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Developments in the Law of Corporate Divorce: The Rights and Remedies of Minority Shareholders

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Shareholder disputes can be among the most difficult and, if not handled properly, costly events in the life of closely held private corporations. Minority shareholders who feel they have been mistreated typically assert claims for a "fair value" buy-out of their shares under Minn. Stat. § 302A.751 ("Section 751") and damages for breach of fiduciary duty.

Shareholders who also serve as corporate managers or employees are afforded substantial protection under Minnesota law. When such a shareholder's employment is terminated or the shareholder is otherwise forced from the company, thus losing the compensation that may constitute the primary or exclusive method by which the owners take earnings out of the company, courts are inclined to grant a corporate divorce by requiring a fair value buy-out of the minority shareholder's stock. In addition to a stock buy-out, plaintiff shareholders in these cases have also been the beneficiaries of large damage awards, which may include damages for breach of contract or for lost earnings/earning capacity, and attorneys' fees under Minn. Stat. §§ 302A.751 and 302A.467.

In light of the potentially devastating results of minority shareholder lawsuits, business lawyers will serve their closely held business clients well by assisting them in preventing such disputes and properly dealing with disputes that do arise.[1] Recent decisions by the Minnesota appellate courts have continued to develop and clarify the law governing minority shareholder disputes, addressing both liability and remedy issues. The Court of Appeals has issued several recent decisions addressing the circumstances that justify a buy-out or other equitable relief under Section 751. The Supreme Court has spoken to the issue of how "fair value" is determined in cases where a fair value stock buy-out is ordered.[2] The appellate courts continue to recognize the broad discretion afforded trial courts in fashioning appropriate relief in the light of the unique facts of each case. These decisions, however, have enunciated several important principles about which business lawyers representing closely held companies should be aware.

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One of the most difficult and frustrating (at least to corporations and their counsel) issues in minority shareholder litigation is why legal principles that are dispositive in other circumstances are not necessarily dispositive in these cases. For example, an "at will" employee can generally be terminated for any reason or no reason, without legal consequences to the employer. Yet, when that employee is a shareholder in a closely held corporation, termination of employment may trigger substantial remedies under Section 751. Why? Likewise, when a buy-sell agreement appears to permit a forced redemption of a shareholder's stock at a formula price (e.g., book value), why, asks the corporation or majority shareholder, can't the company simply implement the contract without potentially subjecting itself to liability for "fair value" under Section 751? The answer, according to the courts, is that the governing statute says so.

In fact, Section 751 directs courts to engage in a broader inquiry beyond the four corners of written shareholder agreements or the technical "at-will" status of a shareholder-employee. The finding that typically triggers a fair value buy-out under Section 751 is a determination that those in control of a closely held corporation have acted in a manner "unfairly prejudicial" toward a plaintiff shareholder. Two recent Court of Appeals decisions[3] have interpreted "unfairly prejudicial" conduct in a closely held company to mean "conduct that frustrates the reasonable expectations of all shareholders" in their capacity as shareholders, directors, officers, or employees of the company. This interpretation is driven by the express language in Section 751, subd. 3a, which provides that in determining whether to grant a buy-out or order other equitable relief:

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

(Emphasis added.)

In short, the inquiry is not limited to the terms of formal written agreements or formal legal relationships. Courts must also examine shareholder "reasonable expectations." Written agreements are "presumed" to reflect reasonable expectations concerning matters dealt with in them. But matters giving rise to shareholder disputes are not always explicitly dealt with in the written agreements and the agreements, while presumptively enforceable, are not dispositive where other facts establish reasonable expectations outside of or different from written contracts.

In its most recent reported decision relating to minority shareholder rights, the Minnesota Court of Appeals addressed the issue of when the termination of an "at-will" shareholder employee will nonetheless entitle the shareholder to relief under Section 751. In Gunderson v. Alliance of Computer Professionals, Inc.,[4] plaintiff was a 20% shareholder and an employee, officer, and director of the closely held corporate defendant, ACP, having joined the company shortly after it was founded and played a critical role in developing the company. Gunderson had no employment agreement. He and the other shareholders signed a buy-sell agreement permitting the involuntary withdrawal of a shareholder by a 3/4 vote of the shareholders, and pursuant to

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which the withdrawing shareholder's stock was to be bought out under a book value redemption formula.

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Although the reasons were disputed, the defendants determined to remove Gunderson from the company. After Gunderson refused to honor a request that he resign, he was terminated as an employee, officer, and director. Pursuant to the buy-sell agreement, ACP offered to buy his shares for the formula price of $2,300, despite expert valuation evidence placing the value of his stock at over $1.1 million. The Court of Appeals held that, although Gunderson was an at-will employee, and therefore "not wrongfully discharged in the breach-of-contract sense," the termination of his employment triggers a separate inquiry under Section 751 into whether ACP unfairly prejudiced Gunderson in his capacity as a shareholder-employee. The "threshold question" in determining whether there has been shareholder oppression based upon employment termination, according to the Court, is "whether the minority shareholder's expectation of continuing employment is reasonable."

While terminated shareholders virtually always claim an expectation to continued employment, the Gunderson Court articulated several principles to be considered in assessing the reasonableness of such an expectation:

- An expectation to continued employment is reasonable in the first instance if continued employment can fairly be characterized as part of the shareholders' investment - e.g., where the shareholder's salary and benefits constitute (at least in part) de facto dividends or where employment was a significant reason for investing in the business.
- To be reasonable, an expectation of continuing employment must be known and accepted by other shareholders. Subjective hopes and desires alone are insufficient.
- An expectation of continued employment must be balanced against the need for flexibility in running the business in a productive manner and, therefore, such an expectation is not reasonable where "the shareholder-employee's own misconduct or incompetence causes the termination."
- Shareholders who sign buy-sell agreements permitting termination of employment for any reason and obligating the sale of shares to the corporation upon termination of employment "would not likely" be able to establish a reasonable expectation to continued employment.
- An employee who makes no capital investment but buys a small percentage of stock through periodic offerings or receives a small percentage of stock as part of a compensation package probably lacks a reasonable expectation of continued employment.

The Gunderson Court ultimately concluded that Gunderson had raised factual issues regarding his claim that termination of his employment violated his shareholder-employee expectations and that, if he prevails on that issue on remand, he will be entitled to a fair value buy-out of his shares.

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Interestingly, the Court separately analyzed Gunderson's expectations as a shareholder (as distinct from his expectations as a shareholder-employee) and held that, under the facts of that case, application of the buy-sell agreement to remove him as a shareholder and attempt to redeem his stock under the formula value did not violate Gunderson's shareholder expectations. (Because the buy-sell agreement did not address employment expectations, this holding did not prevent Gunderson from recovering fair value if the termination violated his shareholder-employee expectations.) The Court articulated the following principles governing assessment of shareholder expectations:

- Written agreements are not dispositive of shareholder expectations in all circumstances and shareholder expectations may arise from understandings not stated in the agreement.
- Reasonable expectations can be inferred from the fiduciary relationship among close corporation shareholders and the duty, expressed in Section 751, subd. 3a, that shareholders must "act in an honest, fair, and reasonable manner in the operation of the corporation." Thus, controlling shareholders have a substantive obligation of fairness, e.g., not to withhold dividends or "use corporate assets preferentially." They also have a procedural obligation not to use unfair or oppressive negotiation tactics.
- As the Court of Appeals held recently in Berreman v. West Publishing Co.,[5] shareholders have a duty to act with complete candor in their negotiations with each other. Failure to disclose material information may give rise to relief under Section 751.
- Use of a buy-sell agreement manipulatively to force the sale of shares may violate a shareholder's expectations.
- In the absence of specific written agreements, reasonable expectations may be determined by reference to the understandings that would be expected to result from "associative bargaining"–i.e., the understandings reasonable shareholders would have reached if they had bargained over how their investments should be protected.

In other recent decisions, the Court of Appeals has demonstrated the importance of the facts of a particular case in determining whether the "presumptive" effect of shareholder agreements will result in the strict enforcement of the agreement or justify broader relief under Section 751. Powell v. Anderson[6] involved a claim by the daughter of the corporation's founder. She had been gifted approximately 25% of the company's shares, but was required to sign an unambiguous share redemption agreement providing that, upon her father's death, she would sell her shares back to the company at book value. However, because the Court found that the majority shareholder had acted unfairly and prejudicially toward the plaintiff, the Court awarded her the substantially higher "fair value" for her shares and did not restrict her to the contractual book value recovery.

In Drewitz v. Walser,[7] on the other hand, the Court strictly enforced the parties' written agreements. The plaintiff shareholder was subject to an employment agreement, which expired by its terms on March 31, 1999, and a shareholder agreement providing that if the plaintiff's employment was terminated for any reason, he was obligated to sell his shares back to the company at book value. After the expiration of the employment agreement, the plaintiff's employment was terminated and the company sought to implement the redemption provisions of the shareholder agreement. In light of the fixed term of the employment contract, the Court of Appeals concluded that the plaintiff did not have a reasonable expectation to continued employment beyond the expiration date of the contract. After examining the factual record, the

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Court could find no factual basis for overcoming the presumptive enforcement of the written contracts.

While these cases reflect the critical importance of the unique facts of each case, they (particularly Gunderson) do provide closely held companies and their counsel with guidance in preventing and successfully resolving shareholder disputes. First, recent cases confirm that written agreements continue to be important. Contracts that are specific, comprehensive, and explicitly address the circumstances giving rise to the dispute are most likely to be enforced. Second, because of the applicable fiduciary duties and duty of honesty and fairness, it is important to properly handle employment terminations when they become necessary. It will be helpful to document and establish a clear record of bad behavior by a shareholder-employee. It is also advisable to give a shareholder-employee notice of misconduct or incompetence and allow an opportunity to correct deficiencies. Finally, companies may want to re-examine the common practice of paying owners salary but no dividends. Likewise, they should consider whether such a "compensation only" policy continues to make sense after a shareholder's employment is terminated. While there are tax and business reasons for this practice, Gunderson suggests that where shareholder-employee compensation is actually a de facto dividend or investment return, taking the job and salary away may well violate the shareholder's reasonable expectations.

Given the broad discretion given courts to do what is fair in light of the specific facts of each case, it is impossible to eliminate the risk of shareholder disputes and litigation. But business lawyers can help their clients reduce the risk through good planning and sound advice based upon the governing principles expressed by the courts.

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1. One issue that corporate counsel must assess early in shareholder disputes is the role, if any, that the lawyer (or his/her firm) should play, particularly if litigation breaks out. The Minnesota Court of Appeals has held that since a lawyer for a closely held corporation owes a duty to all shareholders, taking sides in a shareholder dispute may create a conflict of interest, the significant consequence of which may be to allow the minority shareholder to pierce the attorney-client privilege. See Evans v. Blesi, 345 N.W.2d 775 (Minn. Ct. App. 1984); Miller Waste Mills v. McKay, C4-97-1354 (Minn. Ct. App., Sept. 3, 1997). For a more complete discussion of this issue, see Olson and Louwagie, Will Counsel Please Take the Stand? The Conflict of Interest/Fiduciary Exception to the Attorney-Client Privilege in Minnesota, 70 Henn. Lawyer 10 (Feb. 2001).

2. "Fair value," as interpreted by the courts, is a valuation approach that is generally favorable to minority shareholders because it generally does not involve application of the traditional discounts utilized in determining the "fair market value" of minority shares in a closely held company. For a recent decision by the Minnesota Supreme Court regarding the meaning of "fair value" and a discussion of when a marketability (or illiquidity) discount will be applicable, see Advanced Communication Design, Inc. v. Follett, 650 N.W.2d 285 (Minn. 2000).

3. Gunderson v. Alliance of Computer Professionals, Inc., File No. C2-00-1484, ___ N.W.2d ___ (Minn. Ct. App., May 22, 2001); Berreman v. West Publishing Co., 615 N.W.2d 362, 374 (Minn. Ct. App. 2000). The Gunderson defendants have filed with the Minnesota

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Supreme Court a petition for discretionary review of the Court of Appeals' decision. The Supreme Court has yet to rule on whether it will hear an appeal.

4. Gunderson, supra, note 3.
5. Berreman v. West Publishing Co., supra, note 3.
6. Powell v. Anderson, 2000 WL 943842 (Minn. Ct. App., July 11, 2000).
7. Drewitz v. Walser, File No. C099508 (Minn. Ct. App., May 1, 2001).

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