PLANNING TO AVOID SHAREHOLDER DISPUTES:

A GUIDE FOR STRUCTURING OWNERSHIP AND GOVERNANCE

BY

VINCENT LOUWAGIE
ANTHONY OSTLUND & BAER

COMMON SOURCES OF GOVERNANCE RULES

- Articles of Incorporation
- By-laws
- Shareholder Voting Agreements
- Shareholder Control Agreements
- Employment Agreements
- Minn. Ch. 302A
- Common Law
- Company Policy

SOME OPTIONAL PROVISIONS OF THE ARTICLES OF INCORPORATION

- No cumulative voting
- Board actions to be other than by majority
- Board actions can be in writing by less than all
- How and when shareholder meetings are to be held
- What gives shareholders dissenters rights.
- Elimination of preemptive rights
- Classes of stock

BYLAWS

- Not Required
- May contain anything not inconsistent with law or articles
- Contract among shareholders. Miller Waste Mills v. Mackay
- But adopted, amended or repealed generally by directors
- Shareholders can modify in same manner as articles.

SHAREHOLDER VOTING AGREEMENT

- 302A.455
- Valid and specifically enforceable
- Not all must agree

SHAREHOLDER CONTROL AGREEMENT

- 302A.457
- Valid and specifically enforceable
- All must agree
- Must file with corporation and legend shares

BUY-SELL AGREEMENT

- Can be found in bylaws, shareholder control agreement, or elsewhere
- Provides for events that give rise to right or obligation to purchase shares
- Provides mechanism for determining price
- Provides terms

EMPLOYMENT AGREEMENTS

- Ensure that employment is terminable at will of majority
- Sets forth expectations on effort
- No reasonable expectation of employment for life
- Non-compete?
- Non-solicitation
- Intellectual property protection
- Arbitration

FREEZE-OUT

- Terminating minority shareholder's employment
- Terminating minority shareholder's board or management participation
- Terminating minority shareholder's access to information
- Terminating minority shareholder's return on investment
- Siphoning off profits
- Forcing redemption of shares.

DIRECT V. DERIVATIVE

Of the four cases decided by the Minnesota Supreme Court since 1990 which dealt with shareholder rights and corporate governance under Minn. Ch. 302A, two of them dealt with derivative claims. See also, Northwest Racquet and Swim v. Deloitte & Touche.

Derivative claims are those claims which belong directly to the corporation, but which can be asserted indirectly, by a shareholder, on behalf of the corporation under certain circumstances.

INJURY IS DETERMINATIVE

"In analyzing whether a claim is direct or derivative, we look not to the theory in which the claim is couched, but instead to the injury itself." Northwest Racquet and Wessin.

ANATOMY OF A DERIVATIVE LAWSUIT

- Claim by shareholder seeking relief for and asserting right of corporation
- Governed by Rule 23.06
- Contemporaneous ownership
- Adequacy of representation
- Presuit demand requirement/demand futility
- Special Litigation Committee
- Settlement to be approved by Court.
- Attorneys fees for benefit to Corporation.

COMMON LEGAL CLAIMS BY MINORITY SHAREHOLDERS

- **Section 302A.751**
  - Reasonable expectations
  - Unfairly prejudicial conduct by those in control
  - Deadlock
  - Recognizes the "duty which all shareholders in a closely held corporation owe one another to act in an honest, fair and reasonable manner"
  - Requires court to consider 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."

- Breach of Fiduciary Duty
- Self Dealing by those in Control
- Usurping Corporate Opportunity
- Breach of Duty of Loyalty
- Conversion
- Fraud

REASONABLENESS OF EMPLOYMENT EXPECTATION

- Employment part of investment?
- Known and accepted by other shareholders?
- Shareholder misconduct or incompetence?
- Agreement specifically providing for termination?
- Any capital investment? Or part of compensation package?

ASSESSING SHAREHOLDER EXPECTATIONS

- Written agreements not dispositive
- Controlling shareholder have a substantive obligation of fairness
- Obligation of complete candor in negotiations
  - But see Berreman v. West Pub.,
- "Associative bargaining," i.e. the understandings reasonable shareholders would have reached if they had bargained over how their investments should be protected.

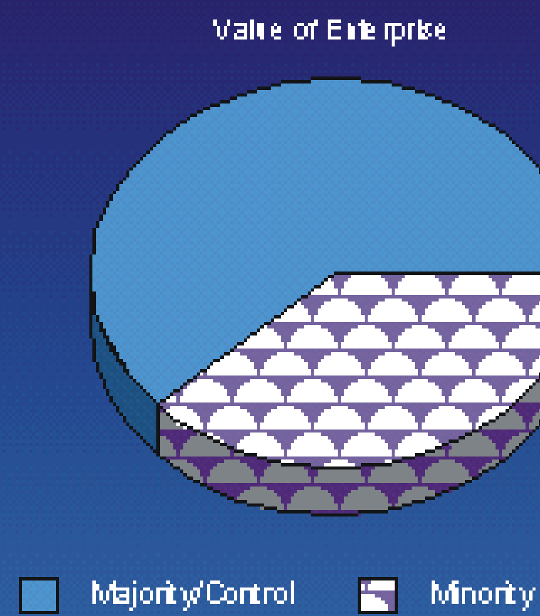
SOURCES OF COURT AUTHORITY

- Broad equitable authority
  - 302A.467
  - 302A.751
- Writ of Mandamus
- Buyout under 302A.751
- Dissolve corporation under 302A.751

DISSENTER'S RIGHTS

- 302A.471 and 302A.473.
- "Court * * * shall determine the fair value of the shares, taking into account any and all factors the court finds relevant, computed by any method or combination of methods that the court, in its discretion, sees fit to use, whether or not used by the corporation or by a dissenter." Minn. Stat. 302A.473 subd. 7.

FAIR VALUE v. FAIR MARKET VALUE



DISCOUNTS

- Minority
  - Not allowed. MT Properties v. CMC Real Estate Corp., 481 N.W.2d 383 (Minn. Ct. App. 1992).
- Marketability
  - Allowed only under extraordinary circumstances
  - Ok to prevent "unfair wealth transfer." Advanced Communication Design, Inc. v. Follett, 615 N.W.2d 285 (Minn. 2000)

TYRANNY BY THE MINORITY

- Inspection of Books and Records under 302A.461
  - Public Corporation = Proper purpose test
  - Privately held Corporation = Some automatic and some proper purpose
  - Burden
  - Protective Order
  - Other Use Prohibited
- Repeated lawsuits
- Create disruption and dissension.
- No fiduciary duty where no control. Advanced Communications v. Follett

HOW DOES PLANNING HELP?

- Agreements specifically enforceable under 302A.457.
- Written agreements presumed to reflect the parties' reasonable expectations presumed to be those in the documents.
- Price and terms presumed to be determined by agreement, "unless the court determines that the price or terms are unreasonable under all the circumstances of the case."
- But see, Powell v. Anderson

BEWARE OF CONFLICT

- Evans v. Blesi
- Miller Waste Mills v. Mackay

KEY ELEMENTS OF SARBANES OXLEY ACT

- Extend statute of limitations for securities fraud.
- CEO and CFO must certify. Jail.
- New Action against D's and O's for insider trading during blackout period.
- Whistleblower protection.
- 2 Biz day disclosure of insider stock sales.
- Prediction: Will make auditors richer.
- Prediction: Will make securities lawyers richer.