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When Abel Sues Cain:

HOW MINORITY SHAREHOLDERS SEEK REDRESS FOR CORPORATE WRONGS IN LIGHT OF *WESSIN V. ARCHIVES*

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Abel and Cain enter into a corporate brotherhood flush with the optimism of bright ideas and unending trust. Then Abel catches Cain with his hand in the till. Abel sues Cain.

The court dismisses the case.

Why, given that minority shareholders have every right under Minn. Stat. § 302A.751, subd. 1(b)(5), to seek relief when the corporation's assets are being misapplied or wasted,[1] is your client's case dismissed? Because § 751 and the rule governing shareholder derivative litigation, Minn. R. Civ. P. 23.06, have had a head-on collision in the Minnesota Supreme Court, and Rule 23.06 won. A minority shareholder, even in a closely held corporation,[2] cannot sue a majority shareholder on his own behalf for misappropriation or waste of corporate assets. Whatever hope he had of doing so after last year's decision by the Minnesota Court of Appeals in *Wessin v. Archives*[3] evaporated when the Minnesota Supreme Court reversed the appellate court's decision and held that closely held corporations are bound by the same requirements for shareholder derivative actions that apply to larger or publicly held corporations.[4]

Those requirements dictate that individual shareholders may not sue on their own behalf for misconduct that directly injures the corporation and only indirectly injures its shareholders. Instead, if shareholders are to sue at all, they must bring a derivative suit on behalf of the reluctant corporation, which will then be governed by the myriad procedural requirements of Minn. R. Civ. P. 23.06. Rule 23.06 protects the corporation and its other shareholders from strike suits by requiring that a derivative plaintiff have been a shareholder at the time of the transactions in question and that he adequately represent the interests of similarly situated shareholders.[5] Rule 23.06 also prohibits a derivative plaintiff from dismissing or compromising his suit without notice to all shareholders and approval of the court. Finally, Rule 23.06 requires a shareholder plaintiff to make a demand that the corporation enforce its rights before he files suit on its behalf. Unless the minority shareholder plaintiff shows the corporation wrongfully refused his demand, or he can allege that demand would be futile (which is a harder standard to satisfy than it appears), the shareholder plaintiff may not sue for relief.[6] The Supreme Court explained why in *Wessin v. Archives*.

The Groundrules Announced in *Wessin v. Archives*

In *Wessin v. Archives*, the plaintiff minority shareholders alleged that the majority owner, also the President and CEO, inappropriately paid himself and his wife, an officer, a director, and a shareholder, dividends not paid to other shareholders. The plaintiffs alleged that the dividends took the form of bonuses, favorable equipment leases, and reimbursement of personal expenses. The plaintiffs alleged that the CEO fraudulently concealed the alleged misappropriation of funds, and that plaintiffs relied on his misrepresentations in not seeking like dividends or demanding that the CEO return his dividends. The plaintiffs further alleged that the CEO's wife failed to report or attempt to prevent the CEO's alleged misconduct.

The plaintiffs sued on their own behalf, rather than on behalf of the corporation. They made no attempt to comply with the rules governing shareholder derivative actions. They asserted claims for common law fraud, fraud in violation of § 751, unfair prejudice in violation of § 751, and breach of fiduciary duties.[7] The plaintiffs sought money damages for their claims of common law fraud and breach of fiduciary duty. For their § 751 claims, the plaintiffs sought "equitable relief, including the repayment to Archives of any excess consideration and other distributions previously paid by Archives" to the CEO and his wife. The plaintiffs did not specify any non-monetary equitable relief they might be seeking.

On a motion for judgment on the pleadings, the trial court dismissed the plaintiffs' complaint without prejudice on the grounds it asserted derivative claims and the plaintiffs had not complied with the requirements for shareholder derivative litigation.[8]

The appellate court reversed, ruling that in addition to claims for indirect injuries (which the court did not enumerate), the plaintiffs had alleged three "direct injuries" stemming from their claims for fraud (both common law and statutory), breach of fiduciary duty, and unfair prejudice.[9] First, they had alleged direct injury for not having sought dividends comparable to those paid to the CEO. The appellate court noted that although all shareholders would have shared in any declared dividend, and thus their alleged injury was not "separate and distinct from" those of the other shareholders, that fact did not transform the plaintiffs' fraud claim into a derivative one.[10] Second, the court held that breach of the fiduciary duty owed between shareholders in a closely held corporation created a direct injury. And third, unfair prejudice, according to the Court of Appeals, "is by its nature ordinarily a direct claim" involving a direct injury.[11] The appellate court proceeded to hold that where direct and derivative claims were pled together, plaintiffs were not required to comply with Rule 23.06.[12]

The appellate court also surveyed the policy implications of imposing derivative pleading requirements on shareholders in closely held corporations. It noted that it was unlikely there would be a truly disinterested board to consider a Rule 23.06 demand.[13] Moreover, the Court of Appeals noted that in a derivative suit, any recovery would go to the corporation, which in a closely held corporation might inure primarily to the benefit of the wrongdoing majority shareholder.[14] More generally, the Court of Appeals noted that subjecting minority shareholders to the derivative pleading requirements would restrict their access to the remedies available under § 751. For these reasons, the Court of Appeals opted to follow the American Law Institute's rule allowing courts discretion to determine whether shareholders of a closely held corporation may bring a direct action.[15]

The Minnesota Supreme Court rejected the appellate court's policy arguments, reversed its holding, and reinstated the trial court's judgment on the grounds that all of the plaintiffs' claims were derivative and plaintiffs admittedly failed to satisfy the derivative pleading requirements in Rule 23.06. Citing the previous decision of *PJ Acquisition Corp. v. Skoglund*,[16] the Court stated that it is the alleged injury, not the asserted legal theories, that must be analyzed to determine whether claims are direct or derivative. Because the plaintiffs in *Wessin* alleged waste and misappropriation of corporate assets, any injury was to the corporation, and only indirectly affected the shareholder plaintiffs. Therefore, the damages belonged to the corporation, and any claims were required to be brought on its behalf.[17]

In rejecting special treatment for closely held corporations, the Court reasoned that the pleading rules for shareholder derivative actions constrain shareholders from filing multiple and conflicting suits (which the appellate court deemed unlikely in the context of closely held corporations)[18] and allow corporations to govern their own affairs.[19] Moreover, though closely held corporations are considered to be akin to partnerships by Minnesota courts, by choosing the benefits of incorporation, they have also accepted the imposition of corporate formalities, including the requirements for derivative litigation imposed by Rule 23.06.[20] Finally, the Court held that it makes no difference whether direct and derivative claims appear in the same suit. Where there are derivative claims, those claims must comply with Rule 23.06.[21]

What's Left of § 751?

Commentators and courts have viewed § 751 as a powerful protector of minority shareholders in closely held corporations.[22] When faced with deadlocked directors, fraud committed by directors against officers or employees, unfair prejudice by directors against officers or employees, failure to elect directors for two consecutive meetings due to a division in voting power, misapplication or waste of corporate assets, or expiration of the articles of incorporation, § 751 is the most effective of several litigation options open to aggrieved minority shareholders.[23] Under the statute, minority shareholders may obtain dissolution, a mandatory buyout at fair value, or other equitable relief.[24]

Section 751 was thought to be particularly valuable because it ostensibly provided a direct route to attack corporate decisions generally protected by the business judgment rule. The business judgment rule reflects judicial recognition that courts are ill-equipped to evaluate the internal management decisions of corporate directors.[25] As a result, courts will not interfere with corporate decisions unless the majority of the decision-makers are alleged to have a conflict of interest, as when they are accused of self-dealing or usurpation of corporate opportunity.[26] Though § 751 litigants still would have to overcome the business judgment rule, or show the requisite conflict of interests to circumvent the rule, it was thought they could do so without the additional burden of satisfying the requirements of Rule 23.06, including overcoming the business judgment protection that adheres to a board's decision to refuse a Rule 23.06 shareholder demand.

The Minnesota Supreme Court has now ruled that § 751 does not create direct rights of action for minority shareholders in closely held corporations where a direct action does not exist on its own.[27] In "freeze out" and "squeeze out" situations, where Cain is trying to rid himself of Abel, § 751 continues to provide broad remedies for direct suits. But where the majority shareholder is instead misappropriating or wasting corporate assets, the expanded remedies in § 751 do not eliminate the traditional direct/derivative distinction.

Challenges in Pleading Shareholder Actions

Minority shareholders retain the right to seek redress for misconduct by majority shareholders and others if the corporation shirks, or almost certainly would evade, its responsibility to do so. Here are some practical thoughts, then, about initiating and defending against shareholder claims in light of *Wessin v. Archives*.

First, before your client files a lawsuit, determine who has been injured or, more practically, whose money or rights have been squandered. Those of the corporation? Follow the rules for a derivative suit. Any claim that is limited to waste of corporate assets, mismanagement, or usurpation of corporate opportunity is likely to be classified by the courts as derivative.[28] If, on the other hand, your client's rights as a shareholder have been harmed in a manner that does not necessarily involve harm to the corporation, the claim is likely to be direct. While the analysis is of necessity fact-specific, the following scenarios likely support direct claims:

- a shareholder is singled out to not receive dividends paid to other shareholders;[29]
- a shareholder is divested of his active role in the management of the corporation;[30]
- certain shareholders are in effect "squeezed out" by the issuance of shares to others;[31]
- majority shareholders sell all or substantially all the assets of the corporation without approval of minority shareholders, in violation of Minn. Stat. § 302A.661, subd. 2;[32]
- a shareholder is denied access to the corporation's books and records in violation of Minn. Stat. § 302A.461, subd. 4;[33]
- a shareholder is denied the right to vote on a transaction;
- a shareholder's right under the articles of incorporation or bylaws is eliminated;

- a shareholder's right under a shareholder control or buy-sell agreement is breached.

Second, if the injury is to the corporation, and therefore derivative, the claims belong to the corporation, so the corporation generally gets to decide whether to litigate. If you represent the aggrieved minority shareholder, consider serving a letter demanding that the corporation enforce its rights to redress the wrongs committed by the majority shareholder. If your client is on the receiving end of such a letter, take it seriously. Do not give the minority shareholder grounds to claim wrongful refusal of the demand. Consider appointing a "special litigation committee" comprised of one or more outside directors or other qualified person(s) unaffiliated with the corporation to evaluate the allegations, report findings, and take action to implement those findings.[34] By statute, special litigation committees are authorized to take such action, including moving to dismiss a derivative lawsuit if it is later brought by a minority shareholder.[35] Though funding a special litigation committee will cost your client money up front, if the committee recommends against pursuing the claims, they will likely be defeated, if the lawsuit even gets filed.[36]

Third, if your client served a demand that has been rejected and she or he still wants to proceed on the theory that the demand was wrongfully refused, learn everything you can about why the demand was rejected, the scope of the investigation, and who participated in the decision making. If a special litigation committee was appointed, learn who was on it, who else participated in its investigation and deliberations, and anything else to determine whether the committee was independent and conducted its investigation or evaluation in good faith.[37] Your client will have to plead lack of independence or lack of good faith if she or he is to prevail on a motion to dismiss the derivative action.[38]

Fourth, if your client opts for the more customary route of a "demand-excused" derivative case, be prepared to back up the claim that a demand would have been futile with particularized allegations of the reasons why. Though under prevailing Minnesota law, domination of the board by the alleged wrongdoers might be sufficient to excuse a demand,[39] more recent case law from the federal court suggests such domination or efforts by the alleged wrongdoers to entrench themselves will not be sufficient.[40] Their control over other directors' income, however,[41] or egregious misappropriation of corporate funds or self-dealing makes it more likely that your client would defeat a motion to dismiss based on the failure to make a demand.[42]

Conclusion

The MN Supreme Court's decision in *Wessin v. Archives* served to clarify an often disputed area of the law of shareholder rights. Where their claims are derivative, shareholders in closely held corporations must face the procedural hurdles of Rule 23.06 (including the demand requirement), the potential death-knell of a special litigation committee's report, and the presumption of legitimacy given to disinterested corporate action under the guise of the business judgment rule.[43] Counsel for closely held corporations and their shareholders can best help their clients navigate the minefield of shareholder litigation with a copy of *Wessin v. Archives* and Rule 23.06 as their guides.

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1. Minn. Stat. § 302A.751 (1999 Supp.) provides:

Subdivision 1. **When permitted**. A court may grant any equitable relief it deems just and reasonable in the circumstances or may dissolve a corporation and liquidate its assets and business:

b) In an action by a shareholder when it is established that:

(1) the directors or the persons having the authority otherwise vested in the board are deadlocked in the management of the corporate affairs and the shareholders are unable to break the 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;

(4) the shareholders of the corporation are so divided in voting power that, for a period that includes the time when two consecutive regular meetings were held, they have failed to elect successors to directors whose terms have expired or would have expired upon the election and qualification of their successors;

(5) the corporate assets are being misapplied or wasted; or

(6) the period of duration as provided in the articles has expired and has not been extended as provided in section 302A.801. . . .

2. A closely held corporation means a corporation with no more than 35 shareholders. Minn. Stat. § 302A.011, subd. 6a (1999 Supp.). The shareholders are usually active in the business; they serve as directors, officers, or employees; there is generally no market for the stock; and dividends are rare. Westland Capital Corp. v. Lucht Eng. Inc., 308 N.W.2d 709, 712 (Minn. 1981).

3. Wessin v. Archives, 581 N.W.2d 380 (Minn. Ct. App. 1998) (*Wessin I)*.

4. Wessin v. Archives Corp., Nos. C5-98-28, C3-98-30 (Minn. May 13, 1999) (*Wessin II)*.

5. PJ Acquisition Corp. v. Skoglund, 453 N.W.2d 1, 5 (Minn. 1990). A plaintiff may also bring a derivative action if his shares devolved on him after the transaction at issue occurred. Minn. R. Civ. P. 23.06 (1996).

6. Winter v. Farmers Educ. and Coop. Union of Am., 259 Minn. 257, 107 N.W.2d 226, 233 (Minn. 1961); *see also* Reimel v. MacFarlane, 9 F. Supp.2d 1062, 1065-66 (D. Minn. 1998) (outlining difficulties in pleading demand futility).

7. Plaintiffs also asserted a claim for breach of various loan agreements, but that claim was settled before the case was appealed. *See Wessin II* slip op. at 2.

8. Wessin v. Archives Corp., No. PI 95-1550, Order of September 15, 1997 (Minn. Dist. Ct., 4th Dist.).

9. *See* Wessin I, 581 N.W.2d at 385-86.

10. *See* Wessin I, 581 N.W.2d at 385.

11. *Id.* at 385.

12. The court did not limit its holding concerning direct and derivative claims to cases brought by shareholders of closely held corporations. It thus left open the possibility that when direct and derivative claims are combined in an action against publicly held corporations, they might also be exempt from the requirements of Rule 23.06.

13. *See* Wessin I, 581 N.W.2d at 390.

14. *Id.* at 390.

15. To allow the direct action, a court should find that doing so will not "(i) unfairly expose the corporation or the defendants to a multiplicity of actions, (ii) materially prejudice the creditors of the corporation, or (iii) interfere with a fair distribution of the recovery among all interested persons." Principles of Governance: Analysis and Recommendations, § 7.01, cmt. e (American Law Institute [ALI] 1994). Other courts have adopted the ALI rule to differing degrees. *See cases cited in* Wessin I, 581 N.W.2d at 389-90; *cases cited in* D. Kleinberger and I. Bergmanis, *Symposium: Closely Held Business: Problems and Solutions: Direct vs. Derivative, Or What's a Lawsuit Between Friends in an "Incorporated Partnership?"*, 22 Wm. Mitchell L. Rev. 1203, 1255 n.269 (1996).

16. 453 N.W.2d 1 (Minn. 1990).

17. *See* Wessin II, slip op. at 5.

18. *See* Wessin I, 581 N.W.2d at 389.

19. *See* Wessin II, slip op. at 7.

20. *Id.* at 7.

21. *Id.* at 7.

22. *See, e.g.,* Wessin I, 581 N.W.2d at 387-88; Kleinberger, *supra* note 15, at 1211; J. Anthony and K. Vegoe Boraas, *Minority Shareholder Rights–Revisited*, The Hennepin Lawyer, March-April 1996, at 20.

23. Minn. Stat. § 302A.751 (1999 Supp.). Other options include suing for dissenters' rights under Minn. Stat. §§ 302A.471-473 (1999 Supp.) and seeking equitable remedies under § 302A.467 (1985).

24. Minn. Stat. § 302A.751, subd. 2.

25. Black v. NuAire, Inc., 426 N.W.2d 203, 210 (Minn. Ct. App. 1988) (*citing* Auerbach v. Bennett, 393 N.E.2d 994, 1000 (N.Y. 1979)).

26. *See, e.g.,* Westgor v. Grimm, 318 N.W.2d 56, 59, (Minn. 1982).

27. *See* Wessin II, slip op. at 5; PJ Acquisition Corp. v. Skoglund, 453 N.W.2d 1, 6 (Minn. 1990).

28. *See, e.g.,* Wessin II, slip op. at 6; Skoglund v. Brady, 541 N.W.2d 17 (Minn. Ct. App. 1995) (holding minority shareholders' claims based on promissory notes issued to directors, bonuses paid to those directors, sale of newly issued shares to a director in exchange for forgiveness of a debt owed by the corporation to him, and various other transactions constituting alleged usurpation, waste, and fraud were derivative claims).

29. *See, e.g.,* Segerstrom v. Holland Piano Mfg. Co., 160 Minn. 95, 97, 199 N.W. 897, 899 (1924); Murphy v. Country House, Inc., 349 N.W.2d 289, 292 (Minn. Ct. App. 1984).

30. *E.g.,* McCallum v. Rosen's Diversified, Inc., 153 F.3d 701, 704 (8th Cir. 1998).

31. *E.g.,* Wenzel v. Mathies, 542 N.W.2d 634, 641 (Minn. Ct. App. 1996).

32. *E.g.*, Warthan v. Midwest Consol. Ins. Agenices, Inc., 450 N.W.2d 145, 149 (Minn. Ct. App. 1990).

33. *E.g., id.* at 149.

34. Minn. Stat. § 302A.241, subd. 1 (1999 Supp.)

35. *Id.*

36. If a special litigation committee reports that a shareholders' derivative action is not in the corporation's interest, and the committee's investigation and evaluation were independent and conducted in good faith, courts uniformly dismiss the pending lawsuit. *E.g.,* Drilling v. Berman, 589 N.W.2d 503 (Minn. Ct. App. 1999) (dismissing derivative claims where independent special litigation committee concluded, following good faith investigation, that claims lacked merit); Skoglund v. Brady, 541 N.W.2d 17 (Minn. Ct. App. 1995) (dismissing derivative claims where good faith investigation by independent special litigation committee of one attorney yielded recommendation against pursuing corporate waste claim).

37. Your client may well be denied the opportunity to take discovery on these issues while defendant's motion to dismiss for failure to comply with Rule 23.06 is pending.

See, Scattered Corp. v. Chicago Stock Exch., Inc., 701 A.2d 70, 76-68 (Del. 1997). Therefore, it is important to investigate your client's allegations before filing. One investigative tool is the statutory right to review the corporation's (including the special litigation committee's) books and records relating to the consideration of the demand. *See* Minn. Stat. § 302A.461, subd. 4 (1999 Supp.).

38. *See* Skoglund, 541 N.W.2d at 21.

39. Winter v. Farmers Educ. and Coop. Union, 107 N.W.2d 226 (Minn. 1961).

40. Reimel v. MacFarlane, 9 F.Supp.2d 1062, 1066 (D. Minn. 1998) (director defendants' alleged efforts at entrenchment did not lead to inevitable conclusion they would refuse to dispose of controversy without litigation).

41. *See* Professional Management Assoc., Inc. v. Coss, 574 N.W.2d 107, 111 (Minn. Ct. App. 1998) (applying Delaware law, where alleged wrongdoer exercised control over compensation of majority of directors, demand would have been futile); Rales v. Blasband, 634 A.2d 927, 937 (Del. 1993).

42. *See Reimel*, 9 F.Supp.2d at 1066.

43. *See* Kleinberger, *supra* note 15, at 1226; *see also* Grime v. Donald, 673 A.2d 1207, 1218-19 (Del. 1996).

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