

SHAREHOLDER-EMPLOYEES AND OTHER OWNER EMPLOYEES

Many businesses in Minnesota are organized as non-public or “private” corporations. Private corporations are those whose shares are not regularly traded on a recognized public market.

The issue of who owns shares in a private corporation is important, not only in terms of equity ownership and voting control, but with respect to the rights and liabilities to and among the shareholders, officers, directors and employees in such corporations. The same is true for members, governors and managers in limited liability companies (LLCs) and for partners in Minnesota partnerships.

THE RIGHTS AND DUTIES AMONG SHAREHOLDERS, OFFICERS AND DIRECTORS IN PRIVATE CORPORATIONS

The law controlling companies incorporated in Minnesota generally holds that shareholders, officers and directors owe duties of good faith and loyalty to the corporation and, under certain circumstances, to each other.³⁶⁸ Frequently, these duties are described as being “fiduciary” in nature. In making decisions regarding the conduct of business matters, it is therefore important for the controlling officers, directors and shareholders to evaluate, on a case-by-case basis, whether their chosen course of action may violate any of their duties to the shareholders, including shareholder-employees, or to the corporation. The courts have defined these duties as follows:

- **Director’s and Officer’s Duty.** A director or officer has the general duty to act in good faith, in a manner reasonably believed to be in the best interests of the corporation, with the care an ordinarily prudent person in a like position would exercise under similar circumstances and to avoid acts of self-dealing and conflicts of interest.
- **Shareholder’s Duty.** The controlling shareholder(s) in every private corporation has a duty to the minority shareholder(s) not to use his control for the purpose of self-dealing, including the conduct of actions which are fraudulent, illegal or unfairly prejudicial to the minority shareholder. All shareholders in closely-held corporations (i.e., those with 35 or fewer shareholders) have a duty to act toward one another and the corporation in good faith, which the courts in Minnesota and elsewhere have defined in terms of varying degrees of fiduciary duty.

In actual practice, the above-described duties are often alleged to have been breached when controlling shareholders, officers or directors act to their personal benefit and/or to the personal detriment of the minority shareholder or the corporation. While there is no complete listing of the circumstances in which these duties are found to have been breached, these claims usually involve such financial and corporate control issues as diverting business opportunities; using funds or services for personal financial gain; withdrawing excess compensation and/or other personally valuable benefits from the corporation; and excluding minority shareholders from the reasonable benefits of ownership in the corporation. Although some of these claims may technically belong to the company, in certain circumstances minority shareholders have asserted these types of claims directly against the majority shareholders, especially where the minority owner can establish some unique injury or damage to his or her investment.

Careful advance and ongoing planning can minimize the risk of breaching these duties.

THE EMPLOYEE AS SHAREHOLDER

Frequently, corporate management is presented with the question of whether to issue shares to key employees either as non-cash incentive compensation or pursuant to a buy-in formula. This type of benefit can be used to attract or retain qualified personnel and increase productivity by granting the employee a proprietary interest in the business. The issuance of shares to an employee, however, raises significant corporate governance and employment law issues which must be considered carefully. Some of the major issues are identified below.

- **Impact on the Employment Relationship.** An employee's ownership of shares can potentially affect the corporation's ability to alter the terms of his or her employment, including the right to terminate the employee's employment. In Minnesota, a court has broad discretion to issue relief to a shareholder who has been improperly harmed in his or her capacity as a shareholder or as an employee. Accordingly, even if employed as a non-contract, "at-will" employee, an employee-shareholder may argue that a termination of his or her employment violated a "reasonable expectation" of continued employment, or other related employment terms, growing out of his or her status as a shareholder.³⁶⁹ The potential damages in a shareholder case are very large, and may include wages until expected retirement age, dividends and other distributions of corporate profits, the value of stock options that the shareholder was not allowed to exercise, and other missed opportunities to participate in the financial rewards of a company.

Whether an employee's status as a shareholder creates a reasonable expectation of continuing employment turns upon the unique facts of each case. Among the potentially relevant factors are the amount of money the individual has invested into the company, the level of financial risk undertaken by the employee-shareholder, the degree of effort he or she has spent in making the company successful, discussions among the shareholders about their employment

expectations, the policies or practices with respect to other employee-shareholders, and the tension between the controlling shareholders' desire to manage the company effectively with the minority shareholders' desire to continue employment. Accordingly, careful consideration must be given in both issuing stock to an employee and in modifying such an employee-shareholder's employment terms, including termination of employment. These risks can be minimized by entering into definitive agreements with the employee regarding his or her shareholder rights, as discussed below.

- **Voting Control.** The issuance of additional shares to an employee could impact the voting control over the management of the corporation through the election of directors and selection of officers. Whether the issuance of shares will cause an unacceptable dilution or transfer of voting control should always be evaluated in advance of making any commitment to transfer shares.
- **Disclosure of Corporate Information.** Shareholders in Minnesota corporations generally have the right, without a showing of need, to access certain corporate information that employers may not normally share with all of their employees, including annual financial statements, board resolutions and actions, bylaws, articles and shareholder records. Additionally, upon a showing of proper purpose, shareholders in a privately-held company generally have the right to examine other corporate records.³⁷⁰ The confidentiality of corporate records should be considered when determining whether to make stock ownership available to employees.
- **Conditions of the Employee's Stock Ownership.** Management should carefully consider the following issues before issuing stock to an employee:
 - What terms will govern the employee's ownership and voting of the stock while employed by the company?
 - Will the employee be allowed to continue to own the shares if employment is terminated?
 - How will the shares be valued and purchased if the employee desires, or is required, to sell them by specific agreement with the corporation?

These questions can be resolved through definitive "shareholder control" and "buy-sell" agreements entered into with the employee in advance of transferring any shares. Under Minnesota law, there is a presumption that such agreements reflect the reasonable expectations of the shareholders to the extent that issues are addressed in the documents.³⁷¹ In addition, management may prefer to implement other incentive programs, including "phantom" stock plans, which can give the employee a proprietary interest in the performance of the business while avoiding the stock ownership issues identified above.

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Shareholder-employee issues are so complex and significant to the long-term success of a business that company owners and management should obtain competent legal advice prior to entering into any agreements to transfer shares to any employee.

THE RIGHTS AND DUTIES AMONG MEMBERS, GOVERNORS AND MANAGERS IN LIMITED LIABILITY COMPANIES AND AMONG PARTNERS IN PARTNERSHIPS

The members, governors and managers of LLCs formed under Minnesota law have essentially the same duties and responsibilities to one another as do the shareholders, directors and officers in privately-held companies and have heightened responsibilities in closely-held LLCs.³⁷² The same is true for partners in Minnesota partnerships. Employee ownership issues raise the same concerns in LLCs and partnerships as they do in corporations.

³⁶⁸ Minn. Stat. §§ 302A.251, subd. 1, 302A.361 (2011).

³⁶⁹ *Gunderson v. Alliance of Computer Prof'l, Inc.*, 628 N.W. 2d 173 (Minn. Ct. App. 2001).

³⁷⁰ Minn. Stat. § 302A.461 (2011).

³⁷¹ Minn. Stat. § 302A.751, subd. 3a (2011).

³⁷² Minn. Stat. §§ 322B.663, 322B.69, 322B.833, subd. 4 (2011).