MANAGING (REASONABLE) EXPECTATIONS: PRACTICAL CONSIDERATIONS FOR COUNSELING CLIENTS REGARDING CLOSELY HELD CORPORATIONS, POST-BAUR

POLK COUNTY BAR ASSOCIATION

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Des Moines, Iowa

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I. **Introductory Comments:** Closely-held Corporations, their Unique Characteristics, and the Perceived Need to protect their Minority Shareholders.

A. What is a Closely Held Corporation? Generally, a privately held corporation with a small number of shareholders (commonly <25 shareholders). What "characteristics" distinguish them from publicly traded companies? Closely-held corporations oftentimes—

i. Involve a **homogeneous (or "intimate") group** of shareholders (e.g., family members, group of professionals or other specialists, etc.).

ii. Have **no ready market** for their shares (a challenge for a shareholder seeking to liquidate the interest).

iii. Have governing documents (bylaws, buy-sell agreements, etc.) that impose **transfer restrictions** on the stock (in the interest of "keeping the business in the family," or serving as barrier to entry into the corporate professional group, etc.).

iv. Involve **disproportionate** ownership interests (giving rise to the controlling sh'er – non-controlling sh'er dichotomy)—e.g., in a family farm corporation, mom and dad leave controlling (majority) interest to the child operating the farm and non-controlling (minority) interests to the children having no operational involvement).

v. Involve shareholders with divergent **expectations** relating to **corporate governance, distributions of earnings, management and employment.** For example, majority shareholder(s) may have effective control over board appointment, officer designations and employment decision; however, minority shareholder may hold subjective expectation of holding director/officer titles and corporate employment.

B. Business Judgment Rule (BJR). Historically, corporations have been board-centric entities. Directors govern and officers manage while the shareholders supply the capital. The BJR—

i. Is the "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985)(citations omitted).

ii. Means that a court will not substitute its judgement for that of the board if the latter's decision can be attributed to any rational business purpose. *Id.*

C. Modern trend: Protecting the Minority Shareholder from "Freeze-out" of the Majority. There has been a broadening of statutory grounds for involuntary dissolution—a tool for the minority shareholder to counter so-called "freeze-out" tactics of controlling shareholders in their roles as directors and officers.

D. Involuntary Dissolution under Iowa Law. Iowa Code Section 490.1430 authorizes a shareholder to file an action seeking dissolution[1] of the corporation on the basis of any of the following conditions:

i. Director Deadlock. The directors are deadlocked in the management of the corporate affairs, the shareholders are unable to break

[1] Note that Iowa's Revised Uniform Limited Liability Company Act similarly provides an LLC member or transferee a path to seek involuntary dissolution on the—

> [G]rounds that the managers or those members in control of the company have done any of the following:
> (1) Have acted, are acting, or will act in a manner that is illegal or fraudulent.
> (2) Have acted or are acting in a manner that is oppressive and was, is, or will be directly harmful to the applicant.

Iowa Code § 489.701.

the deadlock, and either **irreparable injury** to the corporation is threatened or being suffered, or the business and affairs of the corporation **can no longer** be conducted to the **advantage of the shareholders** generally, because of the deadlock. (Iowa Code § 490.1430(1)(b)(1)(2016)(emphasis added).)

ii. Oppression. The directors or those in control of the corporation have acted, are acting, or will act in a manner that is **illegal**, **oppressive**, or **fraudulent**. (*Id.* at (1)(b)(2)(emphasis added).)

iii. Shareholder Deadlock. The shareholders are deadlocked in voting power and have failed, for a period that includes at least **two consecutive annual meeting dates**, to elect successors to directors whose terms have expired. (*Id.* at (1)(b)(3)(emphasis added).)

iv. Waste. The corporate assets are being **misapplied or wasted**. (*Id.* at (1)(b)(4)(emphasis added).)

v. Noteworthy Section 490.1430 Amendment (Effective 1/1/2014): Statutory involuntary dissolution generally cannot be invoked against a corporation that (on the date of the petition): (a) has stock which is publicly traded; or (b) is a "large" privately held company (must have at least 300 shareholders and its outstanding shares (excluding shares owned by executives, directors and certain other persons) must have a market value of at least $20M). *See* Iowa Code Ann. § 490.1430 (2)(emphasis added).

E. What is Oppressive Conduct? The Iowa's Business Corporation Act (Iowa Code Chapter 490) does not define "oppressive" conduct. Neither does the Model Business Corporation Act (on which Chapter 490 was based).

i. Other Jurisdictions. Jurisdictions have adopted alternative standards for evaluating claims of oppression. Generally speaking, alternatives include:

1. *"Bad" Acts by the Person(s) in Charge.* Some courts have concluded that oppression is: "burdensome, harsh and wrongful conduct . . . or a visible departure from the standards of fair dealing and a violation of fair plan on which

every shareholder who entrusts his money to a corporation is entitled to rely." *Fix v. Fix Material Co.*, 538 S.W.2d 351, 358 (Mo.Ct. App. 1976).

2. *Reasonable Expectations Standard.* Other courts examine whether the conduct frustrated the reasonable expectations of the shareholders. *See, e.g., Stefano v. Coppock*, 705 P.2d 443 (Alaska 1985).

ii. Iowa Court of Appeals Decisions Finding Oppressive Conduct (Pre-*Baur*).

1. One example—terminating a minority shareholder's employment and effectively transferring business to new entity (*Maschmeier v. Southside Press, Ltd.*, 435 N.W.2d 377 (Iowa Ct. Ap. 1988)).

2. Another—controlling shareholder of corporation (an S corporation for tax purposes) discontinues the practice of making shareholder tax distributions (needed to defray pass-through income tax liability) in order to gain leverage in buy-out negotiation (*Lee v. Meloan*, 787 N.W.2d 479 (Iowa Ct. App. 2010)).

II. Iowa Supreme Court Weighs-in: Adopts "Reasonable Expectations" Standard. In 2013, the Iowa Supreme Court (SC) adopted the "**reasonable expectations**" legal standard for determining whether oppression exists (*Baur v. Baur Farms, Inc.*, 832 N.W.2d 663 (Iowa 2013)("*Baur I*")).

A. *Baur I*: A (Very) Brief Case Summary: Minority shareholder (Jack) in a family farm corporation brings shareholder oppression claim against corporation/majority shareholder (Bob). District court enters a directed verdict for corporation/majority shareholder holding that there is no basis for oppression; minority shareholder appeals. On appeal, the Iowa Supreme Court reviews the case *de novo*:

i. SC Holding:

> The determination of whether the conduct of controlling directors and majority shareholders is oppressive . . . must focus on whether the **reasonable expectations of the minority shareholder have been frustrated under the circumstances**. We need not catalogue here all the

> categories of conduct and circumstances that will constitute oppression frustrating the reasonable expectations of minority shareholders' interests. We hold that **majority shareholders act oppressively** when, having the **corporate financial resources** to do so, they fail to satisfy the **reasonable expectations** of a minority shareholder by paying **no return** on shareholder equity while declining the minority shareholder's **repeated offers** to sell shares for **fair value**.

Baur I, 832 N.W.2d 663 at 674.

ii. Remand and Instructions to District Court. The SC reverses and remands to the District Court with the instruction that it is to apply the newly adopted "reasonable expectations" standard in adjudicating the oppression claim. In its decision, the SC examines the corporation's long history, including: (1) a 1984 bylaws amendment that included a buyout provision calculated on the basis of book value; (2) the two shareholders' disagreements regarding certain corporate decisions while serving as directors and officers (including whether to reinvest profits or issue dividends); (3) the majority shareholder's expansion of the board from 2 to 3 members and decision to not re-elect minority shareholder to officer; and (4) the parties' failed attempts to negotiate a buy-out of the minority shareholder, culminating in the minority shareholder's offer to sell his shares for $1.825M which the corporation "fail[ed] to accept" before the dissolution action was filed.[2] The decision goes on to conclude, in part—

> Although we have identified the legal standard for adjudicating Jack's claim of oppression, we express no view on the question of whether the last position taken by [the corporation] during negotiations on the [$1.825M] price offered for Jack's interest in the corporation was outside the range of fair value and incompatible with the reasonable expectations of a shareholder in Jack's position under circumstances

[2] The district court's findings on remand clarified that the corporation did not respond to the minority shareholder's last demand of $1.825M prior to his filing of the dissolution lawsuit. *Baur v. Baur Farms, Inc.*, 2015 WL 4036105 (Iowa Ct. App. 2016).

including a history of no return on shareholder equity during the several decades of the corporation's existence.

B. *Baur II*: On Remand, District Court Finds that Minority Shareholder's Last Demand for Buy-out Exceeded Fair Value, Dismisses Dissolution Action. The District Court determines that the "**fair value**" of the minority shareholder's shares was the "market value of [the corporation's assets] **discounted for their liquidation value**." *Baur v. Baur Farms, Inc.*, 2016 WL 4036105 (Iowa Ct. App. 2016) ("*Baur II*").

   i. Liquidation value takes into consideration **taxes and other costs** that would result from liquidation of the corporation.

   ii. Held: The minority shareholder's buy-out demand of $1.825M exceeded **fair value** because it failed to appropriately account for the **significant inhering tax liability** that the corporation (a C corporation for tax purposes) and the remaining shareholders would bear when the appreciated farmland was eventually sold. The Iowa Court of Appeals affirmed dismissal (7/27/2016); SC denied appeal for further review (11/9/2016).

   iii. Compelling illustration of impact of inhering corporate level tax liability in the shareholder buy-out context (from *Baur II* District Court opinion):

Assume assets with FMV of $1M, zero basis and assumed tax rate of 40% = $400K inhering tax liability	$1,000,000 (market value)
	Less: $260,000 paid subsequently for a 26% interest
	Less: $230,000 paid subsequently for a 23% interest
	$110,000 left after 51% owner pays the $400,000 tax liability

III. Review of "Fair Value" Statutory Definition in the Context of *Baur II*.

A. Per Iowa statute, "Fair Value" means the value of the corporation's shares determined according to the following:

i. Immediately before the effectuation of the corporate action to which the shareholder objects.

ii. Using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal.

iii. Without **discounting for lack of marketability or minority** status except, if appropriate, for amendments to the articles pursuant to section 490.1302, subsection 1, paragraph "e."

Iowa Code § 490.1301 (emphasis added).

B. The Iowa Supreme Court has stated that in making a determination of "fair value" the court should consider any relevant factor not inconsistent with the statutory definition. *Northwest Investment Corp. v. Wallace*, 741 N.W.2d 782, 786 (Iowa 2007).

C. To reiterate, *Baur II* indicates that costs of liquidating the corporation should be considered in deciding fair value (at least in the dissolution context). *Baur II,* 2016 WL 4036105.

IV. Practical Considerations: When Shareholder Dissension Arises.

Issues to consider when it appears that an oppression (or other involuntary dissolution) lawsuit may be imminent.

A. <u>From the Corporation's Perspective</u>.

i. <u>Does the complaining shareholder have a defensible position?</u>

1. Has a return on equity been paid recently or historically? Are there financial resources to pay a dividend or other return on equity? Have there been repeated offers by the shareholder to sell shares for fair value?

2. Note: Iowa Supreme Court's cautionary dicta regarding giving too much weight to minority shareholder concerns—"We caution, however, that courts must be careful when

determining relief to avoid giving the **minority a foothold** that is oppressive to the majority." *Baur v. Baur Farms, Inc.*, 832 N.W.2d 663, 678 (Iowa 2013) (emphasis added).

3. Following the SC's *Baur I* ruling, the Court of Appeals has affirmed dismissal of several owner oppression cases. *See, e.g., Morse v. Rosendahl*, 885 N.W.2d 220 (Iowa Ct. App. 2016) (holding that conduct of the majority member of the LLC was not oppressive where there was no evidence of decline of repeated offers to sell shares at fair value); *Ahrens v. Ahrens Agr. Industries Co.*, 2015 WL 2089372 (Iowa Ct. App. May 6, 2015). These recent decisions seem to support the notion that a shareholder's invocation of involuntary dissolution does not give rise to an unfettered "put" of shares on the corporation.

ii. Determine applicable "fair value". Obtain an appraisal to support value of shares. Consider all costs of liquidation in arriving at fair value, e.g., inhering tax liability, other "costs" of liquidation. Be prepared to analyze and respond to demands for buy-out.

iii. Consider whether the corporation has the financial resources to purchase the interest. In *Baur II*, the District Court considered this factor. Perhaps fashion a buy-out proposal with purchase price payable in installments payable over a term of years. *C.f.* Iowa Code § 490.1434(5) (providing that court may order buy-out terms to include payment of the purchase price in installments where necessary in the interest of equity).

iv. Consider potential for an alternative resolution (short of buy-out or lawsuit). What does the complaining shareholder seek? A salary? Dividend?

v. If a petition for dissolution is filed, the court has flexibility to fashion an alternative remedy (avoid dissolution). *Baur I,* 832 N.W.2d 663 at 677 – 678; *see also* Iowa Code § 1434.

B. From the Minority Shareholder's Perspective.

i. Is there a basis to assert a claim? Consider whether the reasonable expectations have been frustrated. Review bylaws, shareholder agreements, past course of conduct.

ii. Remedy sought. Is dissolution a desirable outcome? Statutory buy-out under Iowa Code § 490.1434?

iii. Consider cost of lawsuit. Minority shareholder must personally finance a dissolution action. Court may award petitioning shareholder reasonable fees and expenses of counsel and experts if the court finds shareholder has "probable grounds" for relief under Iowa Code § 490.1430(b)(2)(illegal, fraudulent or oppressive conduct) or (4) (waste).

V. Practical Considerations: Planning for Disharmony. Planning issues to consider when organizing a closely-held entity and formulating its governing documents (including articles, bylaws and shareholders agreements):

A. Entity Selection. If corporate entity structure is not a "must", consider other entity types. E.g., limited partnership. *See* Iowa Code § 488.801 – 802.

B. Governance/Management. Governing documents should clearly identify expectations related to governance and management. If concerned about majority owner abuse—

i. Limit power of the board of directors.

ii. Implement greater voting thresholds ("Supermajority" actions) for certain corporate decisions.

iii. Define expectations related to salaries of directors, officers and key employees.

C. Identify other Reasonable Expectations. Consider committing "reasonable expectations" to writing. E.g., is the corporation established as a means to own and operate the business as a "single economically viable unit so that such business will continue to be owned by the lineal descendants of the owners for generations to come?" Have all new owners sign joinder agreements (to shareholder agreements) and affirmatively acknowledge the express purposes of the corporation or other entity.

D. Consider inclusion of Transfer Restrictions and a Clear Buy-out Formula.

i. The buy-out formula (triggered by violations of transfer restrictions and/or other actions) should be clear. In dicta, the Supreme Court's *Baur I* decision noted that other jurisdictions have declined to "enforce transfer price restrictions determined by formulas producing transfer prices so small in relation to the true value of the shares as to make the restrictions unconscionable or oppressive." If to be based on book value, book value should be calculated based on generally accepted accounting principles (GAAP). Consider what adjustments might be appropriate (e.g., updating corporate real estate to fair market value).

ii. Consider inclusion of buy-out formula providing for payment of purchase price in installments over a term of years.

iii. To the extent there's a disagreement regarding the buy-out calculation, have procedures in place to break the impasse.

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