minn. Ct. App. Dec. 11, 1990) (dissolution ordered where 50/50 owners were deadlocked); Signal Bank, N.A. v. Kemnitz Sand & Gravel, Inc., 2002 WL 31415422 (Minn. Ct. App. Oct. 29, 2002) (dissolution ordered where there was conflicting testimony regarding ownership and distribution of shares, the two owners were deadlocked, and the corporation was insolvent with creditor suits imminent).

B. “Fair Value” Buy-Out.

The remedy of choice under Section 751 in most cases is a “fair value” buy-out of the complaining shareholder’s stock in the corporation.⁵ What constitutes “fair value” is often one of the most contentious issues in a shareholder dispute.

1. Procedure.

The court may order a buy-out upon the establishment of any of the triggering events identified in subd. 1 of Section 751. While a buy-out is usually ordered following a trial, Section 751 also authorizes a buy-out on motion (subd. 2). If the court orders a buy-out on motion, the parties have the opportunity to agree on the price and terms of the buy-out. If they

⁵ It is usually the plaintiff minority shareholder (or 50% owner) who seeks to have his/her shares purchased by the company and/or the controlling shareholder(s). However, under Section 751, the court can order the sale of shares held by either a plaintiff or a defendant shareholder to the corporation or the opposing shareholder(s). Section 751, subd. 2.

