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A Survey Of Recent Developments In The Law: Business Organizations

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VI. BUSINESS ORGANIZATIONS

A. *Direct v. Derivative: What is the Proper Test?*

In *Wessin v. Archives Corp.*,¹ the Minnesota Court of Appeal attempted to clarify the proper analysis used in distinguishing between direct and derivative claims.² This action presented an opportunity for the judiciary to resolve ambiguity in the test used to determine whether a shareholder suffered a direct injury distinct from the corporation. A review of the appellate court decisions illustrates the importance of such clarification.

The Minnesota Court of Appeals found that the proper inquiry was whether the shareholder had suffered a direct injury distinct from the corporation.³ The need for clarification arose from language in other Minnesota Supreme Court cases indicating that the relevant inquiry in determining whether a claim belongs to the corporation rather than its shareholders is whether the injury to each shareholder is of the "same character."⁴ Additionally, the court found that the derivative pleading requirements⁵ are not triggered where an action involves both direct and derivative claims.⁶ The Minnesota Supreme Court disagreed and concluded that such combination claims must indeed adhere to derivative pleading requirements.⁷ The supreme court failed, however, to recognize the unique nature of the closely held corporation.

Archives Corporation ("Archives") is a closely held Minnesota

1. 581 N.W.2d 380 (Minn. Ct. App. 1998), *rev'd and remanded*, 592 N.W.2d 460 (Minn. 1999).

2. 581 N.W.2d at 381-82.

3. *See id.* at 384.

4. *Seitz v. Michel*, 148 Minn. 80, 87-88, 181 N.W. 102, 105 (1921) ("*Seitz I*"). There is also a second *Seitz* case, *Seitz v. Michel*, 148 Minn. 474, 181 N.W. 106 (1921) ("*Seitz II*").

5. *See* MINN. R. CIV. P. 23.06; *see also infra* note 41.

6. *See Wessin*, 581 N.W.2d at 390-91 ("The language of the rule, the legislative and common law history, and the need for coherent litigation procedures persuade us that derivative pleading requirements should not apply to actions that combine direct and derivative claims.").

7. *See Wessin v. Archives Corp.*, 592 N.W.2d 460, 462 (Minn. 1999).

corporation dealing in document storage and retrieval.⁸ The minority shareholders alleged that John Jerome ("Jerome"), the company's president, chief executive officer, and majority shareholder⁹ committed the following acts: (1) he failed to comply with certain loan agreements limiting his compensation; (2) he failed to complete an accurate accounting of the company's net profits for 1989-1992; and (3) he attempted to avoid the company's income limitations by paying his wife a salary.¹⁰ In addition, the shareholders alleged self-dealing in that Jerome compensated himself and his wife through constructive dividends not paid to other corporate shareholders.¹¹ Finally, the shareholders alleged a series of misrepresentations by Jerome regarding his compensation, dividend payments, and the financial status of Archives.¹²

Two minority shareholders settled their claims and sold their shares back to Archives.¹³ When negotiations with the two remaining shareholders failed, they brought suit against the majority.¹⁴ The district court ruled in favor of the defendants, finding that the minority shareholders incorrectly pled derivative claims as direct injuries.¹⁵ On appeal, the Minnesota Court of Appeals reversed and remanded, finding that the district court's summary of the case law demonstrated a variance in the standard for determining whether an action is direct or derivative.¹⁶

The court began its analysis by noting that "[r]ecent decisions by Minnesota courts and federal courts interpreting Minnesota law distinguish between direct and derivative claims by focusing on whether the shareholder's injury is 'of the same character' as that of other shareholders."¹⁷ This "same character" language first ap-

8. See *Wessin*, 581 N.W.2d at 382.

9. See *id.* Jerome owned 52% of the company's stock. See *id.*

10. See *id.*

11. See *id.*

12. See *id.*

13. See *id.*

14. See *id.*

15. See *id.*

16. See *id.* at 383.

17. *Id.* As an example, the court cited *Northwest Racquet Swim & Health Clubs, Inc. v. Deloitte & Touche*, 535 N.W.2d 612 (Minn. 1995). See *Wessin*, 581 N.W.2d at 383. In *Norwest Racquet*, the Minnesota Supreme Court noted that in distinguishing between direct and derivative claims, courts must "consider whether the injury to the individual plaintiff is separate and distinct from the injury to other persons in a similar situation as the plaintiff." *Northwest Racquet*, 535 N.W.2d at 617 (citations omitted).

peared in *Seitz v. Michel* (“*Seitz I*”).¹⁸ *Seitz I* involved a claim for waste of corporate assets.¹⁹ A key issue in *Seitz I* was whether that type of claim belonged to the corporation or to the shareholders.²⁰ In determining the specific fact question in that case, the Minnesota Supreme Court employed the “same character” test.²¹ However, the court of appeals in *Wessin* stated that this test was only to be applied in that narrow fact situation, not with regard to determination of direct or derivative claims in general.²² Moreover, the court of appeals noted that *Seitz I* was decided in 1921, sixty years before the enactment of Minnesota’s existing Business Corporations Act.²³ This act was meant to protect against the type of abuses seen in the *Seitz* cases.²⁴ Thus, according to the court of appeals, it is uncertain whether the “same character” language is applicable anymore, even given the correct interpretation of the *Seitz I* court’s intent.²⁵

After distinguishing *Seitz I* and acknowledging the origin of the faulty determination of when a claim is direct or derivative, the court of appeals turned to the correct test. The court found that the correct test in determining whether an action is direct or de-

18. 148 Minn. 80, 87-88, 181 N.W. 102, 105 (1921) (*Seitz I*).

19. *See id.* at 83, 181 N.W. at 103.

20. *See id.* at 87, 181 N.W. at 105.

21. *See id.*

22. *See Wessin*, 581 N.W.2d at 384. Specifically, the court noted that “[t]he ‘same character’ language is not the test for distinguishing direct claims from derivative claims. It is merely the court’s description of the derivative injury at issue.” *Id.* The *Wessin* court then quoted the following passage from *Seitz I*, which supports this reading:

Money which might have been distributed among them as dividends has been wasted. The value of all stock has been diminished. The injury to each stockholder is of the same character. Whether the guilty officers were animated by hostility towards a particular stockholder or by greed, or were merely improvident, the result is the same and affects all the stockholders alike.

Id. (quoting *Seitz*, 148 Minn. at 87-88, 181 N.W. at 105). Of course this reading of the *Seitz I* court’s use of the “same character” language is not consistent with their explicit language. The Minnesota Supreme Court in *Seitz I* stated that in determining whether a claim belongs to the corporation rather than to its shareholders, the relevant inquiry is “whether the injury to each stockholder is of the same character.” *Seitz*, 148 Minn. at 87-88, 181 N.W. at 105.

23. *See Wessin*, 581 N.W.2d at 384.

24. *See id.*

25. *See id.* The court of appeals specifically stated that “[e]ven when the language of *Seitz I* and *Seitz II* is correctly cited, its strict applicability is questionable.” *Id.*

ivative is whether the shareholder has suffered an injury that is distinct from the corporation.²⁶ If they have, the action is direct.²⁷ If not, the claim belongs to the corporation.²⁸ According to the *Wessin* court, this standard corresponds with the modern trend requiring the plaintiff to be injured directly, or independently from the corporation, in order to form the basis for a direct action.²⁹ This is an emerging trend in Minnesota case law.³⁰ The court of appeals noted, however, that other jurisdictions have recognized that the test for determining whether an action is direct or derivative is whether the shareholder has suffered an injury that is distinct from the corporation.³¹

The court of appeals next turned to specific guidelines to aid in the determination of when a claim is direct or derivative.³² The court first advised other courts to examine the nature of the shareholder's claim and the relief that could result from the action by looking at the body of the plaintiff's complaint rather than the plaintiff's actual intention or designation.³³ Next, the court listed

26. *See id.* The court also noted that language in certain Minnesota cases focusing on "a direct injury to the shareholder that is distinct from the injury to the corporation is more consistent with the policies underlying the direct-derivative distinction." *Id.* Specifically, the *Wessin* court was referring to language in *Skoglund v. Brady*, 541 N.W.2d 17 (Minn. Ct. App. 1995), outlining that "[a] shareholder may bring a direct action when the shareholder alleges a direct injury to the shareholder that is separate and distinct from the injury to the corporation." *Id.* (quoting *Skoglund*, 541 N.W.2d at 21).

27. *See id.*

28. *See id.*

29. *See id.* at 384.

30. *See id.* The court found several cases in Minnesota supporting this position. *See Wenzel v. Mathies*, 592 N.W.2d 634, 641 (Minn. Ct. App. 1996) (finding that a derivative action is required when a shareholder suffers harm "that is distinct from the other shareholders or by the corporation itself"); *International Broad. Corp. v. Turner*, 734 F. Supp. 383, 392 (D. Minn. 1990) (recognizing that the test for a direct injury is whether claimant's injury is distinct from the corporation, but characterizing shareholders' claims for breach of fiduciary duty as derivative because the alleged injury was not "separate and distinct from all shareholders").

31. *See Wessin*, 581 N.W.2d at 385. The court of appeals specifically cited to both Delaware and Georgia cases. *See id.* (citing *Kramer v. Western Pac. Indus., Inc.*, 546 A.2d 348, 351 (Del. 1988) (finding that the proper test for determining if an action is direct is whether the shareholder has suffered an injury that is distinct from the corporation); *Grace Bros., Ltd. v. Farley Indus., Inc.*, 450 S.E.2d 814, 816 (Ga. 1994) (noting that the injury distinct from the corporation standard "is generally recognized as the test that distinguishes derivative from direct claims").

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

33. *See id.*

five factors to consider:³⁴ (1) whether the injury results from the plaintiff's other relationships with the corporation, such as the plaintiff's role as an intended beneficiary of a contract;³⁵ (2) whether the alleged misconduct was specifically targeted toward the plaintiff shareholder;³⁶ (3) whether the controlling stockholders engaged in self-dealing that causes a "singular economic injury" to minority interests alone;³⁷ (4) whether the defendants' alleged misconduct violates fiduciary duties owed directly to the plaintiffs;³⁸ or (5) whether the plaintiff is seeking only injunctive or prospective relief.³⁹

Applying these factors and refocusing the analysis on whether the injury is independent or distinct from the corporation, the court found that several of the plaintiff's claims were direct.⁴⁰ However, since the plaintiffs in *Wessin* brought both direct and derivative claims, the court of appeals was next required to determine which claims were subject to the derivative pleading requirements and which were not.⁴¹ The plaintiffs argued that the court should recognize an exception from derivative pleading rules for claims

34. *See id.*

35. *See Arent v. Distribution Sciences, Inc.*, 975 F.2d 1370, 1373 n.2 (8th Cir. 1992) (noting that "[i]ndividual recovery is warranted only if there is a direct injury to the shareholder").

36. *See Northwest Racquet Swim & Health Clubs, Inc. v. Deloitte & Touche*, 535 N.W.2d 612, 619 (Minn. 1995) (finding that defendant may have committed "very specific incidences of misrepresentation").

37. *Grace Bros., Ltd. v. Farley Indus., Inc.*, 450 S.E.2d 814, 816 (Ga. 1994).

38. *See Lee v. Mitchell*, 953 P.2d 414, 423-25 (Or. Ct. App. 1998).

39. *See Grimes v. Donald*, 673 A.2d 1207, 1213 (Del. 1996).

40. *See Wessin v. Archives Corp.*, 581 N.W.2d 380, 385 (Minn. Ct. App. 1998), *rev'd and remanded*, 592 N.W.2d 460 (Minn. 1999). The court found that at least three of the plaintiff's claims were direct: (1) fraud and misrepresentation; (2) breach of fiduciary duty; and (3) unfair prejudice. *See id.*

41. *See id.* at 386. The derivative pleading requirements are found in Rule 23.06 of the Minnesota Rules of Civil Procedure, which states:

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation . . . , the corporation . . . having failed to enforce a right which may properly be asserted by it, the complaint shall allege that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiff's share or membership thereafter devolved on the plaintiff by operation of law The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interest of the shareholders or members similarly situated in enforcing the right of the corporation or association

brought under Minnesota Statutes section 302A.751, subdivision 1(b)⁴² by minority shareholders in closely held corporations.⁴³ The majority shareholder in *Wessin* argued, however, that in *PJ Acquisition Corp. v. Skoglund*⁴⁴ the Minnesota Supreme Court had already considered and rejected this contention.⁴⁵ In response to this contention, the court of appeals found that since the majority opinion in *Skoglund* did not address the exact issue before them, they were free to formulate their own analysis.⁴⁶ The court of appeals saw as the exact issue before them, "whether a shareholder in a closely held corporation who alleges both direct and derivative claims must comply with the derivative action pleading requirements."⁴⁷

In answering this question, the court looked to both the legislative history of section 751 and to case law distinguishing between

42. MINN. STAT. § 302A.751, subd. 1(b) (1998). Minnesota Statutes section 302A.751, subd. 1(b) 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:

....

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

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;

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;

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;

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;

the corporate assets are being misapplied or wasted; or

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

MINN. STAT. § 302A.751, subd. 1(b).

43. See *Wessin*, 581 N.W.2d at 386.

44. 453 N.W.2d 1 (Minn. 1990).

45. *Wessin*, 581 N.W.2d at 386.

46. See *id.*

47. *Id.*

large publicly held corporations and small closely held corporations.⁴⁸ The court found that there has always been a significant difference in the way closely held corporations are treated.⁴⁹ Specifically, the Minnesota Supreme Court has described a closely held corporation as a “partnership in corporate guise.”⁵⁰ For this reason, Minnesota has recognized that a fiduciary relationship exists among the shareholders in a closely held corporation.⁵¹ This type of relationship is much different than those which exist in a large, publicly held corporation, and for this reason the court of appeals found that closely held corporations should not be subject to the same derivative pleading requirements as large corporations.⁵² Finally, the court noted that this approach was consistent not only with Minnesota precedent, but also was an emerging trend in several other jurisdictions.⁵³

48. *See id.* at 386-89.

49. *See id.* at 388-89.

50. *Id.* at 388 (quoting *Westland Capital Corp. v. Lucht Eng'g, Inc.*, 308 N.W.2d 709, 712 (Minn. 1981)).

51. *See id.* (citing *Evans v. Blesi*, 345 N.W.2d 775, 779 (Minn. Ct. App. 1984)). “This fiduciary relationship imposes the highest duties of honesty, integrity, and good faith.” *Id.* (citing *Pedro v. Pedro*, 489 N.W.2d 798, 801 (Minn. Ct. App. 1992)). It is also of some importance that the Minnesota legislature added a new subdivision to Minnesota Statutes section 302A.751 in 1983, which provides that in determining whether to order equitable relief, dissolution, or buyout, a court must consider “the duty which all shareholders in a closely held corporation owe one another to act in an honest, fair and reasonable manner.” *Id.* (quoting MINN. STAT. § 302A.751, subd. 3(a) (1984)).

52. *See id.* at 389. Specifically, the court used the following analysis:

Although the derivative pleading requirements are critical to the successful operation of large publicly held corporations, they are not consistent with the manner in which the Minnesota legislature or the courts treat closely held corporations. Requiring minority shareholders in closely held Minnesota corporations to follow the derivative pleading requirements . . . when bringing actions under Minn. Stat. §302A.751, subd.1 (b), appears inconsistent with its fundamental legislative intent and purpose. A derivative pleading requirement would substantially restrict the availability of Minn. Stat. §302A.751, subd.1. This restriction would thwart the legislative purpose of section 302A.751, subd.1, which was expressly enacted to protect minority shareholders in closely held corporations.

Id.

53. *See id.* This emerging trend was seen in many jurisdictions. *See Watson v. Button*, 235 F.2d 235, 237 (9th Cir. 1956) (permitting individual shareholder to recover for misappropriation of corporate assets by a director “where the rights of creditors and other shareholders are not prejudiced”); *Orsi v. Sunshine Art Studios, Inc.*, 874 F. Supp. 471, 474-75 (D. Mass. 1995) (allowing minority shareholder to bring direct action against close family corporation); *Johnson v. Gilbert*, 621

As an alternative basis for its conclusion that the derivative pleading requirements should not apply to actions involving direct and derivative claims, the court of appeals looked to the language of the civil procedure derivative pleading rule.⁵⁴ Because the derivative pleading rule refers to derivative *actions*, not derivative *claims*, “[a]n action that involves both direct claims and derivative claims would, strictly speaking, not be a derivative action.”⁵⁵ The court admitted that this was a “constrained reading” of the rule, but still saw their approach as consistent with the history and treatment of closely held corporations and emerging case law.⁵⁶

The Minnesota Court of Appeals’ decision in *Wessin* highlights several possible interpretations with regard to the derivative pleading requirements for shareholders in close corporations.⁵⁷ The first interpretation is that minority shareholders in a closely held corporation never have to adhere to the derivative pleading requirements.⁵⁸ Although this conclusion is inconsistent with the court’s ultimate holding,⁵⁹ its long discussion of the differences between closely held corporations and publicly held corporations indicates a preference for this approach by the court.⁶⁰

A second interpretation is that the derivative pleading requirements should apply where there are a greater number of direct claims than derivative claims. This approach is not considered by the court of appeals, but would be more consistent with the requirements of rule 26.03, while still recognizing a difference in

P.2d 916, 918 (Ariz. Ct. App. 1980) (permitting direct action against closely held corporation involving plaintiffs and defendants who “operated more as partners than in strict compliance with the corporate form”).

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

55. *Id.*

56. *Id.* The court in *Wessin* noted an explicit example in *Warthan v. Midwest Consolidated Insurance Agencies, Inc.*, 450 N.W.2d 145, 148-49 (Minn. Ct. App. 1990). See *Wessin*, 581 N.W.2d at 390. According to the *Wessin* court, the Minnesota Court of Appeals in *Warthan* “allowed minority shareholders to bring a direct suit for an arguably derivative claim” *Id.* (citing *Warthan*, 450 N.W.2d at 148-49).

57. See *id.* at 386-89.

58. See *id.* at 389.

59. See *id.* at 390. The court concludes their opinion by noting that “[t]he language of the rule, the legislative and common law history, and the need for coherent litigation procedures persuade us that derivative pleading requirements should not apply to actions that combine direct and derivative claims.” *Id.* at 390-91.

60. See *id.* at 387-89. The court notes that “[a]lthough the derivative pleading requirements are critical to the successful operation of large publicly held corporations, they are not consistent with the manner in which the Minnesota legislature or the courts treat closely held corporations.” *Id.* at 389.

treatment between closely held corporations and large publicly held corporations.

A third interpretation is that minority shareholders must comply with the derivative pleading requirements if any part of their cause of action is derivative. This approach is clearly not favored by the *Wessin* court,⁶¹ but absent legislative action on the subject, this might be the most technically correct attempt at conforming to rule 26.03.⁶²

Fourth and finally, the derivative pleading requirements may read as inapplicable to actions that combine direct and derivative claims. This interpretation of rule 26.03 is the favored approach by the court of appeals and clearly states their holding.⁶³ This last interpretation was not, however, accepted by the Minnesota Supreme Court in their review of the *Wessin* case.⁶⁴ The supreme court found that actions that combine direct and derivative claims must still adhere to the derivative pleading requirements.⁶⁵ The supreme court's reasoning for this position stems from their belief that the court of appeals' interpretation would effectively eliminate the derivative pleading requirements.⁶⁶

For example, under the court of appeals interpretation,⁶⁷ a plaintiff-shareholder could merely plead one direct claim along with a derivative claim, and effectively defeat the derivative pleading requirements. However, the supreme court's view of the derivative pleading requirements seems to lose sight of the need to treat closely held corporations differently than their large, publicly held counterparts. After all, there is always the possibility that a derivative action will be futile because it returns the recovery to the corporation, which is still under the control of the majority-shareholder wrongdoer. The supreme court dealt with this possibility by highlighting the need for a unified standard for all corpo-

61. *See id.* at 389-91.

62. However, this approach presupposes that the Minnesota Court of Appeals' reading of rule 26.03 is incorrect. In the court's view, the rule speaks in terms of *actions*, not *claims*, and "[a]n action that involves both direct claims and derivative claims would, strictly speaking, not be a derivative action." *Id.* at 390.

63. *See id.* at 391.

64. *See Wessin v. Archives Corp.*, 592 N.W.2d 460, 466 (Minn. 1999).

65. *See id.*

66. *See id.* at 467.

67. *See Wessin v. Archives Corp.*, 581 N.W.2d 380, 385-86 (Minn. Ct. App. 1998).

rations.⁶⁸ The supreme court noted that a closely held corporation is still “a corporation with all the rights and limitations proscribed by the legislature.”⁶⁹ As the Seventh Circuit noted, and the Minnesota Supreme Court agreed:

Corporations are not partnerships. Whether to incorporate entails a choice of many formalities. Commercial rules should be predictable; this objective is best served by treating corporations as what they are, allowing the investors and other participants to vary the rules by contract if they think deviations are warranted. . . . “[T]he closely held nature of the corporation [is] irrelevant to the distinction between direct and derivative actions.”⁷⁰

The *Wessin* case is important because it demonstrates an ambiguity in the derivative pleading requirements and illustrates the difficulties inherent in treating closely held corporations differently than their large, publicly held counterparts.⁷¹ This ambiguity is highlighted by the fact that the Minnesota Court of Appeals and the Minnesota Supreme Court came to two different conclusions on ostensibly the same issue. Additionally, the court of appeals’ clarification of the proper test for determining whether an action is direct or derivative⁷² serves as an excellent guide to practitioners dealing in corporate law.

B. *Minority Shareholder Buyouts*

In *McCallum v. Rosen’s Diversified, Inc.*,⁷³ the U.S. Court of Appeals for the Eighth Circuit held that a terminated chief executive officer (“CEO”), a minority shareholder of a closely held Minnesota corporation, was entitled to a court ordered buyout of his shares.⁷⁴ In reaching this decision, the Eighth Circuit noted that Minnesota law does not specifically outline when a court ordered

68. See *Wessin*, 592 N.W.2d at 466.

69. *Id.*

70. *Id.* (quoting *Bagdon v. Bridgestone/Firestone, Inc.*, 916 F.2d 379, 384 (7th Cir. 1990)).

71. See *id.* at 389.

72. See *id.* at 384-86.

73. 153 F.3d 701 (8th Cir. 1998).

74. See *id.* at 704.

buyout is appropriate.⁷⁵ Thus, the Eighth Circuit's role was to determine what the Minnesota Supreme Court would likely hold were it to decide the issue.⁷⁶ In the Eighth Circuit's view, the termination of a CEO, together with an offer to redeem the CEO's stock, was sufficient to warrant a judicially ordered buyout.⁷⁷ The main consequence of this holding is the creation of a per se rule for minority shareholder buyouts when the minority shareholder has a significant management role.

In 1984, Rosen's Diversified Incorporated ("RDI") hired William McCallum ("McCallum") to serve as its CEO and executive vice president.⁷⁸ In 1986, he was named a director.⁷⁹ As a result of strong performance by RDI in the livestock industry, McCallum was rewarded with a bonus of \$186,815 and 12,000 shares of common stock in the company.⁸⁰ In 1991, McCallum was terminated as CEO and removed from the board of directors.⁸¹ McCallum and RDI were subsequently unable to agree on a redemption value for the 12,000 shares of common stock.⁸² McCallum suggested \$5 Million, while RDI suggested \$600,000.⁸³ In the subsequent litigation, RDI's position was that the stock should be redeemed for a small premium over the value determined by the company's Employee Stock Ownership Program ("ESOP").⁸⁴ McCallum alleged that RDI's acts were "unfairly prejudicial" toward him, thus entitling him to equitable relief in the form of a court ordered buyout.⁸⁵ The district

75. See *id.* at 703. The court specifically noted that "[t]he Supreme Court of Minnesota has not confronted the issue of when a minority shareholder is entitled to a court ordered buyout." *Id.*

76. See *Farr v. Farm Bureau Ins. Co.*, 61 F.3d 677, 679 (8th Cir. 1995) (holding that where a particular state court is silent on an issue, the federal court "must determine what that court would probably hold were it to decide the issue. In making this determination, we may consider relevant state precedent, analogous decisions, considered dicta, scholarly works and any other reliable data.").

77. See *McCallum*, 153 F.3d at 704.

78. See *id.* at 702.

79. See *id.*

80. See *id.*

81. See *id.*

82. See *id.* McCallum also owned approximately 3,300 shares of RDI common stock purchased through the company's Employee Stock Ownership Program. See *id.* at 702 n.1. Those shares were not at issue in the instant case. See *id.* at 703.

83. See *id.* at 702.

84. See *id.*

85. *Id.* at 703. McCallum's specific allegations were that RDI's controlling shareholders: "(1) undermined his authority as CEO; (2) excluded him from important company decisions; (3) engaged in conduct directed at minimizing the value of the company; (4) terminated his employment; (5) offered to redeem his

court dismissed McCallum's buyout request on a motion for summary judgment and found that RDI had not acted in an "unfairly prejudicial" fashion.⁸⁶

The Eighth Circuit first noted that the district court had improperly dismissed McCallum's allegations of misconduct by RDI's board of directors.⁸⁷ According to the Eighth Circuit, the district court erred in finding that McCallum was required to observe the derivative pleading requirements for shareholder proceedings.⁸⁸ Because McCallum's allegations were simply examples of unfairly prejudicial conduct by the controlling shareholders and not separate claims on behalf of the corporation, no derivative pleading was required.⁸⁹ The court found support for this proposition in *PJ Acquisition Corp. v. Skoglund*,⁹⁰ where the Minnesota Supreme Court inferred that a shareholder action for equitable relief is not a derivative action.⁹¹

The Eighth Circuit next recognized the unique position of closely held corporations in Minnesota.

The Minnesota legislature, sensitive to the position of minority interests in closely held corporations, enacted legislation to protect these interests.⁹² Minnesota Statutes section 302A.751⁹³ grants equitable authority to the courts where minority shareholder's interests are threatened by those in control of the company.⁹⁴ Specifically, section 751 mandates the buyout of a minority shareholder's interest when "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 . . . or as officers or employees of a closely held corporation."⁹⁵ The phrase "unfairly prejudicial" in section 751, which is to be interpreted lib-

shares at an artificially low price; (6) denied him access to company books, records, and financial information; (7) engaged in self-dealing, usurped company opportunities, and commingled personal ventures with affairs of the company." *Id.*

86. *Id.* at 702.

87. *See id.* at 703.

88. *See id.*

89. *See id.*

90. 453 N.W.2d 1 (Minn. 1990).

91. *See id.* at 6. *See McCallum*, 153 F.3d at 703.

92. *See McCallum*, 153 F.3d at 703.

93. *See* MINN. STAT. § 302A.751, subd. 1(b) (1998).

94. *See* MINN. STAT. § 302A.751, subd. 1(b)(3).

95. *Id.*

erally,⁹⁶ is what the Eighth Circuit was referring to when it found that the Minnesota Supreme Court had yet to confront the issue of when a court ordered buyout was appropriate.⁹⁷

In deciding whether equitable relief was appropriate in this case, the Eighth Circuit turned to the statutory language of section 751. The statute provides that “the reasonable expectations of the shareholders,”⁹⁸ with respect to each other and the corporation, should be considered by the courts in deciding whether to order a buyout.⁹⁹ The court found that “reasonable expectations” often include a significant voice in the management of the company and an opportunity to work.¹⁰⁰ Finally, when looking at the “reasonable expectations” of a shareholder, the focus is on the shareholder’s expectations at the inception of the relationship with the closely held corporation.¹⁰¹

Applying these principles to McCallum’s situation, the court found that McCallum’s “reasonable expectations” were defeated and that RDI had acted in an unfairly prejudicial manner.¹⁰² The Eighth Circuit focused on the fact that stock was given to McCallum as a bonus for outstanding service and as an inducement to remain with RDI.¹⁰³ Because the uncontested facts of the case indicated that McCallum was removed as CEO, he was divested of his primary

96. See *Pedro v. Pedro*, 463 N.W.2d 285, 288-89 (Minn. Ct. App. 1990).

97. See *supra* note 75 and accompanying text. Minnesota courts have yet to thoroughly define “unfairly prejudicial” in the context of section 751.

98. MINN. STAT. § 302A.751, subd. 3(a) (1998).

99. See *McCallum v. Rosen’s Diversified, Inc.*, 153 F.3d 701, 703 (8th Cir. 1998).

100. See *id.* at 704. In formulating this definition of “reasonable expectations,” the Eighth Circuit looked to commentary by Joseph Edward Olson. See *id.* at 703. Olson helped to revise the Minnesota Corporation Act and section 751. See *id.* Olson has stated that section 751 is remedial in nature and “should be liberally construed as an addition to the rights afforded non-controlling shareholders by law and the corporation’s governing documents. The broad scope of Section 751 reflects the Legislature’s trust in the ability of the judiciary to achieve equitable results on the facts appearing in individual cases.” Joseph Edward Olson, *Statutory Changes Improve Position of Minority Shareholders in Closely-Held Corporations*, 53 HENNEPIN LAW. 10, 11 (Sept.-Oct. 1983). The Eighth Circuit quoted the above language in its opinion, aiding in the definition of the phrase “reasonable expectations.” See *McCallum*, 153 F.3d at 703.

101. See *McCallum*, 153 F.3d at 704 (“Although the employment relationship later deteriorated, our focus is on McCallum’s reasonable expectations at the inception of the relationship.”). This mode of analysis is also explicitly required by section 751. See MINN. STAT. § 302A.751, subd. 3(a).

102. See *McCallum*, 153 F.3d at 703-04.

103. See *id.* at 704.

expectations as a minority shareholder in the corporation.¹⁰⁴ His expectations, made all the more reasonable by his position of CEO, were an active role in the “management of the corporation and input as an employee.”¹⁰⁵ Under the Eighth Circuit’s analysis, RDI had no choice but to defeat McCallum’s “reasonable expectations.” If a CEO is also a minority shareholder, a company’s choice to remove him or her will always lead to frustration of the expectation of an active role in the management of the corporation. Thus, the Eighth Circuit has created a per se rule mandating a court ordered buyout where the CEO of a closely held corporation is removed from that position and is also a minority shareholder in the company.¹⁰⁶

It must be noted that this per se rule has two possible limitations. First, in this case it is clear that McCallum did not engage in any type of activity designed to harm the corporation.¹⁰⁷ There were no allegations by RDI that McCallum engaged in self-dealing or that he usurped a corporate opportunity for his own. This type of activity would change the analysis in that a minority shareholder engaging in self-dealing could not successfully argue that the corporation acted unfairly prejudicial toward him. Similarly, a CEO’s “reasonable expectations” in maintaining a voice in the manage-

104. *See id.*

105. *Id.* (quoting *Pedro v. Pedro*, 463 N.W.2d 285, 289 (Minn. Ct. App. 1990)). The Eighth Circuit used this language in *Pedro* to support its definition of “reasonable expectations.” *See id.* at 704. This approach is consistent with the Eighth Circuit’s mandate to follow relevant state precedent in the absence of a state supreme court case directly confronting the issue. *See Farr v. Farm Bureau Ins. Co.*, 61 F.3d 677, 679 (8th Cir. 1995).

106. *See McCallum*, 153 F.3d at 704. One need only look at the holding of this case in order to see that the court has created a per se rule for CEO buyouts. The court says that termination of a CEO “as opposed to an employee that did not have a significant role in management—and then offering to redeem his stock, which was used partially to lure him to remain at the company, constituted conduct toward McCallum as a shareholder sufficient to invoke the requirements of the Minnesota Act.” *Id.* Interestingly, the Eighth Circuit noted in *McCallum* that its holding was not as broad as the Minnesota Court of Appeals in a similar case. *See id.* (“We need not extend our holding as far as the Minnesota Court of Appeal’s, which held that controlling shareholders that terminate the employment of a minority shareholder must make a good-faith effort to buyout the shareholder at a fair price.”) (interpreting *Sawyer v. Curt & Co.*, Nos. C7-90-2040, C9-90-2041, 1991 WL 65320, at *2 (Minn. Ct. App. Feb. 12, 1991) (publication order vacated). In reality, the Eighth Circuit holding seems broader in that a terminated CEO who is also a minority shareholder is entitled to a *court ordered* buyout, not simply a good faith effort by the *majority shareholders* to buy out the shareholder at a fair price.

107. *See id.* at 703.

ment of the company would be defeated where that CEO had usurped a corporate opportunity for himself.

A second possible limitation is the Eighth Circuit's repeated reference to McCallum's stock. The court notes on three occasions that the stock was given to McCallum "as compensation for his outstanding service and as an inducement to remain at RDI, in order to foster its continued growth."¹⁰⁸ Given the court's repeated reliance on this fact in formulating McCallum's "reasonable expectations," it is possible that a minority shareholder who had received stock in a closely held corporation *prior* to being named CEO would not be subject to the same *per se* rule as was McCallum in this case.

C. *Demand Required v. Demand Excused*

In *Reimel v. MacFarlane*,¹⁰⁹ a federal district court applying Minnesota law attempted to clarify the parameters of demand futility¹¹⁰ with regard to Minnesota corporations.¹¹¹ The court began by noting that the Minnesota Supreme Court has not visited the issue of demand futility since 1961,¹¹² and numerous questions still exist regarding when demand is required or excused in Minnesota.¹¹³ These unresolved questions led to the result in *Reimel*, where the court found demand required if the board of directors may have acted in good faith.¹¹⁴ While this finding is consistent with the intentions behind requiring demand on the board, it exposes an am-

108. *Id.*

109. 9 F. Supp. 2d 1062 (D. Minn. 1998).

110. *See id.* at 1065. The court noted the derivative pleading requirements under Federal Rule of Civil Procedure 23.1, which requires that "in a derivative action brought by a shareholder to enforce a right of a corporation, the complaint allege with particularity 'the efforts, if any, made by the plaintiff to obtain the action plaintiff desires from the directors or comparable authority and . . . the reasons for plaintiff's failure to obtain the action or for not making the effort.'" *Id.* (quoting FED. R. CIV. P. 23.1).

111. *See id.*

112. *See id.* (citing *Winter v. Farmers Educ. & Coop. Union*, 259 Minn. 257, 107 N.W.2d 226 (1961)).

113. *See id.* In Minnesota and many other jurisdictions, demand is excused if it would be futile. *See, e.g., Aronson v. Lewis*, 473 A.2d 805, 814-17 (Del. 1984) (excusing demand as futile where factual allegations create a reasonable doubt that either: (1) the majority of the corporation's board was disinterested in the transaction or independent; or (2) the challenged transaction was otherwise the result of a valid exercise of business judgment); *Winter*, 259 Minn. at 267, 107 N.W.2d at 233-34 (finding demand futile where the alleged wrongdoers constitute a majority of the board).

114. *See Reimel*, 9 F. Supp. 2d at 1066-67.

biguity in Minnesota precedent and thus indicates why the subject of demand futility should again be addressed by the Minnesota Supreme Court.

Patricia Reimel ("Reimel") was a shareholder in Otter Tail Power ("Otter Tail"), a Minnesota corporation.¹¹⁵ On January 27, 1997, Otter Tail adopted a shareholder rights plan that was designed to protect it against hostile takeovers.¹¹⁶ The plan created a new class of securities.¹¹⁷ These new securities contained a "flip in" provision, entitling each holder of a right to buy \$140 worth of stock for \$70 upon a triggering event relating to the acquisition of fifteen percent or more of common stock.¹¹⁸ The securities also contained a "flip over" feature, providing that a shareholder may buy \$100 worth of an acquiring company's shares for \$50.¹¹⁹ Neither provision, each known as a "poison pill,"¹²⁰ applied if an offer for all Otter Tail shares was approved by a majority of the company's non-officer directors.¹²¹ Finally, the plan had a "dead hand" feature providing that "flip in" and "flip over" rights could only be redeemed by a majority of the continuing directors on conditions established by them.¹²² Reimel alleged that this "dead hand" feature was enacted to "entrench" the board and make future contests for corporate control "prohibitively expensive and effectively impossible."¹²³ Alternatively, Otter Tail contended that this plan was

115. See *id.* at 1064.

116. See *id.*

117. See *id.* The new class of securities was called "preferred share purchase rights." *Id.* "The rights were declared and became payable as a dividend, one right per share for each of the outstanding common shares of the company on the record date of February 7, 1997." *Id.*

118. See *id.* This provision was alleged by Otter Tail to prevent the acquisitions of the company by outside interests. See *id.* As the court in *Reimel* noted, "[t]his provision deters would be acquirers of Otter Tail by threatening to dilute their holdings and greatly increase the number of shares an acquirer would have to purchase in order consummate a merger, combination, or takeover purchase." *Id.*

119. See *id.* This "flip over" feature would apply in the event of a hostile takeover or merger. See *id.* As the court in *Reimel* noted, "[t]his feature subjects the acquiring company to a half price sale of its own stock and thereby dilutes the interest of its other shareholders, obviously deterring potential acquisitions." *Id.*

120. See generally Robert A. Helman & James J. Junewicz, *A Fresh Look at Poison Pills*, 42 BUS. LAW. 771, 772-74 (1987) (reciting a brief history of "poison pills").

121. See *Reimel*, 9 F. Supp. 2d at 1064.

122. See *id.*

123. *Id.* In analyzing the plaintiff's approach, the court acknowledged that the "dead hand" provision "entrenches the incumbent board by preventing the shareholders—who never approved the Rights—from receiving any offer to purchase their shares without the prior approval of the Continuing Directors." *Id.*

put in place to prevent a hostile takeover of the company.¹²⁴

As no demand was made on the board before initiating the action, the court's analysis focused on whether allegations of a board entrenching itself were sufficient to make demand futile, and thus excused, according to Minnesota law.¹²⁵ Applying the applicable Minnesota law, the court focused on the Minnesota Supreme Court's holding in *Winter v. Farmers Education & Cooperative Union*.¹²⁶ In *Winter*, the Minnesota Supreme Court announced that "demand is not required where it is plain from the circumstances that it would be futile."¹²⁷ The *Reimel* court noted that there have been no recent Minnesota decisions applying the *Winter* principle in the context of pre-suit demand on the board.¹²⁸ The court also announced that no Minnesota case has held that Delaware's approach to demand futility should be followed in Minnesota, even though Minnesota courts have followed Delaware corporate law in other contexts.¹²⁹ Thus, without recent guidance from Minnesota case law, the court was forced to interpret *Winter* in the context of *Reimel*'s failure to make a demand on Otter Tail's board.

The court found that *Winter*'s predominant message was that a "shareholder derivative suit is a last resort, available only where—as in that case—there is no possibility that the board will consider the merits of the demand."¹³⁰ Demand on the board provides it with an opportunity to consider the claim and resolve the dispute without resorting to litigation.¹³¹

124. *See id.*

125. *See id.* at 1065. The court noted that at least one Delaware court has found demand excused where there were allegations of directors' perpetuating themselves in office. *See id.* (citing *In re Chrysler Corp. Shareholders Litig.*, No. 11873, 1992 WL 181024, at *4-*5 (Del. Ch. July 27, 1992)).

126. *See id.* (analyzing *Winter v. Farmers Educ. & Coop. Union*, 259 Minn. 257, 107 N.W.2d 226 (1961)).

127. *Winter*, 259 Minn. at 267, 107 N.W.2d at 234 (citations omitted).

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

129. *See id.*

130. *Id.* The court pointed to the following language in *Winter* to support its interpretation: "The derivative suit is recognized as an extraordinary remedy available only where there is 'no other road to redress.'" *Id.* (quoting *Winter*, 259 Minn. at 267, 107 N.W.2d at 233).

131. *See id.* This policy discussion was included by the *Winter* court as well. *See Winter*, 259 Minn. at 267, 107 N.W.2d at 233. The Minnesota Supreme Court found that "demand upon managing directors and shareholders is important in that it gives the management of the corporation an opportunity to consider the merits of the dispute and determine, in the interests of the corporation and shareholders, whether it might be disposed of without the expense and delay of litigation." *Id.*

Applying these principles to the *Reimel* situation, the court found that demand was not futile.¹³² Because there were no allegations that Otter Tail's board engaged in self-dealing or converted corporate funds, the court found that demand was required on the board.¹³³ Where there are no allegations of "patently egregious board conduct," and where there is a possibility that the board acted in good faith, the court found that demand must be made on the board.¹³⁴ According to the court, this analysis applies even where the alleged wrongdoers constitute a majority of the board.¹³⁵ While this approach has valid policy ramifications in that it discourages litigation, the language in *Winter* creates uncertainty for courts deciding whether demand on the board is futile.

In *Winter*, the Minnesota Supreme Court held that, "[o]rdinarily a demand should be made on the board of directors unless the wrongdoers constitute a majority of the board"¹³⁶ This language indicates a per se approach to demand futility where, as is the case with *Reimel*, the alleged wrongdoers constitute a majority of the board.¹³⁷ Although the *Reimel* court ultimately rejected the approach,¹³⁸ the language in *Winter* is clear and should not be ignored by courts seeking to follow Minnesota precedent. The *Reimel* decision, decided in 1998 by a federal district court applying Minnesota law, is indicative of the confusion surrounding *Winter's* 1961 formulation of demand futility.¹³⁹ Thus, to alleviate confusion surrounding demand futility, the Minnesota Supreme Court should revisit the issue at its first opportunity.

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132. See *Reimel*, 9 F. Supp. 2d at 1066-67.

133. See *id.*

134. See *id.*

135. See *id.* at 1066.

136. *Winter*, 259 Minn. at 266-67, 107 N.W.2d at 233.

137. See *id.*

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

139. See *id.*