

Are Minority Shareholders at Risk?

By Joe Anthony

Minnesota's Legislature and judiciary have demonstrated a high regard for promoting the business interests of corporations while protecting the rights of shareholders of private companies through the fair and equal application of the Minnesota Business Corporation Act (MBCA).

However, the relatively recent Minnesota Supreme Court decision in *US Bank N.A. vs. Cold Spring Granite* 802 N.W.2d 363 (2011) has caused some lawyers to question whether there is a "loophole" in the MBCA that will permit controlling shareholders to eliminate minority interests without providing statutory rights to which the minority have grown accustomed. The court blessed a corporate transaction under § 302 A.423 that forced minority shareholders to sell their shares without the benefit of dissenter's rights or a fair value proceeding. The potential far-reaching effect of the court's decision warrants careful attention.

In *Cold Spring*, the corporation's majority shareholders had been attempting, without success, to acquire the minority shareholders' interests. Ultimately, for a variety of reasons, the majority shareholders concluded that the minority shareholders were a distraction to the business operations of the company. The board of directors, controlled by the majority shareholders, determined that it was in the best interests of the corporation to force the sale of the minority shareholders' interests through a reverse stock split.

The process for effectuating a reverse stock split and forced sale is a multi-step process. The first step is the fractionalization of the corporation's shares. Under certain conditions, the corporation may use § 302A.402 to effectuate a reverse stock split without a shareholder vote. In the second step, the board determines the



value of the fractionalized shares and then votes to redeem those shares at that value. In the final step, the corporation redeems the minority's fractionalized shares for cash. The transaction is legitimate if less than 20% of the corporation's shares are being redeemed and there is no evidence of fraud or other conduct in violation of § 302A.751.

The court found dissenters' rights were not available for a reverse stock split, but the price paid for fractionalized shares must be their "fair value." It also found that "[a] determination by the board of the fair value of fractions of a share is conclusive in the absence of fraud." In considering the type of fraud that must be proved, the court concluded that the common law definition of fraud applied to a reverse stock split. The court found no evidence of fraud in the appraiser's or the board's determination of value.

The court recognized that its decision was of great significance when it declared: "It is clear that the use of a reverse stock split to redeem minority shareholder interests is a powerful weapon in the majority shareholder's arsenal, particularly where, as in the Minnesota statutory scheme, neither the administration

of the reverse stock split nor the valuation process is subject to contemporary judicial supervision.” The court also recognized that the burden that it was imposing on minority shareholders was a high one and that it could be argued that the requirement of proving common law fraud may be viewed as inconsistent with earlier court decisions. Nevertheless, the court concluded: “While the fairness of this approach is open to debate, these policy decisions are within the province of the Legislature.”

The court provided minority shareholders a glimmer of hope when it concluded that section § 302A.751 clearly permits relief notwithstanding the absence of fraud under section § 302A.423. The examples cited by the court include conduct that may violate an agreement among shareholders or actions that constitute a breach of fiduciary duty. The court also held that additional scrutiny beyond merely demonstrating the absence of common law fraud under § 302A.423 may be warranted.

Absent action by the Legislature, the practical takeaway for practitioners is that minority shareholders who hold less than 20% of the stock of a closely held corporation are at risk of having their shares forcibly taken from them at a price determined by those in control. To protect against that possibility, lawyers representing minority shareholders would be wise to negotiate a provision in the by-laws or a shareholder agreement that precludes the use of that statutory provision. Absent such agreements, lawyers need to be well versed in the avenues that exist for attacking the use of a reverse stock split. On the other side of the table, the court has made clear that minority shareholders owning less than 20% of the stock of a corporation may be forced to sell their stock as long as there is compliance with § 302A.423. The interesting question is whether the Legislature will do anything to modify the statute in light of the court’s decision.



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