Freeze-Out Mergers and the New Minnesota LLC Act

Has the Legislature removed a useful dispute resolution tool for LLCs?

The Minnesota Revised Uniform Limited Liability Act that will govern all Minnesota LLCs beginning at the start of 2018 contains sweeping changes, and one of the most dramatic involves the elimination of "freeze-out" mergers. This article discusses options for preserving remedies similar to those afforded by such mergers.

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In April 2014, the Minnesota Legislature enacted a new statute for limited liability companies, Chapter 322C—the Minnesota Revised Uniform Limited Liability Act. The new act became effective on August 1, 2015 for all LLCs formed on or after that date, and will govern *all* LLCs, regardless of when they were formed, on January 1, 2018. It contains sweeping changes in the laws governing LLCs and differs substantially from the prior act, Chapter 322B. The purpose of this article is to address one important aspect of the new act—namely, the impact the new act will have on the ability of LLCs to use "freeze-out" mergers as a mechanism to allow feuding or deadlocked members to resolve their differences in an LLC context and to divide up the company.

Freeze-out mergers under the old act

Although virtually all business partnerships start out positively, with the passage of time it is not uncommon for friction to develop between the partners. Whether it is due to disagreements over how to spend money, loss of trust, personality clashes, or other reasons, there can (and often does) come a point in the life-cycle of a new business when the existing partners conclude that separation is the only real solution. Under the old act, as well as the Minnesota Business Corporations Act (MBCA),[1] one vehicle available to the members to provide for separation was the freeze-out merger.

As the name suggests, a freeze-out merger is one that forces the minority interest to give up its equity in the corporation in exchange for cash or senior securities while allowing the controlling interest to retain its equity.[2] The effect of a freeze-out merger is to remove the minority member from the company through the payment of a "fair value" buyout for his membership position, while allowing the company to continue and the majority member to retain his ownership.

Initially, there was some question as to whether freeze-out mergers involving corporations constituted a *per se* breach of fiduciary duty to the minority shareholders.[3] In 1986, however, the Minnesota Court of Appeals, in *Sifferle v. Micom Corp.*,[4] ruled that if a corporation follows the procedures set forth in the dissenters' rights provisions of the MBCA, the frozen-out shareholder does "not have a right at law or in equity to have a corporate action… set aside or rescinded, except when the corporate action is fraudulent with regard to the complaining shareholder or the corporation."[5] "[T]he appraisal right… is [the plaintiff's] *exclusive remedy* unless the merger is 'fraudulent' to him or the corporation." (emphasis added).[6]

Advantages of the freeze-out merger

Whether freeze-out mergers are a good or a bad thing has been hotly debated over the years, but there is no question that they do provide certain advantages to the parties. First, they allow the majority to remain in control and not be held hostage by an aggressive, distracted, or disloyal minority member. This advantage is often critical where the business is viable or has the potential for positive future growth.

Second, while offering advantages to the majority members, freeze-out mergers also provide significant protections for the minority. Specifically, through the "dissenters' rights" provisions of 322B, the old act allowed the dissenting member to obtain fair value for his or her membership in the company. In this context, "fair value" has been defined as the pro rata value of the shares of a corporation immediately before the effective date of the corporate change *without* reference to any minority discount or discount for lack of marketability, except in extraordinary circumstances.[7] As a result, when faced with a freeze-out merger, the old act allows the frozen-out member to receive a full buyout of his or her membership at a price often much higher than the member could obtain on the open market, provided the minority member followed the procedures for asserting dissenters' rights.

Finally, the freeze-out merger process does not require any involvement of the courts, at least with respect to the question of wrongdoing between the members. On the contrary, the dissenters' rights provisions set forth in detail what

the company and the dissenting member has to do to obtain the protection of the statute. Assuming each side correctly follows the procedures in the statute, and assuming the corporation does not engage in deception, misrepresentation, or actual fraud, the matter will be submitted to the court only if the parties are unable to agree on a fair value price for the dissenting member. In addition, if the matter does wind up in court, the sole issue to be decided should be the issue of "fair value." The court generally will not be required to get into the often messy, difficult, and expensive process of determining the motives of the majority owner and whether any duties existed or were breached.

Freeze-out mergers under the new act

Under the new act, freeze-out mergers, at least as they operated under 322B, are no longer possible. There are a number of reasons for this. First, while the new act does contain broad provisions allowing LLCs to engage in mergers, unless otherwise provided in the company's operating agreement, it also requires *unanimous consent* of the members for the company to sell, lease, exchange, or otherwise dispose of all, or substantially all, of the company's property or to engage in a merger.[8] As a result, in a situation where the members are already fighting, it is unlikely that the company will be able to obtain unanimous consent to any merger, let alone a merger resulting in the minority member losing his or her ownership position.

Second, and even more importantly, even if the LLC's members agree to approve mergers with less than unanimous consent, the new act does not provide for statutory dissenters' rights. As a result, for any LLCs formed after August 1, 2015, unless an LLC's operating agreement specifically provides otherwise, there will be no automatic mechanism available to members that allows the majority member in an LLC to force the minority member to surrender its equity in the company in exchange for a fair value buyout.[9]

One avenue that does exist for the parties to obtain separation under the new act is through the "oppressive conduct" provisions of the new act.[10] Under these provisions, a court is permitted to order that a minority member's membership interests be sold for fair value to the limited liability company or one or more of the other members of the company. To do so, however, the court must be convinced that "it is not reasonably practicable to carry on the company's activities in conformity with the articles of organization and the operating agreement," or that the managers, governors, or those in control acted in a manner that is "illegal," "fraudulent," or "oppressive," and that such conduct "was, is, or will be directly harmful to the applicant."[11]

On the surface it would appear that these provisions probably allow sufficient safeguards for the parties in situations where separation is called for. However, on closer examination there are a number of reasons to suggest that this approach may prove more difficult and less attractive to both majority and minority members than the freeze-out merger process. For one thing, unlike the freeze-out merger process, which potentially can be carried out without the need to involve the courts, the oppressive conduct approach actually *requires* court involvement. This means that in any situation governed by the new act, where the members are unable to resolve their differences voluntarily, the likelihood of a lawsuit is increased.

In addition, it appears likely that such lawsuits will be difficult and expensive. This is because the burden placed on the plaintiff will be to establish that the majority or those in control acted in an illegal, fraudulent, or oppressive manner. Given this burden, it is virtually assured that lawsuits under this provision will be similar to those common under the oppressed shareholder provisions of the MBCA, which tend to be long, bitter, and expensive.

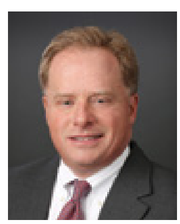
Finally, the language of the "oppressive conduct" provisions of the new act gives extremely broad discretion to the court in fashioning a remedy.[12] Indeed, under the statute the court[13] may order any remedy it deems appropriate, "which may include the sale for fair value of all membership interests a member owns in a limited liability company *to the limited liability company or one or more of the other members*" (emphasis added). This means that, if a minority member initiates an action under the new act, the court could order that the company be dissolved, or it could order either the majority *or the minority* to buy out the other.

Possible remedies

In the absence of amendments to the new act (the propriety of which is beyond the scope of this article), it appears that practitioners can advise at least two alternatives to provide options similar to freeze-out mergers under the old act. The first is to incorporate provisions into the operating agreement that permit (a) merger of the limited liability company with less than unanimous consent, and (b) a mechanism for minority members to dissent from the merger and obtain fair value for their membership interest. The second is to avoid the need for engaging in a merger and provide for expulsion of a member with the consent of all or some majority of the other members and the payment of fair value for the expelled member's membership interest. Of course, there are numerous variations of either possibility, but either of these options should be considered.

Conclusion

As mentioned above, the ability to use freeze-out mergers without breaching fiduciary duties to minority owners has been debated, but judicially approved in Minnesota. The inability of Minnesota limited liability companies to resolve membership disputes through this mechanism under the new act potentially limits the ability of members to avoid costly litigation in order to separate minority members from the company. LLC members and practitioners should consider including provisions in the operating agreement to address the separation of minority members. ▲



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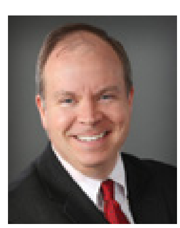

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Notes

1 Minn. Stat. §302A.471-473.

2 *Alpert v. 28 Williams Street Corp.*, 473 N.E.2d 19, 24 n.2, (N.Y.S. 1984).

3 *See* Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 Yale L.J. 1354, 1365-70 (1978).

4 384 N.W.2d 503 (Minn. Ct. App. 1986).

5 Minn. Stat. §302A.471, Subd. 4. To show that the merger was "fraudulent," the shareholder was required to establish that it "was carried out through deception, misrepresentation, actual fraud, or in violation of applicable statutes or articles of incorporation, or in violation of a fiduciary duty." *Sifferle,* 384 N.W.2d at 507.

6 *Sifferle,* 384 N.W.2d at 507. *Sifferle* involved a Minnesota corporation, rather than a limited liability company, and therefore was addressed under the MBCA rather than the Old Act. However, the dissenters' rights provisions in the Old Act are virtually identical to the dissenters' rights provisions in the MBCA. In addition, Minnesota's courts have suggested that the same principles applicable to corporations are applicable to limited liability companies. *See Senior Cottages of Am., LLC v. Morris,* 482 F.3d 997, 1001 (8th Cir. 2007) ("Minnesota limited liability companies share many of the properties of corporations . . . [i]t is therefore appropriate to look to the law governing claims on behalf of corporations for guidance in this case [involving a Minnesota limited liability company]") (citations omitted). As such, it is generally thought that the principles express by the Court in *Sifferle* are applicable in 322B cases.

7 *Advanced Commc'ns Design Inc. v. Follett*, 615 N.W.2d 285, 292 (Minn. 2000); *MT Properties, Inc. v. CMC Real Estate Corp.*, 481 N.W.2d 383, 388 (Minn. App. 1992). By contrast, fair market value is generally defined as the "price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts." *Hamelink v. Hamelink*, 2013 Minn. App. LEXIS 1175 *7 (12/30/2013).

8 See 322C.0407, subd. 3(a) (iv).

9 The new act does retain statutory dissenters rights for LLC s formed prior to 8/1/2015 (322B LLCs), provided their governing documents have not otherwise eliminated such rights. Minn. Stat. §322C.1204, subd. 3(3)(vii).

10 Minn. Stat. §322C.0701, subd. 2.

11 See Minn. Stat. §322C.0701, subd. 1. "Oppressive" conduct is defined in the New Act to be conduct that is "unfairly prejudicial to the applicant member … because the conduct frustrated an expectation of the applicant merger that … is reasonable in light of the reasonable expectations of the other members." Minn. Stat. §322C.0102, subd. 18(a)(3).

12 Minn. Stat. §322C.0701, subd. 2.

13 Because oppressive conduct lawsuits are equitable in nature, they are tried to the court, not a jury. *Pedro v. Pedro*, 463 N.W.2d 285, 288 (Minn. App. 1990).