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Justice Versus Windfall: When is Value "Fair" Among Private Corporation Shareholders?

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Good business people understand their markets, their products, their people. Unfortunately, few business owners fully appreciate what can happen when their most important business relationship goes sour. Specifically, when the shareholders of a private Minnesota business corporation sue each other, many commonly accepted "truths" of corporate business life no longer apply with predictable certainty.

The private (e.g., non-public) and "closely held" (fewer than 35 shareholders) corporation is our most common species of business enterprise. Stated simply, over the past 15 years, the legal landscape governing the relationship among private corporation shareholders has increasingly changed from "majority rules" in virtually all cases, to the need to more greatly satisfy all shareholders' "reasonable expectations" in the variety of occurrences in the typical business. Under the Minnesota Business Corporation Act, Chapter 302A, *et seq*, Minnesota courts are given (and have increasingly used) broad "equitable" powers to grant relief to a shareholder who has been harmed as a "shareholder, officer, director or employee" by the "illegal, fraudulent or unfairly prejudicial" conduct of the directors or controlling shareholders in a closely held corporation [Minn. Stat. § 302A.751(1)(b)(2)(3); § 302A.467]. In evaluating the claims in such lawsuits, Minnesota courts are instructed to consider all shareholders' "reasonable expectations" at the inception of the relationship and as they develop overtime [Minn. Stat. § 302A.751(3)(a)]. This standard, combined with the relatively vague "unfairly prejudicial" threshold of conduct necessary to trigger equitable relief, makes shareholder/corporate governance disputes in these corporations precarious for the ill-advised corporate board of directors or shareholder(s). Indeed, these "reasonable expectation" principles are bilateral, such that overreaching minority shareholders can likewise be subject to equitable relief in favor of the corporation or the other shareholders.

Shareholder disputes arise in as many different contexts as one can imagine in the life of a private business enterprise. Employment terminations of shareholder/employees, family disputes, dividend issues, executive compensation, entrepreneurial ego, succession planning and, at times, simple greed (by either the majority or minority) feed the well spring for these disputes. Of necessity, the Minnesota statutes empowering courts to resolve these cases are flexible, granting judges broad discretion to address the variety of circumstances in which "unfairness" is allegedly wrought by one faction against another within the corporation's ownership and management structure.

This specific remedy provisions of Minnesota law in such cases are similarly flexible. The courts must consider all circumstances in considering appropriate relief and can enter any "equitable" relief deemed just and appropriate. In spite of the power to fashion a variety of remedies, it is perhaps not surprising that the courts have gravitated toward "bright-line" forms of relief in these cases. Here is where the waters become particularly murky and unpredictable for the ill-advised and unprepared. Often, the court will choose the remedy of a forced purchase of the complaining stockholders' stock [Minn. Stat. § 302A.751(2)(3)(b)]. This remedy is appealing because, as a "corporate divorce" among the feuding shareholders, it is often the only truly permanent solution to the shareholder discord.

The problem presented by the attractiveness of the buy-out remedy for a variety of serious shareholder/governance conflicts has been the emergence of certain ill or incompletely conceived legal precedents which bear significantly upon the fair use of this remedy. In an effort to find a logical permanent solution, the courts are sometimes willing to stretch common notions of "prejudice" and "unfairness" in corporate life in order to justify entry of an order for buy-out of the involved shareholder(s). In this environment, both corporate sinners and mere, slightly fallen saints can be and have been directed to purchase a shareholder's stock as a form of permanent solution.

To work in the diverse circumstances presented by shareholder conflicts, the buy-out remedy itself must be flexible. The governing statute in shareholder oppression cases provides that the price shall be the "fair value" as determined by any method or combination of methods deemed appropriate by the court [Minn. Stat. § 302A.751(2), cross-referencing to Minn. Stat. § 302A.473(7)]. It is in the selection of methods and application of share valuation theory where counter-intuitive and arguably unjust valuation decisions have been reached in the name of "fair value." Unless carefully applied, our yet-developing judicial notions of "fair value" under the corporate code can provide a shareholder with a price which exceeds both the actual "fair market value" of the stock and the shareholder's reasonable investment expectation if the court's valuation conclusion is derived from valuation assumptions (e.g., a sale or public offering of the company), which the shareholder in this always private corporation may have had no "reasonable expectation" of ever achieving through this investment.

How did courts in oppression cases under Minn. Stat. § 302A.751 go from carefully reviewing all shareholders' reasonable expectations in deciding whether to enter equitable relief in the first instance [Minn. Stat. § 302A.751(3)(a)] to potentially ignoring the shareholders' reasonable investment expectations in pricing a "fair value" buy-out as a remedy for a violation of those expectations? The answer lies in the failure to recognize the different circumstances which give rise to a "fair value" buy-out under the business code and our courts' desire to date for "bright-line" rules in share valuation case of all types.

Under the business code, a "fair value" share purchase under the court's supervision and authority arises in two contexts: (1) dissenters' rights under Minn. Stat. § 302A.471-.473; and (2) as a remedy in oppression cases under Minn. Stat. § 302A.751. The failure to distinguish between these two potentially disparate circumstances has resulted in some arguably flawed valuation precedents from our courts.

Dissenters' rights arise from such relatively common business events and transactions as amendments to articles of incorporation and bylaws which impact voting rights, or a merger, sale or lease of significant corporate assets [Minn. Stat. § 302A.471]. In such circumstances, an objecting or “dissenting” shareholder can obtain a redemption of his shares at a “fair value” established by the court rather than remain in the corporation or accept the stock or cash price offered by the corporation in a merger transaction. A series of Minnesota state and federal court decisions have established that the “fair value” of a minority share interest for dissenters’ rights purposes: (a) does not include a traditional “minority” valuation discount for lack of voting control; and (b) may not[1] include a traditional “marketability” discount despite the fact that there is no active market for privately held shares. In the marketplace, the “fair market value” of such minority, noncontrolling shares would typically be discounted due to their minority and unmarketable status, sometimes by upwards of 50% or more, from the value of those same shares in an assumed sale of the entire company or in a public offering. By way of an over-simplified example, under these most extreme of dissenters’ rights valuation principles, the “fair value” of a 10% stockholder’s interest in a company valued at $5,000,000 could be set by a court at $500,000, whereas the “fair market value” of the same shares would be discounted by upwards of 50% or more.

The use of the “fair value” standard in the dissenters’ rights context as described above is questionable from a policy standpoint. Granting a dissenter the automatic right to a potentially premium share purchase triggered, for example, by article or bylaw amendments creates the prospect for a windfall “fair value” payment unjustified in light of the specific triggering corporate action or the real value of the investment to the dissenting shareholder. One feature of dissenters’ rights valuation proceedings which differs from oppression cases under Minn. Stat. § 302A.751, of course, is that all of the corporate transactions which trigger dissenters’ rights are forward looking. In evaluating their options, the corporation’s directors and shareholders can at least decide in advance whether the action or transaction is worth the additional financial risk posed by the potential exercise of dissenters’ rights. Remember, all corporate actions which trigger these rights to seek a “fair value” payment do so without regard to motive or the wisdom of the deal. The best and worst of qualifying corporate events trigger these rights equally. However, at least in the dissenters’ rights context, the corporation’s eyes are open to the potential consequences <u>before</u> any triggering action is purposefully taken.

“Fair Value” stock redemptions ordered by the courts under Minn. Stat. § 302A.751 (e.g., oppression cases), however, present potentially different policy considerations than dissenters’ rights cases. Remember, in the oppression case illegal, fraudulent or unfairly prejudicial conduct is required before a court can trigger a fair value buy-out. Remember also that the court must consider <u>all</u> shareholders’ “reasonable expectations” in deciding whether a claimed violation has been proven and in determining what equitable relief, if any, to enter. Remember finally, however, that these cases ultimately become corporate divorces where courts, even in close cases, often understandably lean toward making the underlying legal findings necessary under the act to trigger the court’s authority to enter permanent relief through a buy-out.

So, what’s the problem? Specifically, in its desire to establish a bright-line test, the Minnesota Court of Appeals has expressly adopted the dissenter’s rights “fair value” precedents in the oppression case buy-out. However, a rigid application of what some practitioners assert as the dissenters’ rights “no discount” standard of “fair value” in alleged oppression cases under § 302A.751 can yield aberrant results. For example, in <u>Pooley v. Mankato Iron & Metal, Inc.</u>, 513 N.W.2d 834 (Minn. Ct. App. 1994), a “fair value” buy-out without a minority discount using a hypothetical sale of a business was selected as the primary remedy to permanently resolve an ownership dispute between three brothers in a family business. The business was not going to be sold and the complaining shareholder had no apparent expectation that it would be. Moreover, the shareholder had been fired by his brothers after a series of business-related acts of misconduct, including finally a conviction for criminal assault upon a customer. At trial upon his claim under Minn. Stat. § 302A.751 for a fair value buy-out of his stock, the terminated shareholder asserted that his reasonable expectation of involvement in the business had been defeated by his firing and removal from the board of directors. In an obvious effort to issue needed permanent relief, the trial court found a predicate act of unfair prejudice arising from the plaintiff-shareholder's complete removal from the business and ordered a "fair value" buy-out of his shares without application of any minority discount, despite the minority non-controlling nature of his one-third shareholding. In Pooley, the Court of Appeals affirmed the trial court's rejection of a minority discount by expressly adopting the dissenters' rights "fair value" precedents under Minn. Stat. § 302A.473 which reject a minority discount as a matter of law. It can be persuasively argued that the shareholder in Pooley thereby received an unexpected windfall in the "fair value" purchase of his minority shares which was, in reality, triggered by his own misconduct. Beyond questions of personal fault, the trial and appellate courts in Pooley also failed completely to consider all of the shareholders' reasonable investment expectations in fashioning the buy-out remedy. For example, is it fair to use an undiscounted sale of the business valuation model if such a sale was never planned or expected by any of the shareholders?

In an alleged oppression case under Minn. Stat. § 302A.751, if all shareholders' reasonable expectations must be considered in deciding whether to trigger judicial relief, should not the same shareholder group's reasonable investment expectations be relevant in awarding a buy-out remedy and setting the price? Under both the dissenters' rights and oppression statutes, the court in selecting the appropriate valuation method must consider all relevant facts by "taking into account any and all factors the court, in its discretion, sees fit to use . . ."[Minn. Stat. § 302A.473(7)]. Why then, in an oppression case in particular, should the court not have discretion to determine whether a minority discount is appropriate? What were the shareholders' fundamental investment/corporate control understandings and expectations when investing in this company? Is this a venture capital deal? Was there a plan to sell the company or take it public? Was it the shareholders' intent to pay dividends or to instead grow the company through reinvestment of the profits? Were the shares in question purchased at market or at a discount, gifted, inherited or obtained through sweat equity? If this was a long term investment, should potential buy-out terms be set over an equally long term basis?

These are questions which go to the heart of the shareholders' business relationship, the answers to which should be essential in the courts' exercise of its "equitable" powers under the act. Clearly, using a fair value standard that assumes an immediate or short term cash-out at a public offering or company sale price in each case without market valuation discounts or regard to specific shareholder investment expectations can, in many cases, yield a windfall price and burdensome payment terms which exceed the shareholders' reasonable expectations and are out of proportion with the event of unfairness or "prejudice" which the court has relied upon to trigger the understandably attractive permanent remedy of a shareholder buy-out. While some trial courts have begun to critically readdress these issues, most notably Hennepin County District Court Judge Richard Solum's decision in the Jundt litigation in 1997,[2] Minnesota's appellate courts have not yet adopted a consistent, final approach in both dissenters' rights and oppression cases to be followed by our trial courts. Until they do, the parties involved in such situations must use caution and the best available advice to steer through these choppy waters.

Shareholder disputes involving the above considerations present a myriad of complex and unique issues. The need for flexible remedies in these cases inherently creates a degree of uncertainty in predicting any particular court's decision, fashioned as it must be to address the specifics of each case. It is highly likely that Minnesota's trial and appellate courts will continue to grapple with the establishment of governing tests for these cases over the next several years. In the interim, business owners, directors and shareholders presented with these issues are well advised to seek, and listen carefully to, competent legal advice in taking actions which may trigger such claims. This is one area where an ounce of prevention [see Minn. Stat. § 302A.751(3)(a) regarding presumptions arising from written shareholder agreements] is better, and usually far less expensive, than a pound of cure.

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[1] The Minnesota Court of Appeals has not yet specifically addressed the appropriateness of a "marketability" discount in dissenters' rights cases. The Federal District Court and Eighth Circuit Court of Appeals refused to apply such a discount in a dissenters' proceeding under Minn. Stat. § 302A.471-.473 in Foy v. Klapmeier, 992 F.2d 774 (8th Cir. 1993). The Minnesota Supreme Court has not yet defined "fair value" under either Minn. Stat. § 302A.471-.473 or § 302A.751(2)(3)(b).

[2] In Jundt Associates, Inc. v. Knappenberger, Hennepin County Court File No. 95-1498 (February 1998), Judge Solum, *inter alia*, issued a buy-out order under Minn. Stat. § 302A.751. After reviewing the existing case law, Judge Solum enunciated a test to determine whether there was a reasonable expectation among the shareholders of a privately held business that it would be sold or taken public, thereby making their shares liquid or "marketable" in the ordinary, expected course of the business. In the absence of such a demonstrable expectation, Judge Solum determined that application of a "marketability" or "illiquidity" discount was appropriate in a buy-out under § 302A.751. Judge Solum could not, however, address the appropriateness of a minority discount in determining "fair value" because of the Court of Appeals decision in Pooley v. Mankato Iron & Metal, Inc., adopting for § 302A.751 buy-out purposes the § 302A.473 dissenters' rights valuation precedents prohibiting a minority discount as a matter of law.

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