

# **CORPORATE GOVERNANCE**

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## I. INTRODUCTION

Family-owned and other closely held businesses often ignore corporate governance rules. The “formality” associated with proper corporate governance may be contrary to the informality with which families or friends who form businesses together prefer to operate, or the historical manner in which many closely held businesses have operated. But such companies ignore corporate governance rules at their peril. Understanding and following the rules will generally result in more clearly defined expectations and roles within the company, hopefully resulting in a more effective and well-run business. Regular shareholder meetings, for example, can help improve communication and preemptively help to address problems that may arise in the future. Following the rules of corporate governance can also help in reducing the potential for disruptive and expensive shareholder disputes, and assure that the liability shield that establishing a business as a corporation is designed to provide its shareholders is preserved.<sup>1</sup> Thus, careful observance of the corporate rules can have many practical, legal and economic benefits. Because the rules can be complicated and/or confusing for shareholders, directors and officers of closely

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<sup>1</sup> A company’s lack of adherence to corporate formalities and corporate governance rules can risk the application of the corporate veil-piercing doctrine. In determining whether to apply the doctrine, Minnesota courts look to a number of factors. Specifically, courts rely upon the two-prong test first articulated by the Minnesota Supreme Court in *Victoria Elevator Co. v. Meriden Grain Co.*, 283 N.W.2d 509 (Minn. 1979). The first prong of the Victoria Elevator test considers whether or not the shareholder has established a sufficiently separate corporate entity according to the following factors, which are not exclusive:

1. Insufficient capitalization for purposes of the corporate undertaking;
2. Failure to observe corporate formalities;
3. Nonpayment of dividends;
4. Insolvency of the debtor corporation;
5. Siphoning of funds by a dominant shareholder;
6. Nonfunctioning of other officers and directors;
7. Absence of corporate records;
8. Existence of the corporation as a mere façade for individual dealings.

*Id.* at 512. More than one, but not all, of these factors must be present in order to provide a basis for corporate veil-piercing. *See id.*

Under the second prong of the test, the court looks to whether piercing the corporate veil is required by fairness and whether the corporate entity has been operated in an unjust manner with respect to the plaintiff. *Id.*; *White v. Jorgenson*, 322 N.W.2d 607, 608 (Minn. 1982)

held corporations, it is all the more important that attorneys representing family corporations or their principals have a working understanding of the rules that apply.<sup>2</sup>

## **II. SOURCES OF CORPORATE GOVERNANCE RULES**

The most common sources of rules that govern the existence and operations of a corporation are the Articles, the Bylaws, or other agreements such as Shareholder Control Agreements, Buy-Sell Agreements, or Employment Contracts. In addition, the Minnesota Business Corporations Act (“MBCA”), Minn. Stat. Ch. 302A,<sup>3</sup> contains many procedural and substantive provisions relating to corporate governance, including many “default” provisions that apply to Minnesota corporations unless the Articles or Bylaws modify the statutory requirements. Each of these sources is discussed below.

### **A. The Articles**

The corporate existence begins with the filing of the Articles of Incorporation. Minn. Stat. § 302A.153. Because of this, it is important to have an awareness of the premature commencement of business. In the absence of a corporate existence, persons working together to earn a profit are presumed to be engaged in a partnership, and to share profits and losses in accordance with the rules that apply to partnerships. Minn. Stat. § 323A.0202; *Brcka v. Falcon Elec. Corp.*, 2001 WL 641524, at \*6-7 (Minn. Ct. App. June 12, 2001) (“The supreme court has . . . recognized, without adopting, the rule that when a business is operated following a failure to perfect a contemplated incorporation, the business becomes a partnership. The supreme court [has also] applied the rule that when a business successfully incorporates but later fails to operate as a corporation, the business becomes a partnership.”). Historically, a de facto

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<sup>2</sup> The rules can also be confusing to attorneys. These materials identify and summarize a number of statutory corporate governance provisions. But practitioners, in advising their clients, should carefully review not only the entire statutory provisions, but also the Reporter’s Notes and related caselaw.

<sup>3</sup> These materials focus primarily on the rules applicable to corporations as governed by Chapter 302A. Minn. Stat. Ch. 322B, governing Limited Liability Companies, contains many parallel provisions applicable to LLCs.

corporation might be found to exist in Minnesota where there was (1) some law under which a corporation with powers assumed might lawfully have been created; (2) a colorable and *bona fide* attempt to perfect an organization under such a law; and (3) user of the rights claimed to have been conferred by the law. *Stone v. Jetmar Properties*, 733 N.W.2d 480, 485 (Minn. Ct. App. 2007). However, this rule has since been superseded by statute. *Id.* (citing Minn. Stat. § 302A.153, Reporter’s Notes, which state that “the effective date should coincide with filing so that there can be no doubt that all subsequent corporate acts are the acts of a de jure corporation. This is important because the doctrine of de facto corporations is inapplicable in this state after the enactment of this act.”). Therefore, it is important that if any decisions or actions have been taken on behalf of the corporation before the Articles have been filed that the Company ratify them upon coming into existence.

The Articles must include the name of the corporation, the address of the registered office of the corporation and the name of registered agent, if any, at that address; the aggregate number of shares that the corporation has authority to issue; and the name and address of each incorporator. Minn. Stat. § 302A.111, subd. 1. The MBCA also lists a number of provisions that “may” be included in the Articles, and other provisions that may be included in either the Articles or the Bylaws. *Id.*, subd. 4.

Generally, the Articles can be amended or modified only in accordance with Sections 302A.133 to 302A.139. Minn. Stat. § 302A.131. Only Shareholders can amend the Articles. Minn. Stat. § 302A.135, subds. 2, 4.

LLC’s have rules that are similar to those that apply to corporations with regard to their Articles of Organization. See Minn. Stat. § 322.B.115.

## **B. Bylaws**

After the filing of Articles of Incorporation, the incorporators or the directors named in the Articles can either hold an organizational meeting or take written action to complete the organization of the business, including adoption of Bylaws. Minn. Stat. § 302A.171. The purpose of Bylaws is to establish rules for the internal government of the corporation. *Little Canada Charity Bingo Hall Ass'n v. Movers Warehouse, Inc.*, 498 N.W.2d 22, 24 (Minn. Ct. App. 1993). Bylaws are optional. Minn. Stat. § 302A.181, subd. 1 (corporations “may, but need not, have bylaws”). However, once adopted, Bylaws “must be obeyed” by the corporation, its directors, officers, and stockholders. *Little Canada Charity Bingo Hall Ass'n*, 498 N.W.2d at 24 (quoting *Diedrick v. Helm*, 14 N.W.2d 913, 921 (Minn. 1944)); *see also Isaacs v. Am. Iron & Steel Co.*, 690 N.W.2d 373, 376 (Minn. Ct. App. 2004). In contrast to the Articles, the shareholders and board of directors *both* have power to amend or modify the Bylaws. Minn. Stat. § 302A.181, subs. 2-3. Bylaws are to be fair and reasonable. *Bosch v. Meeker Co-op. Light & Power Ass'n*, 91 N.W.2d 148, 152 (Minn. 1958). At least one Minnesota court has likened Bylaws to contracts. *Miller Waste Mills v. Mackay*, 520 N.W.2d 490, 495 (Minn. Ct. App. 1994) (referring to stock purchase option provision of Bylaws as a “contractual repurchase option”). Generally, a director or member can challenge a corporation’s failure to adhere to its Bylaws, but a third party has no power to challenge a corporation based upon such a violation. *Little Canada Charity Bingo Hall Ass'n*, 498 N.W.2d at 24.

LLCs have rules similar to those applicable to a corporation’s Bylaws. Minn. Stat. §§ 322B.60, 322B.603.

### C. Contracts

There are a number of types of contracts that commonly serve as a source for rules that govern the management or operations of a corporation. These may include Shareholder Control Agreements, Voting Agreements, Buy-Sell Agreements, and Employment Agreements.<sup>4</sup>

Shareholder Control Agreements are written agreements among shareholders that relate to the control of any phase of the business and affairs of the corporation, the relations between and among the shareholders, and/or its liquidation/dissolution. Minn. Stat. § 302A.457, subd.1. A Shareholder Control Agreement is *specifically enforceable* as long as it is signed by all the shareholders, *id.*, but such agreements must not violate statutory provisions that cannot be modified. One example of the use of such agreements is to avoid the likelihood of structural deadlock. A corporation owned 50% by each of two people, for example, may have a Shareholder Control Agreement providing that one person or the other has authority with regard to specifically well-defined matters of the corporation's business.

Voting Agreements are another way that Shareholders can govern their corporation. An agreement by a number of stockholders to combine their votes in order to effectuate a particular policy is not unlawful in absence of evidence of intent to defraud other stockholders or to secure a private benefit at expense of the corporation or the other stockholders. *Hart v. Bell*, 23 N.W.2d 375, 380 (Minn. 1946). Voting Agreements are written agreements "among persons who are then shareholders or subscribers for shares to be issued relating to the voting of their shares." Minn. Stat. § 302A.455. These agreements are valid and specifically enforceable by and against

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<sup>4</sup> Common agreements utilized in limited liability companies are Member Voting Agreements (Minn. Stat. § 322B.366), Member Control Agreements (Minn. Stat. § 322B.37), and Operating Agreements (although Minn. Stat. § 322B.603 was amended in 1999 to substitute "bylaws" for "operating agreement" as the statute's term of art. See Reporter's Notes – 1999 to Minn. Stat. § 322 B.603.)

the parties to an agreement. *Id.* Voting Agreements among members of LLC's are governed by Minn. Stat. § 322B.366.

Buy-Sell agreements are governed by Minn. Stat. § 302A.429. Section 429 dictates that a written restriction on the transfer of shares, whether set forth in the Articles, Bylaws, shareholder resolution, or agreement, is enforceable if it is not “manifestly unreasonable under the circumstances” and is either (1) noted conspicuously on the face or back of the certificate; or (2) included in information sent to the holders of uncertified shares. *Id;* see also, *Miller Waste Mills*, 520 N.W.2d at 495 (enforcing contractual repurchase option contained in the Bylaws). Buy-Sell agreements generally contain conditions and limitations upon the transfer of shares in a corporation. The company or certain shareholders may, for example, be obligated or have the option to purchase the shares of other shareholders if certain contingent events occur, such as death, disability, or termination of employment. Sometimes, these agreements are intertwined with employment agreements, where for example an employee is given shares as part of his or her compensation, and if he or she is terminated, the termination triggers an obligation to sell those shares back to the corporation or to the other shareholders. Another common use of Buy-Sell agreements is to require a shareholder to give the other shareholders and the corporation the right of first refusal in the event that the shareholder would like to sell or transfer his or her shares.

#### **D. Statutory Default Provisions**

The MBCA contains a number of provisions governing corporate activities that apply unless the corporation has modified these rules through its own corporate governance documents. Approximately 20 of these provisions can be modified only in the Articles or in a

Shareholder Control Agreement (but not in the Bylaws). Minn. Stat. § 302A.111, subd. 2.

Among the important statutory provisions that fall into this category are the following:

- The power to adopt or amend Bylaws vested in the Board (Section 302A.181)
- Cumulative voting for directors (Section 302A.215, subd. 2)
- All shares are common shares entitled to vote and are of one class (Section 302A.401, subd. 2)
- All shares have equal rights and preference as to all matters not otherwise provided for by the board (Section 302A.401, subd. 2).
- Certain preemptive rights of shareholders (Section 302A.413).

A comparable number of statutory provisions can be modified in the Articles, in a Shareholder Control Agreement, or in the Bylaws. *Id.*, subd. 3. This set of provisions includes the following examples:

- Directors serve indefinite terms that expire at the next regular meeting of shareholders (Section 302A.207)
- Compensation of directors is fixed by the Board (Section 302A.211)
- Certain methods for removal of board members or filling board vacancies (Sections 302A.223, 302A.225)
- Notice of board meeting need not state the purpose (Section 302A.231, subd. 3)
- Rules regarding establishment of committees (Section 302A.241)
- Mandatory indemnification for officers and directors (Section 302A.521).

The following discussion of various corporate governance rules is based on provisions of the MBCA. As discussed, some of these provisions may be modified in the Company's Articles, Bylaws, or Agreements.

### **III. SHAREHOLDER MEETINGS**

Shareholders are to have an initial meeting to elect a board of directors. Minn. Stat. § 302A.171. Meetings of shareholders are to be held annually or on a less frequent periodic basis, but need not be held unless required by the Bylaws or Articles. Minn. Stat. § 302A.431. The old statute required meetings once a year, but this is no longer the case. If a meeting has not been held in the last 15 months, however, a shareholder or shareholders holding 3% or more of the shares may call a regular meeting. *Id.*, subd. 2. The meeting can cover any business and also includes an election of any directors who serve for an indefinite term. *Id.*, subd. 4.

Special meetings of shareholders may be called by the CEO, CFO, two or more directors, a person authorized by the Articles or Bylaws, or a shareholder or shareholders with 10% or more of shares. Minn. Stat. § 302A.433, subd. 1. Business at special shareholder meetings is limited to the purpose stated in the notice for the meeting. *Id.*, subd. 4. The special meeting provision allowing meetings to be called by a shareholder or shareholders with 10% of the shares is mandatory and cannot be changed by Articles or Bylaws. *See* Minn. Stat. § 302A.111, subs. 1, 2 (not listing Section 433 as a provision that can be modified in the Articles, a Shareholder Control Agreement, or the Bylaws). If either a regular or special shareholder meeting is held due to demand of one or more shareholders, it must be held in the county where the principal executive officer of the corporation is located. Minn. Stat. § 302A.431, subd. 3; 302A.433, subd. 3.

Notice of any meeting must be given to every shareholder entitled to vote. Minn. Stat. § 302A.435. Absent a specific notice requirement fixed by law (or shorter period established by the Articles or Bylaws), notice of a shareholders meeting must be given at least 10 days, but not more than 60 days, before the meeting. *Id.*, subd. 2. Meetings to approve certain transactions,

such as mergers, require a lengthier notice period. *E.g.*, Minn. Stat. § 302A.613, subd. 1 (plan of merger exchange must be submitted at a shareholder meeting for which written notice is provided at least 14 and not more than 60 days before the meeting). Meetings may take place by telephone or other remote communication. Minn. Stat. §§ 302A.431, subd. 3, 302A.433, subd. 3, 302A.436.

A shareholder may cast votes by appointing a written proxy filed with a corporate officer at or before a shareholder meeting. Minn. Stat. § 302A.449.

#### **IV. BOARD MEETINGS**

Meetings of the board may be held as provided in the Articles or Bylaws at any place that the board chooses. Minn. Stat. § 302A.231, subd. 1. They can also take place by remote communication. *Id.*, subd. 2. Unless the Articles or Bylaws provide otherwise, a director may call a board meeting by giving at least ten days' notice. *Id.*, subd. 4. The notice need not state the purpose of the meeting unless the Articles or Bylaws require it. *Id.* One issue that can sometimes create friction is whether a board member is entitled to have his or her personal lawyer present at a board meeting. The caselaw on this issue is relatively limited. *See*, P. Colton, *A Corporate Director's Right to Counsel at Board Meetings: When is the Door Closed to Counsel?*, 71 THE HENNEPIN LAWYER 16 (July/Aug. 2002) (discussing caselaw and concluding that little reliance can be placed in the caselaw and statutory commentary on the issue).

#### **V. WRITTEN ACTIONS**

An action that is required or permitted to be taken at a shareholder meeting may be taken by written action signed or consented to by authenticated electronic communication by all of the shareholders entitled to vote in the action. Minn. Stat. § 302A.441. The Board can take any

action by written action if it is allowed in the Articles and is an action that does not require shareholder approval. Minn. Stat. § 302A.239. For the board to take written action the action has to be either signed or consented to by authenticated electronic communication by all of the directors. *Id.*

## **VI. COMMITTEES**

Generally, a resolution approved by the affirmative vote of a majority of the board may establish committees having the authority of the board in the management of the business of the corporation only to the extent provided in the resolution. Minn. Stat. § 302A.241, subd. 1. A committee does not have to consist of board members, but committee members must be natural persons. *Id.*, subd. 2. Notably, though one need not be a director to be a member of a committee, all committee members are deemed to be directors for the purpose of the standard of conduct rules expressed in Minn. Stat. § 302A.251, conflict of interest rules expressed in Minn. Stat. § 302A.255, and the indemnification provisions of Minn. Stat. § 302A.521. Committees – other than the special litigation committees (discussed in Section XI below) – are subject to the direction and control of the board. Minn. Stat. § 302A.241, subd. 1. A committee may create a subcommittee and delegate some or all of its authority to that subcommittee. *Id.*, subd. 2a. A subcommittee can consist of one or more members of the committee. *Id.* “The establishment of, delegation of authority to, and action by a committee does not alone constitute compliance by a director with the standard of conduct set forth in section 302A.251.” *Id.*, subd. 6.

## **VII. BOARD MEMBERS**

### **A. Standard of Conduct**

Minn. Stat. § 302A.251, subd. 1 provides that a director shall discharge the duties of the position of director in good faith (honesty in fact), 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. Directors owe a fiduciary duty to the corporation and to the corporation's shareholders. *Wenzel v. Mathies*, 542 N.W.2d 634, 641 (Minn. Ct. App. 1996); *In re Fergus Falls Woolen Mills Co.*, 41 F.Supp. 355, 364 (D. Minn. 1941). In addition to the standard of conduct and duties of a director, Minnesota law imposes additional duties on one who is also a shareholder of a closely held corporation. Such shareholders "owe one another [the duty] to act in an honest fair, and reasonable manner in the operation of the corporation." Minn. Stat, § 302A.751, subd. 3a; *see also, Evans v. Blesi*, 345 N.W.2d 775, 779 (Minn. Ct. App. 1984) (law imposes on such shareholders the "highest standard of integrity in their dealings with each other").

In fulfilling his or her duties, a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data prepared or presented by: (1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented; (2) counsel, public accountants, or other persons as to matters that the director reasonably believes are within the person's professional or expert competence; or (3) a committee of the board upon which the director does not serve, duly established in accordance with section 302A.241, as to matters within the designated authority, if the director reasonably believes the committee to merit confidence. Minn. Stat. § 302A.251, subd. 2. Nonetheless, if a director who has knowledge concerning the matter in question that makes his or her reliance on any of the last three sources of information unwarranted, but relies upon them anyway, that director may be vulnerable to a claim that he or she has violated the standard of conduct required of a director. *Id.*

In considering the best interests of the corporation, a director may consider the interests of the corporation's employees, customers, suppliers, and creditors, the economy of the state and nation, community and societal considerations, and the long-term as well as short-term interests of the corporation. *Id.*, subd. 5.

A director who is present at a meeting of the board when an action is approved by affirmative vote of a majority of the directors present is presumed to have assented to the action approved, unless the director: (1) *objects* at the beginning of the meeting to the transaction of business because the meeting is not lawfully called or convened and does not participate thereafter in the meeting; (2) *votes against* the action at the meeting; or (3) is *prohibited* by section 302A.255 from voting on the action. *Id.*, subd. 3.

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 in the Articles. However, the Articles shall not eliminate or limit the liability of a director: (a) for any *breach of the director's duty of loyalty* to the corporation or its shareholders; (b) for *acts or omissions not in good faith* or that involve intentional misconduct or a knowing violations of the law; (c) under section 302A.559 (liability for illegal distributions) or 80A.23 (securities law violations); (d) for any transaction from which the director derived an improper personal benefit; or (e) for any act or omission occurring prior to the date when the provision in the Articles eliminating or limiting liability becomes effective. Minn. Stat. § 302A.251, subd. 4.

LLC's have similar rules regarding the standard of conduct required. Minn. Stat. § 322B.663.

## **B. Election**

Directors must be natural persons. The method of their election and any additional qualifications for directors can be determined by the terms of the Articles or Bylaws. Minn. Stat. § 302A.205. To be elected to the board, a director only needs to receive a plurality (as opposed to a majority) of the voting shares present. Minn. Stat. § 302A.215, subd. 1. Unless the Articles provide otherwise, this section provides for cumulative voting. *Id.* Cumulative voting means that the shareholder gets to cast a number of votes equal to the number of shares he or she owns *multiplied* by the number of directors up for election – and can designate the votes entirely for one candidate or distribute the votes on multiple candidates as he or she desires. *Id.*, subd. 2. This can be an important aspect of minority shareholders' rights, because cumulative voting allows even minority shareholders with sufficient (but less than majority) voting power to achieve board representation. Importantly, shareholders planning to cumulate their votes must give written notice of that intent before the vote on the election. *Id.* The ability to modify or amend the Articles or Bylaws to deny or restrict cumulative voting is restricted, and cannot be achieved if enough shares sufficient to elect a single director under cumulative voting vote against the amendment. *Id.*, subd. 3.

LLC's also have rules that provide for cumulative voting. Minn. Stat. § 322B.63.

## **C. Vacancies**

Unless different rules for filling vacancies are provided for in the Articles or Bylaws, vacancies on the board resulting from the death, resignation, removal, or disqualification of a director may be filled by the affirmative vote of a majority of the remaining directors, even if they constitute less than a quorum. Minn. Stat. § 302A.225. Vacancies on the board resulting from newly created directorships may be filled by the affirmative vote of a majority of the

directors serving at the time of the increase. *Id.* Each director elected by the board to fill a vacancy holds office until a qualified successor is elected by the shareholders at the next regular or special meeting of the shareholders. *Id.*

#### **D. Removal**

Any or all of the directors may be removed at ANY time with or without cause, if (1) the director was named by the board to fill a vacancy; (2) the shareholders have not elected directors in the interval between the time of the appointment to fill a vacancy and the time of the removal; and (3) a majority of the remaining directors present affirmatively vote to remove the director.

Minn. Stat. § 302A.223. A director also can be removed by shareholders by vote of majority of shares. *Id.* In a corporation that has cumulative voting, unless the entire board is removed simultaneously, a director is not removed from the board if there are votes sufficient to elect the director at an election of the entire board under cumulative voting cast against removal of the director. *Id.*, subd. 4.

### **VIII. Officers**

#### **A. Standard of Conduct**

An officer must 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. Minn. Stat. § 302A.361. This standard includes the duties of good faith, loyalty, and care. “Officers are subject to much the same standard of conduct as are directors, with a few differences.” *Id.*, Reporter’s Notes; *see also, Miller v. Miller*, 222 N.W.2d 71, 78 (Minn. 1974) (officers entrusted with active management occupy fiduciary relationship to the corporation). The standard of conduct is not automatically met, as in the case of directors, by reason of reliance upon

information provided by others unless it is subsumed under the circumstances within the phrase “ordinarily prudent person in a like position under similar circumstances.” Minn. Stat.

§ 302A.351, Reporters Notes. An officer has no right to rely on information provided by another person if the matter relied upon is within that officer’s area of direct responsibility. *Id.* “On the other hand, that officer may have a right to rely on others if the matter is outside the scope of the relying officer's responsibility.” *Id.*

### **B. Election/Appointment**

The Board of Directors appoints the corporate officers. The MBCA specifically calls for appointment of a chief executive officer and chief financial officer. Minn. Stat. § 302A.305. In addition, “[t]he board may elect or appoint, in a manner set forth in the articles or bylaws or in a resolution approved by an affirmative vote of a majority of the directors present, any other officers or agents the board deems necessary for the operation and management of the corporation....” Minn. Stat. § 302A.311. “Any number of offices or functions of those offices may be held or exercised by the same person.” Minn. Stat. § 302A.315. Officers are required, and persons exercising the functions of officers are deemed elected. Minn. Stat. §§ 302A.301; 302A.321. This rule has had a comparable existence as the “de facto” officer rule. A “de facto officer” of private corporation is one exercising powers of office under color of election or appointment. *State v. Kylmanen*, 231 N.W. 197, 198 (Minn. 1930) (“The general rule is that a person is a director de facto where he is in possession of the office and exercising the duties thereof under color or appearance of right. . . . One may be a de facto officer though he is ineligible to hold the office.”).

LLC’s have similar rules. Managers are required. Minn. Stat. § 322B.673. The standard of conduct required of managers of an LLC is located in Minn. Stat. § 322B.69.

### **C. Removal**

An officer may resign by giving written notice to the corporation. Minn. Stat. § 302A.341, subd. 1. An officer may be removed at any time, with or without cause, by a resolution approved by the affirmative vote of a majority of the directors present, subject to the provisions of a shareholder control agreement. *Id.*, subd. 2. A Minnesota court has held that a CEO does not have authority to terminate a CFO (unless the Shareholder Control Agreement provides otherwise), as this authority is vested in the board. *Fisher v. Jeddeloh*, No. A07-0630, 2008 WL 933478 at \*2 (Minn. Ct. App. April 8, 2008).

### **IX. CONFLICTS OF INTEREST**

Minnesota corporate governance rules specifically address the handling of conflict of interest transactions. Corporate transactions with a director (or entity related to a director) should be approved in a manner consistent with Minn. Stat. § 302A.255. Under that statute,

a contract or transaction between a corporation and one or more of its directors, or between a corporation and an organization in or of which one or more of its directors are directors, officers, or legal representatives or have a material financial interest, is not void or voidable because the director or directors (or related organizations) are parties or because the director or directors are present at the meeting of the shareholders or the board or a committee at which the contract or transaction is authorized, approved, or ratified, if it is approved in a manner consistent with any of the following:

(a) The contract or transaction was, and the person asserting the validity of the contract or transaction sustains the burden of establishing that the contract or transaction was, fair and reasonable as to the corporation at the time it was authorized, approved, or ratified;

(b) The material facts as to the contract or transaction and as to the director's or directors' interest are fully disclosed or known to the holders of all outstanding shares, whether or not entitled to vote, and the contract or transaction is approved in good faith by (1) the holders of two-thirds of the voting power of the shares entitled to vote which are owned by persons other than the interested director or directors, or (2) the unanimous affirmative

vote of the holders of all outstanding shares, whether or not entitled to vote;

(c) The material facts as to the contract or transaction and as to the director's or directors' interest are fully disclosed or known to the board or a committee, and the board or committee authorizes, approves, or ratifies the contract or transaction in good faith by a majority of the directors or committee members currently holding office, but the interested director or directors shall not be counted in determining the presence of a quorum and shall not vote; or

(d) The contract or transaction is a distribution described in section 302A.551, subdivision 1, [outlining certain standards for making distributions], or a merger or exchange described in section 302A.601, subdivision 1 or 2.

Minn. Stat. § 302A.255, subd. 1.

In one Minnesota case, a corporation had four directors present at a board meeting. *Possis Corp. v. Continental Machine Inc.*, 425 N.W.2d 286, 290-92 (Minn. Ct. App. 1988). Two of them were “interested” directors with a conflict of interest. *Id.* at 289. The other two were “non-interested,” or independent, directors. *Id.* The two interested directors were not allowed to vote on the transaction because they had a conflict of interest. *Id.* at 290. The two remaining independent directors voted for the corporate action; however, they did not represent a “majority of the directors present” to pass the action under Minn. Stat. § 302A.237. *Id.* at 291-92. The corporate act was therefore void. *Id.* at 292.

LLC’s have similar rules. Minn. Stat. § 322B.666

## **X. COMPENSATION**

Subject to any limitations in the Articles or Bylaws, the board may fix the compensation of directors. Minn. Stat. § 302A.211. Traditionally, the board has set the salary for the officers as well as the directors. *See, e.g., Schmitt v. Eagle Roller Mill*, 272 N.W. 277, 285 (Minn. 1937) (refusing to find that salary for officer as set by directors was excessive); *cf. C.J. Duffey Paper Co. v. Reger*, 588 N.W.2d 519 (Minn. App. 1999) (affirming award of officer compensation

where CEO had set his own compensation). There are fiduciary considerations in setting levels of compensation. Minn. Stat. § 302A.211, Reporter's Notes. The board should consider the financial health of the corporation in setting such compensation, *see Backus v. Finkelstein*, 23 F.2d 531, 537 (D. Minn. 1924), and conform to the business judgment rule. A salary should not be unreasonable, excessive, or arbitrary. *Seitz v. Union Brass & Metal Mfg. Co.*, 189 N.W. 586, 587 (Minn. 1922). Such a salary may be vulnerable to a suit in equity brought by a minority shareholder. *Id.*; *see also* Minn. Stat. § 302A.211, Reporter's Notes (noting that unreasonable director compensation may be challenged through an action for equitable relief under Section 302A.467). Additionally, a Minnesota court has held that bonuses received by corporate officers without authority from board of directors must be returned. *Barrett v. Smith*, 242 N.W. 392, 395 (Minn. 1932). Generally, a claim that excess compensation should be repaid to the corporation is viewed to be a derivative action brought on behalf of the corporation rather than a direct claim brought on behalf of shareholders – even in closely held corporations – unless the claim is that one director has been excluded from compensation paid to others. *Wessin v. Archives Corp.*, 592 N.W.2d 460, 465 (Minn. 1999).

An officer or director may not be entitled to compensation while he is acting without good faith. *Seitz*, 189 N.W. at 588-89; *see also, Bolander v. Bolander*, 703 N.W.2d 529, 548 (Minn. Ct. App. 1999) (equitable relief, including forfeiture of compensation, may be appropriate where director/officer violated statutory standard of care to act in corporation's best interests).

A board resolution fixing compensation of a director as a director, officer or employee is not viewed to be a transaction between the corporation and a director with a material financial interest under the interested director transaction statute, Section 302A.255. Therefore, the

participation by a director in approving his or her compensation does not render the compensation arrangement void or voidable. Minn. Stat., § 302A.255, subd. 2.

LLC's have similar rules. Minn. Stat. § 322B.623.

## **XI. SPECIAL LITIGATION COMMITTEES**

Special litigation committees may be utilized by corporations in response to shareholder derivative lawsuits or in other situations where claims of the corporation must be considered.

“Committees may include a special litigation committee consisting of one or more independent directors or other independent persons to consider legal rights or remedies of the corporation and whether those rights and remedies should be pursued.” Minn. Stat. § 302A.241. Special litigation committees enable a corporation to determine whether to pursue claims or to seek to dismiss or settle a derivative suit (suit brought by a shareholder on behalf of the corporation), and are often used where members of the Board, which would otherwise act with respect to the lawsuit, suffer from a conflict of interest. *In re UnitedHealth Group*, 754 N.W.2d 544, 550-51 (Minn. 2008); *see also* Vincent Louwagie and Cory Olson, *Cutting the Cost of Derivative Claims: The Role of the Special Litigation Committee*, BENCH & BAR OF MINN. (March 2009).

The special litigation committee must satisfy the requirements of the business judgment rule. *In re United Health Group*, 754 N.W.2d at 551. A court defers to the decision of a special litigation committee if a board properly delegates its authority to act to the special litigation committee. *Id.* A court should defer to an SLC's decision with respect to a shareholder derivative action “if (1) the members of the SLC possessed a disinterested independence and (2) the SLC's investigative procedures and methodologies were adequate, appropriate, and pursued in good faith.” *Id.* at 559. In order to determine whether the special litigation committee is independent and therefore complies with the business judgment rule, the court

examines the totality of the circumstances. *Id.* at 560. The Minnesota Supreme Court has noted that the factors employed by other courts in examining such independence included, but were not limited to:

- (1) whether the members are defendants in the litigation;
- (2) whether the members are exposed to direct and substantial liability;
- (3) whether the “members are outside, non-management directors”;
- (4) whether the members were on the board when the alleged wrongdoing occurred;
- (5) whether the “members participated in the alleged wrongdoing”;
- (6) whether the members approved conduct involving the alleged wrongdoing;
- (7) whether the members or their affiliated firms “had business dealings with the corporation other than as directors”;
- (8) whether the members “had business or social relationships with one or more of the defendants”;
- (9) whether the members received advice from independent counsel or other independent advisors;
- (10) the severity of the alleged wrongdoing; and
- (11) the size of the committee.

*Id.* at 560 n.11 (citation omitted).

If the special litigation committee fails to meet the requirements of good faith and adequate independence such that its decision merits no judicial deference, the corporation does not get a “do over” regarding the decision to allow the shareholder derivative action to proceed. *See Janssen v. Best & Flanagan*, 662 N.W.2d 876, 888-90 (Minn. 2003). Instead, “when the committee authorized with making a business decision for the corporation is found to lack the independence needed to grant summary judgment, or where the independence is uncertain, the derivative suit proceeds on its merits.” *Id.* at 889 (declining to consider adequacy of a second investigation allegedly correcting defects in the initial investigation where initial investigation was inadequate).

## **XII. INDEMNIFICATION RIGHTS**

Officers and directors who are sued, or otherwise become embroiled in litigation with respect to conduct as an officer or director may be entitled to indemnification from liability

and/or payment of attorneys' fees by the company. Under the MBCA, a corporation "shall" indemnify a person made or threatened to be made a party to a proceeding by reason of the former or present "official capacity" as an officer or director if, with respect to the acts or omissions of the person complained of in the proceeding, the person:

1. has not been indemnified by another source;
2. acted in good faith;
3. received no improper personal benefit;
4. in the case of a criminal proceeding, had no reasonable cause to believe the conduct was unlawful; and
5. believed the conduct was in the best interests of the corporation (see statute for caveat).

Minn. Stat. § 302A.521, subs. 1-2. In addition, such an officer or director is entitled to payment or reimbursement by the corporation of attorneys' fees and expenses in advance of the final disposition of the case if s/he provides a written affirmation of a good faith belief that the criteria for indemnification have been satisfied and to repay any amounts received if it is ultimately determined that the criteria have not been satisfied and the facts then known would not preclude indemnification. *Id.*, subd 3.

The Articles or Bylaws either may prohibit indemnification or advances of expenses otherwise required or may impose conditions on indemnification or advances of expenses in addition to the other conditions in Section 521, including monetary limits on indemnification or advances of expenses, as long as the prohibition or conditions apply equally to all persons or to all persons within a given class. *Id.*, subd. 4.

The individuals typically seeking indemnification or advance of attorneys' fees are often Board members, so the corporation must consider the appropriate manner of determining eligibility for indemnification or advances. Section 521, subd. 6 provides that such

determinations in advance of final disposition of the proceeding may be made in any of the following ways:

(1) by the board by a majority of a quorum, if the directors who are at the time parties to the proceeding are not counted for determining either a majority or the presence of a quorum;

(2) if a quorum under clause (1) cannot be obtained, by a majority of a committee of the board, consisting solely of two or more directors not at the time parties to the proceeding, duly designated to act in the matter by a majority of the full board including directors who are parties;

(3) if a determination is not made under clause (1) or (2), by special legal counsel, selected either by a majority of the board or a committee by vote pursuant to clause (1) or (2) or, if the requisite quorum of the full board cannot be obtained and the committee cannot be established, by a majority of the full board including directors who are parties;

(4) if a determination is not made under clauses (1) to (3), by the affirmative vote of the shareholders required by section 302A.437, but the shares held by parties to the proceeding must not be counted in determining the presence of a quorum and are not considered to be present and entitled to vote on the determination;  
or

(5) if an adverse determination is made under clauses (1) to (4) or under paragraph (b), or if no determination is made under clauses (1) to (4) or under paragraph (b) within 60 days after (i) the later to occur of the termination of a proceeding or a written request for indemnification to the corporation or (ii) a written request for an advance of expenses, as the case may be, by a court in this state, which may be the same court in which the proceeding involving the person's liability took place, upon application of the person and any notice the court requires. The person seeking indemnification or payment or reimbursement of expenses pursuant to this clause has the burden of establishing that the person is entitled to indemnification or payment or reimbursement of expenses.

Minn. Stat. § 302A.521. subd. 6.

Section 521 also provides that the termination of a proceeding by “judgment, order, settlement, conviction, or upon a plea of nolo contendere or its equivalent does not, of itself,

establish that the person did not meet the criteria set forth in this subdivision.” *Id.*, subd. 2(b). In *Augustine v. Arizant, Inc.*, 751 N.W.2d 95 (Minn. 2008), a CEO and chairman of the board of a company sought indemnification for criminal proceedings in which he pleaded guilty to “knowingly and intentionally” aiding and abetting the making of a false statement or misrepresentation of material fact regarding the determination of medical benefit payments. *Id.* at 99. The Minnesota Supreme Court determined that despite his guilty plea on the criminal charge, there was still an issue of material fact to be determined as to whether the officer and director had operated in “good faith” such that he was entitled to indemnity from the company for the criminal charge. *Id.* at 101 (the guilty plea by itself was insufficient to establish lack of good faith, because criminal defendants plead guilty for a number of reasons).

### **XIII. BOOKS AND RECORDS**

Corporations must on occasion deal with requests by shareholder for corporate documents and information. A shareholder has an “absolute right, upon written demand, to examine and copy” the share register and all documents corporations are required to keep. Minn. Stat. § 302A.461, subd. 4. Thus, a shareholder is always entitled, upon a written demand, to inspect and copy:

- (1) records of all proceedings of shareholders for the last three years;
- (2) records of all proceedings of the board for the last three years;
- (3) the corporation’s articles and all amendments currently in effect;
- (4) the corporation’s bylaws and all amendments currently in effect;
- (5) certain financial statements;
- (6) reports made to shareholders generally within the last three years;

- (7) a statement of the names and usual business addresses of its directors and principal officers;
- (8) voting trust agreements;
- (9) shareholder control agreements;
- (10) the share register; and
- (11) a copy of agreements, contracts, or other arrangements or portions of them incorporated by reference under section 302A.111, subdivision 7.

Minn. Stat. § 302A.461, subs. 2, 4.

Upon a showing of “proper purpose,” a shareholder of a non-public corporation is entitled to inspect and copy any other documents, as well. *Id.*, subd. 4. A “proper purpose” is “one reasonably related to the person’s interest as a shareholder, beneficial owner, or holder of a voting trust certificate of the corporation.” *Id.* It has been determined that it is a “proper purpose” to request the books and records of a corporation to determine an “accurate value on their shares of stock, and to evaluate the conduct and affairs of the corporation’s officers and majority shareholders so as to determine the effects on the financial condition [of the company].” *Fownes v. Hubbard Broadcasting, Inc.*, 225 N.W.2d 534, 536 (Minn. 1975); *Uldrich v. Datasport Inc.*, 349 N.W.2d 286, 289 (Minn. Ct. App. 1984) (evaluation of conduct and affairs of the other shareholders, officers and directors is a proper purpose). By contrast, requesting documents for purely personal purpose, such as improving one’s position in a lawsuit against the company is not a proper purpose. *Bergmann v. Lee Data Corp.*, 467 N.W.2d 636, 640 (Minn. Ct. App. 1991). The company may also be able to rebut the shareholder’s claimed purpose. *Id.* (Shareholder’s “assertion that he sought inspection to investigate alleged officer misconduct and to communicate with stockholders created a prima facie showing of proper purpose, but was

rebutted by respondents' evidence that the actual purpose was to improve appellant's position in the pending [employment] suit against respondents.)

While a corporation may be required to produce certain documents in response to a shareholder demand, the statute takes into consideration the legitimate concerns of corporations to avoid disclosure of confidential information. Thus, if the parties cannot agree to acceptable confidentiality agreements, a corporation may apply to a court to seek a protective order permitting the corporation to withhold portions of corporate records or prevent premature disclosure of competitively sensitive information. A protective order can also impose other reasonable restrictions on the production of corporate information. Minn. Stat. § 302A.461, subd. 4a.

#### **XIV. EQUITABLE REMEDIES**

The MBCA provides express remedies in the case of violations of corporate governance rules contained in the Act. There are two primary sources of equitable relief in the MBCA. A court may grant “equitable relief it deems just and reasonable” where a shareholder has established that (1) the directors or persons with authority are in an unbreakable deadlock; (2) the directors or those in control of the corporation have acted fraudulently or illegally toward one or more shareholders in their capacities as shareholders or directors, or as officers or employees of a closely held corporation; (3) the directors or those in control of the corporation have acted in a manner unfairly prejudicial toward one or more shareholders in their capacities as shareholders or directors of a corporation that is not a publicly held corporation, or as officers or employees of a closely held corporation; or (4) the shareholders are so divided that they have been unable to elect successors to directors whose terms have expired or would have expired upon the election and qualification of their successors for two consecutive regular meetings. Minn. Stat.

§ 302A.751, subd. 1. This statute, often employed to remedy claims of minority shareholder “oppression,” grants courts broad power to consider all relevant facts and circumstances in making a determination regarding equitable relief, which can often include violations of corporate governance norms. This statute is also designed to enforce the “reasonable expectations” of the shareholders, with the statute specifically providing that written agreements, including buy-sell agreements and other agreements between or among shareholders and/or the company (some of which are discussed above), are “presumed” to reflect the parties’ reasonable expectations as to matters dealt with in the agreements. *Id.*, subd. 3a.

The second statute, more specifically focused on statutory corporate governance violations, is Minn. Stat. § 302A.467. Section 467 provides that “[i]f a corporation or an officer or director of the corporation 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.” This statute is discretionary, not mandatory, and grants the courts broad discretion to remedy statutory violations, including violation of the statutory duty of care of an officer/shareholder. *Bolander v. Bolander*, 703 N.W.2d 529, 548 (Minn. App. 2005).

Section 467 can be successfully paired, for example, with a denial of access to the company’s books and records as required by Minn. Stat. § 302A.461. Minn. Stat. Ann. § 302A.461, 1981 Reporter's Notes (a shareholder's right to inspect corporate records “may be enforced in a proceeding under section 302A.467”); *Blohm v. Kelly*, 765 N.W.2d 147, 158 (Minn. Ct. App. 2009). However, Section 467 only applies to violations of Chapter 302A. Minn. Stat. § 302A.467 (stating that the court may order equitable relief “[i]f a corporation or an officer or director of the corporation violates a provision of this chapter” (emphasis added));

*Isaacs v. American Iron & Steel Co.*, 690 N.W.2d 373, 379 (shareholder may not make claim for equitable relief for violation of company's bylaws under Section 467; such a claim must be based upon a provision of chapter 302A).