

No. A08-1157

STATE OF MINNESOTA

IN COURT OF APPEALS

D. RANDALL BLOHM,

Appellant,

v.

BRUCE D. KELLY and BNK, Inc. a Minnesota
Corporation, individually and collectively,

Respondents

APPELLANT'S BRIEF AND APPENDIX

JOHN D. HAGEN, JR.
Attorney at Law
P.O. Box 15609
Minneapolis, MN 55415
(612) 623-0908
Attorney Reg. No. 0039330

Attorney for Appellant

TIMOTHY P. McCARTHY
Chestnut & Cambronne, P.A.
204 North Star Bank
4661 Highway 61
White Bear Lake, MN
(612) 336-2937

Attorney for Respondents

The appendix to this brief is not available for online viewing as specified in the *Minnesota Rules of Public Access to the Records of the Judicial Branch*, Rule 8, Subd. 2(e)(2).

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STATEMENT OF ISSUES

I. ARE ANY OF PLAINTIFF'S CLAIMS ACTIONABLE AS DIRECT CLAIMS, RATHER THAN AS DERIVATIVE CLAIMS?

The trial court held that all of Plaintiff's claims are either derivative or moot.

Most Apposite Case:

Pedro v. Pedro, 463 N.W.2d 285 (Minn. App. 1991)

Most Apposite Statute:

Minn. Stat. §302A.751 (2004)

II. DID THE TRIAL COURT ERR BY STAYING PROCEEDINGS TO ALLOW REVIEW BY A SPECIAL LITIGATION COMMITTEE?

The trial court stayed proceedings over the objections of the Plaintiff.

Most Apposite Case:

Janssen v. Best & Flanagan, 662 N.W.2d 876 (Minn. 2003)

Most Apposite Statute:

Minn. Stat. § 302A.241, subd. 1 (2006)

III. DID THE TRIAL COURT ERR IN DISMISSING PLAINTIFF'S CLAIMS IN DEFERENCE TO THE SPECIAL LITIGATION COMMITTEE?

The trial court ruled in the negative.

Most Apposite Case:

Janssen v. Best & Flanagan, 662 N.W.2d 876 (Minn. 2003)

Most Apposite Statute:

Minn. Stat. § 302A.241, subd. 1 (2006)

STATEMENT OF THE CASE

This is an action for breach of fiduciary duty with regard to a small closely-held corporation. Plaintiff Blohm is the sole minority shareholder and was a passive investor. Defendant Kelly is the majority shareholder and is the corporation's sole director.

The corporation's affairs were wound up and its assets all were sold. Kelly issued Blohm a check purportedly representing his share in the proceeds. Blohm asked to see financial records in order to verify the accounting, but the records were not produced.

Blohm sued Kelly and the corporation. (See Appellant's Appendix, A-1) Proceedings were held in the Fourth Judicial District, Hennepin County, before the Hon. Charles A. Porter, Jr. After 20 months of litigation, just before the date of trial, Defendants sought a stay to have the claims reviewed by a Special Litigation Committee. (A-14) Plaintiff opposed this procedure on grounds that it was untimely, unfair, and unwarranted by the nature of the claims. (A-16)

The district court granted the stay as requested by the Defendants. (A-18) The Special Litigation Committee reviewed the Plaintiff's claims. Its report recommended that, insofar as the claims were derivative, the corporation should not pursue them.

Defendants then moved for summary judgment. (A-19) The district court held that the Plaintiff's claims were all derivative or moot. The court deferred to the Special Litigation Committee under the business judgment rule, and dismissed Plaintiff's claims with prejudice. (A-21) Plaintiff then perfected this appeal. (A-32)

STATEMENT OF FACTS

General Background

Plaintiff D. Randall Blohm is an attorney. He met the Defendant Bruce Kelly about 1989. At that time, Kelly was part owner of Auto-Max, Inc., a franchisor of automobile service stores. (Blohm Depo., Ex. M to Special Litigation Committee Report, p. 13 (the Special Litigation Committee Report ("SLC Report") is an Exhibit to the Affidavit of Timothy McCarthy))

Auto-Max was in financial jeopardy at the time, and was the subject of much creditor litigation. Kelly retained Blohm to represent his interests separately from those of his associates, Bruce Faulken and Clarence Johnson. (Id., pp. 13-14)

Blohm assisted Kelly to form a corporation called BNK, Inc. This corporation purchased two of the Auto-Max stores. Blohm agreed to take an ownership interest in BNK as compensation for his work. (Id., pp. 16-17; 20-23)

The parties' agreement was that Blohm would have 20% of BNK's stock. Kelly, however, changed his mind and refused to convey the stock to Blohm. Blohm sued Kelly, Faulken and Johnson in order to enforce the agreement's terms. (Id., pp. 18-20)

The parties reached a settlement in May 1993. Their agreement confirmed that Blohm should have 20% of the stock, and the stock was issued to him at that time. (Id., p. 21; see Settlement Agreement, Ex. O to SLC Report)

As part of the settlement, Blohm, Kelly and BNK, Inc. also signed a Shareholder Agreement. (See Ex. O to SLC Report, p. 1, ¶ 2) Among other matters, this agreement (1) prohibited transactions with Kelly's former associates and (2) gave each party the

"absolute right" to examine corporate records:

[T]he parties agree that BNK, Inc. will not enter into any transaction with either Bruce C. Faulken or Clarence Johnson, or with any other person or entity controlled directly or indirectly by either of them, unless Bruce D. Kelly and D. Randall Blohm concur in writing that such proposed transaction is in furtherance of the reasonable business interests of BNK, Inc. ...

* * *

In addition to the absolute rights granted by Minnesota Statutes §302A.461, subd. 4(a), each party shall have the absolute right to examine and copy, in person or by legal representative, all other corporate records, including all business records, at any reasonable time, subject only to such protection as may be necessary to prevent further dissemination of the inventions, trade secrets and other confidential corporate information.

(Ex. P to SLC Report, pp. 9, 11 (emphasis added))

For almost twelve years, Blohm held his stock in BNK as a passive investor. He did not hire, fire, give orders, sign documents, interact with accountants, or make his presence known as an owner. (Blohm Depo., pp. 52-53) On occasion, Blohm and Kelly had casual conversations about the status of BNK's operations, and Kelly's responses seemed credible. (Id., pp. 48-49)

The Management of BNK

Kelly was the president and sole director of BNK from its inception. (See Ex. J to SLC Report) When the company was formed in 1991, its Board passed a resolution giving Kelly a salary of \$50,000 per year, in addition to "reasonable expenses incurred by him on behalf of this corporation." (Id., Resolution No. 9)

In 1996, BNK closed one of its two original locations (the Edina store). It continued to operate the second store on University Avenue in St. Paul. (Kelly Depo., p.

37) The evidence indicates that, as time went on, Kelly devoted substantially less time to BNK's affairs than he had done before.

The St. Paul store was run by a manager, Jim Davis. Among other functions, Davis did inventories and placed most of the orders for auto parts. (Id., pp. 43, 47-48) Accountants Don and Debra Lindstedt were hired to do BNK's bookkeeping from 1992 to 2005. (Debra Lindstedt Depo., Ex. L to SLC Report, pp. pp. 9, 15; Don Lindstedt Depo., Ex. R to SLC Report, p. 26) Another firm was hired to do BNK's tax returns. (Debra Lindstedt Depo., pp. 19-20)

Kelly spent most of his time at another company in which he had an interest, Lake Country Classics. Kelly admits that, in the early 2000s, he sometimes worked 40-hour weeks at Lake Country Classics, and was probably spending more time at Lake Country than he was at BNK. (Kelly Depo., pp. 18-19)

At his deposition, Kelly was notably vague with regard to his work at BNK. He stated that he had "no idea" how many hours he put in there, and refused to estimate how many hours he spent on BNK's paperwork or customer contacts. (Id., pp. 21, 26-27) He refused to estimate how often he personally ordered auto parts. (Id., pp. 23-25)

BNK provided Kelly with numerous benefits. Among other matters, BNK provided Kelly with a leased car, with health insurance for him and his wife, and with Super America credit cards for him and his wife. The car was treated as a "business expense" on BNK's books, with no allocation for the time or mileage that Kelly devoted to Lake Country Classics. (Id., pp. 61-62; 66-67)

Lake Country Classics and the MBNA Credit Card

As noted above, the Shareholder Agreement expressly prohibited BNK from transacting business with entities controlled by Kelly's former associates, Faulken and Johnson. However, the record shows that BNK repeatedly engaged in such transactions and commingled funds with such an entity -- Lake Country Classics, Inc.

Kelly testified that he thinks that he owns 20% of Lake Country Classics, and that Faulken and Johnson own 80%. (*Id.*, p. 42) Kelly states that he "manages the store" for Lake Country and does for Lake Country what paid contractors do for BNK -- accounting, taxes, and payroll. (*Id.*, pp. 9-12, 19)

Lake Country ordered auto parts through BNK as "a convenience for Bruce," and Lake Country also apparently bought parts for BNK (Debra Lindstedt Depo., pp. 64-65; Kelly Depo., p. 62) Meanwhile, Lake Country's credit card customers made payments to BNK, because Lake Country had no credit card processing system. (Kelly Depo., pp. 62-62, 122) Funds were commingled, and BNK wrote Lake Country reimbursement checks. (Kelly Depo., p. 57)

More ambiguity arose from Kelly's use of a personal credit card (the MBNA card) to pay for BNK expenses, Lake Country Classics expenses, and personal expenses as well. (*Id.*, pp. 48-49) Kelly contends that he regularly told BNK's accountants which expenses were which. When asked to break down a credit card statement at his deposition, however, he said, "Your guess is as good as mine." (*Id.*, p. 52)

The Sale of BNK's Assets

In late 2004, Kelly decided to sell BNK's assets to the store manager, Jim Davis.

(Id., pp. 38-39) He informed his co-owner, Blohm, who thought that the sale was in both parties' interests, and had no objection. (Blohm Depo., pp. 41, 45)

Blohm acted as scrivener for Kelly and Davis in drafting the documents of sale. He took no part in negotiating the terms of the sale, and charged no fee to Kelly or to BNK. (Id., pp. 32-36, 45) He assisted Davis to form his own new business entity, Ninety Blue, after having disclosed his ownership interest in BNK to Davis and obtained a waiver. (Id., pp. 33-38) Blohm also explained his representation of Davis and Ninety Blue to Kelly. (Id., p. 34)

The sale of BNK's assets was closed on January 31, 2005. At about the same time, Kelly used BNK checks to settle various accounts. These checks, which totaled some \$58,309, include, inter alia, payments to MBNA, to Super America, and to Kelly personally. (See Exhibit Q to the Special Litigation Committee Report)

Among these payments was one of \$24,627 for the outstanding balance on Kelly's personal MBNA credit card. (Id.; Blohm Depo., pp. 57, 74-75) At his deposition, Kelly could not say what part of the January 2005 MBNA statement was for BNK expenses, for Lake Country expenses, and for personal expenses. (Kelly Depo., pp.103-07) He specifically could not say whether a \$5,200 item on the statement was a personal debt or a business expense. (Id., pp. 111-12, 115)

A BNK balance sheet is dated February 28, 2005. It lists "Total Assets" of \$20,131.59. A note beside this entry in the handwriting of BNK's accountant states "Distributed to Bruce -- \$100 stock" and "\$20,031.59 Dist." (Kelly Depo., p. 118) Kelly denies that he received such a payment, and states that he doesn't know how much he

received, but admits that the amount appears on a BNK tax return. (Id., pp. 119-20)

In May 2005, Kelly sent Blohm a check for \$2,400. This check purportedly represented Blohm's 20% share in proceeds from the asset sale. (Kelly Depo., pp. 97-98)

Kelly states that he personally calculated Blohm's share. (Id., p. 98) However, he doesn't recall how he did the calculation, nor does he have documentation to support it. (Id., pp. 98-99) Kelly also professes not to recall how much he personally received from the sale. (Id., p. 120)

Blohm had expected a larger amount ("a multiple of \$2,400") as his share of the sale. However, he had no good idea of what BNK's assets had been worth. (Blohm Depo., pp. 58-59)

Kelly's Denial of Financial Information to Blohm

As noted above, the Shareholders' Agreement expressly provided that Blohm should have "the absolute right to examine and copy ... all business records, at any reasonable time." (Exhibit P to Special Litigation Report, p. 11) Before the asset sale, in the fall of 2004, Blohm began to request financial information from Kelly and from BNK's accountants. (Blohm Depo., pp. 91-92)

Some of Blohm's requests were partially complied with, but others were "stonewalled." (Id., p. 44) He set up a number of meetings with Kelly and with his accountants, but the meetings were cancelled. (Tr., p. 49) One of Kelly's accountants recalls that Blohm complained to him repeatedly that he was "never getting any information from Bruce." (Don Lindstedt Depo., p. 96)

At his deposition, Blohm specified many documents that he had requested in vain.

These documents included tax returns, the closing inventory, bank statements, check registers, auto leases, and equipment purchases. (Blohm Depo., pp. 49-51; 54-55; 83)

At his deposition, Kelly was sarcastic and vague when questioned on the subject of Blohm's document requests. He flatly admitted that he had not looked for some of the documents, didn't recall whether he had looked for others, remarked ironically that he had been looking "for a pair of pliers" instead, and stated that "I'm not very good of keeping track of stuff." (Kelly Depo., pp. 87-92)

Blohm produced correspondence showing that he persistently had asked for documents. On April 27, 2005, he wrote to BNK's accountant Don Lindstedt (copying Kelly):

I have reviewed no financial information concerning the liquidation of BNK, Inc. since the January 25, 2005 closing of the sale to Ninety Blue, LLC except for the usual "Auto Max Shuffle." In order that I might attempt to understand what you and Bruce are doing I would appreciate it if you would furnish to me at this time copies of the company's bank account statements and check registers for the months of January, February and March 2005.

(Exhibit A to Pl. Complaint (emphasis added), admitted by Answer, ¶12) On June 10, 2005, Blohm wrote to Kelly, stating inter alia:

On January 31, 2005 we closed the sale of B.N.K., Inc. assets to Ninety Blue, LLC. As you are aware, I have by letter requested of Don Lindstedt, B.N.K., Inc.'s accountant, certain bank statements and check registers to assist me in independently determining my share of the net proceeds from the sale. To this date my requests have been ignored. In fact, most recently Don advised that subsequent to my initial request, true to form, he shuffled all of the current B.N.K., Inc. records to you.

By this letter I am renewing my request for copies of the B.N.K., Inc. bank account statements and check registers for the months commencing January 1, 2005 to the current date. In addition, request is made for a copy of the

federal and state income tax returns with all schedules for 2004 and 2005.
...

Bruce, I simply want an honest count and reasonable opportunity to verify that I am receiving my share of B.N.K., Inc. equity. This is not rocket science. Unfortunately, your repeated efforts to stonewall my requests for information have created a suspicion that you are attempting to conceal something.

* * *

(Exhibit B to Pl. Complaint (emphasis added), admitted by Answer, ¶12)

The Present Litigation

Blohm brought this action against Kelly and BNK in January 2006. The Complaint does not purport to state claims that properly might be characterized as "derivative," on behalf of the corporation. (See A-1)

Blohm's Complaint alleged that Kelly had refused him access to BNK's books and records. (See id., ¶¶ 10-14) It alleged further:

A preliminary review of those fragmentary samples of financial records of BNK furnished to Plaintiff discloses disbursements of BNK funds for unknown purposes not properly related to the business activities of BNK and also the apparent commingling of the assets of BNK with the assets of other business entities affiliated with Defendant, including Lake Country Classics, Inc., a Minnesota corporation.

(Id., ¶ 16 (emphasis added)) Blohm pled counts for breach of fiduciary duty and for fraudulent or illegal conduct. (Id., ¶¶ 18-24)

Through discovery, Blohm sought to compel production of the books and records of BNK to which he had been denied access. The record demonstrates egregious delays in the production of these records. (See Affidavit of Stacey Sever, Ex. H) Specifically:

- On April 19, 2006, Blohm served his First Request for Production of

Documents. (Id., Ex. A attached to Ex. H)

- On June 21, 2006, Blohm (then acting pro se) wrote to Defendants' counsel stating that "your client's Response is now long overdue" and requesting a response. (Id., Ex. C attached to Ex. H)
- On October 17, 2006, Blohm's counsel wrote to Defendants' counsel renewing the request for documents and offering to pick them up at counsel's home office. (Id., Ex. C attached to Ex. H, p. 2)
- On December 5, 2006, Blohm's counsel again wrote to Defendants' counsel requesting overdue documents which the court had ordered produced. She stated, in part:

[T]here are several items which have not yet been produced from *Plaintiff's First Request for Production*, which was served on April 19, 2006. We are specifically interested in any documents evidencing the distribution of proceeds after the sale of the business and during the winding up of the corporation. ... These were also ordered to be produced by Judge Porter during the September 21, 2006 conference call. However, in defendants' *Response to the First Request for Production*, the most recent bank statements provided are dated December 2004. We have not seen any documents which show the distribution of proceeds of the sale or the winding up. We request that defendants produce the remaining documents immediately.

(Id., Ex. C attached to Ex. H, p. 3 (emphasis added; italics in original))

- On January 18, 2007, Blohm's counsel wrote to Defendants' counsel giving notice of another conference call with the trial court to deal with issues concerning the Defendants' outstanding discovery. (Id., Ex. C attached to Ex. H, p. 4)

- On January 22, 2007, Blohm's counsel wrote to the trial court (copying Defendants' attorney) in preparation for the conference call. She stated, in part:

Over a period of more than two years, Plaintiff made repeated demands to review BNK, Inc. business documents. These demands include written requests dated April 27, 2005 and June 10, 2005 (attached as Exhibits A and B to the Complaint on file herein), and *Requests for Production of Documents* dated April 19, 2006. The issue was also addressed during the court's September 21, 2006 telephone conference. Despite these repeated demands, Defendants have refused to provide Plaintiff access to the business records of BNK, Inc. sufficient to allow Plaintiff to verify that the assets of BNK, Inc. have been distributed in accordance with the contract and applicable Minnesota law.

(Id., Ex. C attached to Ex. H, p. 5 (emphasis added; italics in original))

- On March 7, 2007, Blohm's counsel gave notice of a Motion to Compel. Her memorandum of law recited all the foregoing matters and stated:

Plaintiff arranged for a conference call scheduled for the morning of January 26, 2007 to discuss defendants' failure to provide discovery responses. Defendants' counsel was notified of this conference call by voice mail and U.S. Mail. [Citation omitted] Attorney Demmer was not reachable by telephone on the date of the telephone conference. The Court rescheduled the conference call for January 31, 2007. The court's clerk provided notice to attorney Demmer. Again, on the date of the telephone conference, attorney Demmer was not reachable by telephone.

(Id., Ex. H, Memorandum, p. 3 (emphasis added))

After all these delays and refusals, Defendants finally retained new counsel and produced some of the documents in issue. Blohm incurred extensive attorneys' fees in his two years' quest to obtain the financial records to which he had been guaranteed access

by the Shareholders' Agreement. (See Pl. Supplemental Answers to Interrogatories, No. 8, at p. 9; Ex. C to SLC Report)

The Special Litigation Committee Report

Discovery in this case was closed on September 15, 2007. The deadline for motions was September 25, 2007. Trial was scheduled for the week certain of October 29, 2007. (See Scheduling Order of June 28, 2007)

On October 10, 2007, just prior to the scheduled trial, BNK's Board of Directors (Kelly) resolved to appoint a Special Litigation Committee. This Committee was to "investigate" Blohm's claims and recommend whether BNK itself should pursue them (i.e., whether BNK should sue Kelly). Defendant's counsel then sought to stay the case by means of an informal letter to the judge:

On October 10, 2007 the Board of Directors of BNK, Inc. adopted a corporate resolution forming a special litigation committee pursuant to Minn. Stat. §302A.241 to investigate the claims raised by D. Randall Blohm ... in order to analyze the legal rights or remedies of the corporation and determine whether those rights or remedies should be pursued. ...

In light of this corporate resolution, the defendants are requesting that this action, over which you are presiding, be stayed until such time as the special litigation committee issues it's [sic] report. ...

(Letter of Oct. 12, 2007 from Timothy McCarthy to the Hon. Charles Porter (A-14)

(emphasis added))

Plaintiff's counsel vigorously objected to this procedure. By letter to the court, he stated:

Defendants' request is untimely and improper. We are only two weeks from the week certain court trial in this case. The Court's June 28, 2007 *Scheduling Order, Referral to Mediation and Order Setting Trial* required

that any dispositive or non-dispositive motions in this case be heard by September 25, 2007. ...

This case was commenced in January 2006 and, since that time, extensive discovery has been done on the case. Mediation was held on September 20, 2007. Plaintiff has filed his *Witness List* and *Exhibit List* in accordance with the Court's Scheduling Order. Defendants had ample opportunity to make a motion with their request over the past 20 months. And yet, only on the eve of trial do Defendants submit this informal letter request. ...

(Letter of Oct. 15, 2007 from John Angell to the Hon. Charles Porter (A-16) (emphasis added; italics in original))

The court, however, granted the stay. Its brief order made no assessment of any of Plaintiff's objections. (See Order of October 22, 2007 (A-18))

BNK's Special Litigation Committee consisted of a single attorney, Terrence Fleming. BNK directed him to determine "whether those claims originally asserted by Blohm have sufficient merit such that they should be pursued by the Company." (SLC Report, p. 1)

Fleming issued his Special Litigation Committee Report in January 2008. The Report expressly recognized that some of Blohm's claims for relief might be direct claims, rather than derivative claims, and outside the purview of the Committee. (See *id.*, pp. 1, n. 1, 12) However, it stated that claims for excessive compensation and wrongful diversion of BNK's assets all were "classic derivative claims." (*Id.*, p. 1, n. 1)

The Report assessed evidence bearing on these claims and concluded that they had no merit. (*Id.*, pp. 12-18) It concluded: "based on its investigation of the allegations and derivative claims made by D. Randall Blohm, the Committee recommends that the Company not pursue any action against Bruce Kelly." (*Id.*, p. 19)

The Summary Judgment Order

Defendants moved for summary judgment based upon the Committee's Report. Plaintiff filed numerous exhibits opposing the motion, along with a memorandum demonstrating genuine issues of material fact as to all his claims against the Defendants.

The district court held that all of Plaintiff's claims were derivative except for his claim for access to corporate records. It held that the latter claim was moot. (Order, p. 6) As to derivative claims, the court deferred to the SLC Report, on grounds of the "business judgment rule." (Id., p. 8)

The district court entered summary judgment dismissing all the Plaintiff's claims with prejudice. Plaintiff then perfected this appeal.

ARGUMENT

Summary Introduction

This case turns on basic considerations of fairness to the Plaintiff. He was paid a suspiciously small sum as his purported share in the proceeds of sale of the business. He reasonably sought access to the records of the business (to which he had an absolute contractual and statutory right) to verify his share.

The records were denied the Plaintiff through more than two years of repeated demands and of expensive litigation. Some, but not all, of the records requested were finally produced. Proof of the value of Plaintiff's share meanwhile was made increasingly difficult because of fading memories occasioned by the passage of time.

On the eve of trial, Defendants informed the court that the corporation (now an

empty shell) had appointed a Special Litigation Committee to "investigate" Plaintiff's claims. Plaintiff protested that his claims were direct, not derivative, and that Defendants' request to stay the action was egregiously untimely. Nevertheless, the court stayed the action and eventually dismissed all Plaintiff's claims in deference to the Committee's report.

The court's holding clearly was in error. In the first place, Plaintiff's claim to enforce his right of access to records indisputably was not derivative, but direct. Defendants breached a fiduciary duty in denying his right of access. Plaintiff is entitled to a remedy for this breach, including (1) his attorneys' fees and other costs of enforcing the right of access, and (2) an accounting, based upon the increased problems of proof.

Plaintiff's other claims also should be held direct and not derivative. The Committee itself expressly recognized that some of the claims might be direct. Courts broadly recognize that claims of the sort in issue here (two shareholders and no third-party creditors) should not be deemed derivative claims.

If this Court holds that some of Plaintiff's claims are derivative, then it must review the reference of those claims to the Special Litigation Committee. The Court should hold that the trial court erred in staying the action to allow that reference on the eve of trial. The Committee's appointment was an untimely exercise in forum-shopping which manifestly prejudiced the Plaintiff.

If this Court holds that the action was properly stayed, it should hold that the district court erred in dismissing the claims in deference to the Committee's report. The Committee improperly gave a legal judgment, rather than a business judgment.

Moreover, it improperly placed burdens of proof on the Plaintiff where the law imposes them on the Defendant. Thus, its report deserved no deference under the business judgment rule.

I. SOME OR ALL OF PLAINTIFF'S CLAIMS ARE ACTIONABLE AS DIRECT CLAIMS, NOT AS DERIVATIVE CLAIMS.

Standard of Review

On questions of law, the appellate court is not bound by the district court's determination and exercises de novo review. *Frost-Benco Electrical Association v. Minnesota Public Utilities Commission*, 358 N.W.2d 639, 642 (Minn. 1984); *Stoche v. Berryman*, 632 N.W.2d 242, 247 (Minn. App. 2001)(applying the *Frost-Benco* standard to an analysis of "direct" and "derivative" claims).

A. Distinguishing Direct from Derivative Claims

In *Northwest Racquet Swim and Health Clubs, Inc., v. DeLoitte & Touche*, 535 N.W.2d 612 (Minn. 1995), the Court addressed the distinction between direct and derivative claims. It held:

Minnesota had long adhered to the general principle that an individual shareholder may not assert a cause of action that belongs to the corporation. [citations omitted] Generally speaking, in such a case, redress must be sought in a "derivative" action on behalf of the corporation rather than in a direct action by the individual shareholder.

* * *

[T]his court has previously suggested that the method in Minnesota for distinguishing between a direct and a derivative claim is to 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.

Id. at 617 (emphasis added).

Shortly afterward, in *Wessin v. Archives Corporation*, 592 N.W.2d 460 (Minn. 1999), the Court again explained:

In determining whether a claim is direct or derivative, we have focused the inquiry to whether the complained-of injury was an injury to the shareholder directly, or to the corporation. [citation omitted] Where the injury is to the corporation, and only indirectly to the shareholder, the claim must be pursued as a derivative claim.

Id. at 464 (emphasis added).

Wessin, like the present case, involved a dispute among shareholders of a closely-held corporation. In holding the claim in *Wessin* derivative, the Court noted: "There is no indication in the record that the parties at any time entered into a shareholder agreement."

Id. at 462.

In the present case, by contrast, the parties did enter into a Shareholder Agreement. (See Ex. P to SLC Report) Some of Plaintiff's claims arise from breaches of that agreement. Thus, they state injuries to the Plaintiff rather than to the corporation.

The rest of Plaintiff's claims should be treated as direct in the distinctive circumstances of this case. Plaintiff is the sole minority shareholder and thus is the only person suffering injury. The corporation is out of business and has no third-party creditors.

Under such circumstances, courts generally treat claims of the sort presented here as direct. The reasons supporting the derivative-claim concept do not apply. As will be shown below, this Court should hold that all the Plaintiff's claims are direct.

B. The Claim for Access to Corporate Records

1. The Direct Nature of the Claim

It is well-settled that claims to enforce a shareholder's right to inspect corporate records are direct. See, e.g., 2 R. Thompson, *O'Neal and Thompson's Oppression of Minority Shareholders and LLC Members* (Rev. 2d Ed. 2004), § 7:8, p. 7-62; *Kesling v. Kesling*, 546 F. Supp. 2d 627, 634 (N. D. Ind. 2008) ("actions 'to vindicate rights belonging to the shareholders themselves,' such as the 'right to ... inspect corporate books ... are considered direct, or individual, actions").

In *Carlson v. Rabkin*, 152 Ohio App. 3d 672, 789 N.E.2d 1122 (2003), as in the present case, plaintiffs sued to enforce their right to inspect corporate records. As in the present case, the trial court dismissed the plaintiffs' complaint. The appellate court reversed, stating in part:

[A] member's statutory right to inspect the books and records of a nonprofit corporation, upon written demand stating a reasonable and proper purpose, gives rise to a direct claim, not a derivative one. Likewise, the rights of a member to demand an accounting ... implicate individual rights of the member. These are special injuries that are distinct from an injury suffered by all members. Therefore, these are direct claims, and it is not necessary that the members comply with Civ.R. 23.1 before filing their suit.

* * *

It seems to us that [the corporation] offered absolutely no legitimate, good-faith reason why it had not complied with the members' request. We conclude that the members' complaint stated a prima facie case for judicial intervention to enforce their statutory right to inspect the corporate books and records. Therefore, we hold that the trial court erred in dismissing this part of the members' complaint.

789 N.E.2d at 1130 (emphasis added).

A similar holding is warranted here. As in *Carlson*, the record here shows

"absolutely no legitimate, good faith reason" why the Defendants failed to produce financial records sought by Blohm for well over two years.

The present case is especially compelling because Blohm had a contractual, as well as a statutory, right to have prompt access to the records. The Shareholders' Agreement expressly granted him "the absolute right to examine and copy ... all business records, at any reasonable time." (Ex. P to Special Litigation Committee Report, p. 11 (emphasis added)) And Minn. Stat. § 302A.461, subd. 4(b) (2004) provides:

A shareholder ... of a corporation that is not a publicly held corporation has a right, upon written demand, to examine and copy, in person or by legal representative, other corporate records at any reasonable time only if the shareholder ... demonstrates a proper purpose for the examination.

(emphasis added)

This Court should hold that Plaintiff's claim to enforce his right of access was direct. The denial of access was an injury to Plaintiff individually, and not to the corporation. Thus, Plaintiff has a direct claim to enforce his right of access.

2. The Claim is Not Moot

The district court held that Plaintiff's claim for access to the corporate records was "moot." (See Order, p. 7) That holding demonstrably was in error.

Blohm could not tell whether Kelly had paid him fairly for his ownership interest without access to the records. The evidence shows that Kelly egregiously refused to provide him access. Among other pertinent facts (which all must viewed in Blohm's favor, under summary judgment standards) are the following:

- Blohm repeatedly made verbal requests for access to the records, beginning

shortly before the corporation was sold. (Blohm Depo., pp. 91-92)

- Blohm set up meetings with Kelly and BNK's accountants, but the meetings were cancelled. (*Id.*, p. 49)
- One of Kelly's accountants recalls that Blohm complained to him repeatedly that he was "not getting any information from Bruce." (Don Lindstedt Depo., p. 96)
- Blohm wrote to the accountant and to Kelly ("Bruce, I simply want an honest count and reasonable opportunity to verify that I am receiving my share"), asking to see specific records, prior to filing this litigation. (Complaint, Exs. A, B)
- Kelly and his first attorney failed to respond to Requests for Production, despite repeated letters and an order from the judge in a telephone conference. (Stacey Sever Aff., Ex. H, attached Exs. A to C)
- Kelly admitted that he had not even looked for some of the requested documents and didn't know whether he had looked for others. (Kelly Depo., pp. 87-92)
- Blohm's attorney finally was obliged to bring a Motion to Compel, with an extensive memorandum and affidavits, to obtain production of documents. (Sever Aff., p. H)

After more than two years of requests and litigation, Blohm finally was allowed to inspect many records. It is by no means clear, however, that he was shown all the

pertinent documents. At his deposition, Blohm identified numerous records which had not yet been produced -- tax returns, the closing inventory, bank statements, check registers, auto leases, and equipment purchases. (Blohm Depo., pp. 49-51, 54-55, 83)

Even if it were shown that Defendants produced all the documents which they presently possess, Plaintiff's claim for access would not be "moot." Blohm has a right to recover the costs of obtaining the documents, including attorneys' fees. And insofar as the protracted delay or the loss of documents prevents an accurate accounting, Blohm should be compensated in damages. This will be explained below.

3. Attorneys' Fees for Enforcing the Right of Access to Records

Attorneys' fees are authorized by statute for violations of the Minnesota Business Corporations Act. Minn. Stat. § 302A.467 provides:

If a corporation or an officer or director of the corporation violates a provision of this chapter, a court in this state may, in an action brought by a shareholder of the corporation, grant any equitable relief it deems just and reasonable in the circumstances and award expenses, including attorneys' fees and disbursements, to the shareholder.

(emphasis added)

As shown above, the denial of access to records in the present case was clearly a violation of the Business Corporations Act. Thus, it gave rise to a claim for fees.

Moreover, an award of fees is justified because of Kelly's breach of a fiduciary duty.

It is well settled that the shareholders in a closely-held corporation owe a fiduciary duty to each other. *Pedro v. Pedro*, 463 N.W.2d 285, 288 (Minn. App. 1991). This relationship "imposes the highest standards of integrity and good faith" in their dealings with one another. *Wenzel v. Mathies*, 542 N.W.2d 634, 641 (Minn. App. 1996).

This fiduciary duty is enforceable both at common law and under the Minnesota Business Corporations Act. See Berreman v. West Publishing Co., 615 N.W.2d 362, 367, 373 (Minn. App. 2000). The common law duty "include[s] the duty to disclose material information about the corporation." Id. at 371.

The statutory remedy for breach of fiduciary duty is grounded in Minn. Stat. §302A.751 (2004). *Berreman*, at 373-74. That statute provides, in pertinent part:

302A.751. Judicial intervention; equitable remedies or dissolution

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

* * *

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

* * *

(3) the directors or those in control of the corporation have acted in a manner unfairly prejudicial toward one or more shareholders in their capacity as shareholders or directors of a corporation that is not a publicly held corporation, or as officers or employees of a closely held corporation.

(emphasis added)

This statute is to be construed liberally to redress the rights of minority shareholders, who stand "in a vulnerable position." See Pedro, 463 N.W.2d at 288-89. The statute gives the courts authority to vindicate "the reasonable expectations of shareholders." See Berreman, 615 N.W.2d at 374.

In the leading case of *Pedro v. Pedro*, this Court reviewed egregious misbehavior by the majority shareholders in a closely-held corporation. The Court approved an award

of attorneys' fees to redress a breach of fiduciary duty under the statute. It stated:

[T]he trial court must make two findings before it may award attorney fees. It must first find that there was a breach of fiduciary duty. If so, then the court must find that the breaching party acted "arbitrarily, vexatiously, or otherwise not in good faith."

463 N.W. 2d at 290 (emphasis added). See also *Pedro v. Pedro*, 489 N.W.2d 798, 801, 804 (Minn. App. 1992) ("*Pedro II*") (affirming an award, after remand, of \$200,000 for "attorneys' fees and expenses" in redressing the breach of fiduciary duty).

In the present case, the record clearly establishes a fact issue as to whether Kelly acted "arbitrarily, vexatiously, or otherwise not in good faith" in denying Blohm access to corporate records. Blohm thus is entitled to seek attorneys' fees expended for enforcing his right of access. The district court clearly erred in dismissing the attorneys' fee claim as "moot."

4. Additional Relief for the Denial of Access to Documents

In assessing the other issues in this matter, the Court should be mindful of their linkage to the denial of access to records. The egregious delays in production, and the apparent loss or withholding of some records, creates many difficulties of proof.

It is crucial to note, in this respect, that Kelly and his accountants state that their memories have faded with regard to many factual details. Kelly's 2007 deposition is rife with declarations that "I don't remember," or words to that effect. (See Kelly Depo., pp. 10, 11, 12, 13, 16, 17, 18, 21, 26, 27, 37, 40, 42, 44, 46, 47, 49, 50, 52, 55, 57, 59, 61, 64, 66, 68, 72, 87, 88, 89, 90, 91, 92, 94, 95, 99, 100, 101, 105, 106, 107, 110, 111, 112, 114, 115, 116, 117, 118, 120, 121) Had the records been produced in late 2004 or early 2005,

the memories of Kelly and his accountants presumably would have been more acute.

This Court should hold that all injuries flowing from the delay in producing the records are direct. Under Minn. Stat. § 302A.751, the trial court has broad equitable power to fashion a remedy for such injuries. See Pedro I, 463 N.W.2d at 288-89; Berreman, 615 N.W.2d at 373-74 (court has authority to vindicate “reasonable expectations” of shareholders).

In the present matter, Blohm’s reasonable expectations included (1) prompt access to records, and (2) an honest accounting and division of proceeds after the corporate assets were sold. A proper equitable remedy would be to require Defendants to give an accounting and to sustain the burden of proof.

This Court, accordingly, should reverse the holding that the access-to-records claim is “moot.” The Court should remand that claim with instructions that the trial court (1) award attorneys’ fees for obtaining access to the records, and (2) order an accounting as equitable relief for the delay in producing the records. The Plaintiff’s claim supporting this relief indisputably is a direct claim, not a derivative claim.

C. Additional Claims for Breach of Fiduciary Duty

The trial court dismissed Blohm's claims for breach of fiduciary duty on grounds that "Kelly's fiduciary duties ran to the corporation rather than to Blohm." (Order, p. 5) On this basis, the court held that Blohm's claims for breach of duty were derivative claims rather than direct claims. (See id., p. 6)

The trial court's holding clearly was in error. As noted above, shareholders in closely-held corporations owe a fiduciary duty to each other. Pedro, 463 N.W.2d at 288.

Blohm's fundamental claim in this action is that Kelly breached a fiduciary duty in distributing the assets of BNK when he wound up the corporate affairs. As shown above, Minn. Stat. § 302A.751 authorizes broad equitable relief (e.g., an order for an accounting) to redress such breaches of duty.

Defendants contend that some of Blohm's claims involve injuries to the corporation (e.g., wrongful disbursements and excessive compensation), and thus are derivative. As shown below, any injuries of that nature should be deemed direct in the circumstances here (two shareholders and no third-party creditors).

In large part, however, Blohm's claims for breach of fiduciary duty do not depend on injuries to the corporation. Rather, they depend on breaches of the Shareholder Agreement – e.g., (1) the forbidden transactions with Lake Country Classics, and (2) distributions of corporate assets to Kelly in excess of his contractual share, through payments on his credit card and other payments made at the time of the winding-up of the corporation's affairs. (See Affidavit of Kenneth Fromm, Ex. B, C; and Exhibit Q to the SLC Report)

The Special Litigation Committee itself expressly recognized that some of Blohm's claims might be direct, and expressly made no findings on them. (See Special Litigation Committee Report, p. 12) The trial court improperly dismissed these claims.

Whether a fiduciary duty has been breached generally is a question of fact. *Berreman*, 615 N.W.2d at 367. Summary judgment on a fiduciary-duty claim "is only appropriate where no rational finder of fact could conclude" that a defendant's actions breached its duty. Id. This Court should hold that the record establishes a direct claim as

to whether Kelly breached a fiduciary duty to Blohm.

D. Claims of Wrongful Disbursement and Excessive Compensation

Plaintiff claims that Kelly made improper disbursements of corporate assets and took excessive compensation from the company. These claims should be resolved pursuant to an order that Kelly provide an accounting on Plaintiff's direct claims, as explained above.

If these claims are assessed independently, the Court should nonetheless treat them as direct. In most contexts, the claims would be derivative. Here, however, a direct right of action should be recognized.

In *Wessin v. Archives Corporation*, the Minnesota Supreme Court explained the rationale for requiring derivative actions. It stated:

The purpose of Minn. R. Civ. P. 23.06 relates in large part to limiting recovery to the real party in interest. [citation omitted] The rule also helps to avoid multiple and conflicting suits, and protects corporate creditors. [citations omitted] A closely held corporation can have up to 35 shareholders. [citation omitted] There is the possibility of multiple creditors and of numerous shareholder factions. A uniform, fair and predictable mechanism for enforcing claims of the corporation is important for the corporation and all of the shareholders.

592 N.W.2d at 466 (emphasis added).

This rationale does not apply to the present matter. By contrast to *Wessin*, the present case involves only two shareholders and a corporation with no ongoing business. Accordingly, there is no possibility of "multiple and conflicting suits," or of "multiple creditors and of numerous shareholder factions."

In such situations, courts broadly decline to treat the claims in issue as derivative

claims. A leading treatise states:

A growing number of courts recognize that the derivative-direct distinction makes little sense when the only interested parties are two individuals or sets of shareholders, one who is in control and the other who is not. As one court recognized, the debate over derivative status can become "purely technical." ... Other courts have noted that where there are only two shareholders there is no practical need to insist on derivative suits when there is little likelihood of a multiplicity of suits or harm to creditors. Judges recognize that often it would be futile to require a minority shareholder to sue on behalf of the corporation when the only other shareholder is the defendant and any recovery in a derivative suit would return funds to the control of the defendant, rather than to the injured party.

2 R. Thompson, *O'Neal and Thompson's Oppression of Minority Shareholders and LLC Members*, at 7-67 to 7-68 (emphasis added).

In *W & W Equipment, Inc. v. Mink*, 568 N.E.2d 564 (Ind. App. 1991), for example, a corporation had only two shareholders and no creditors. One of the shareholders sued the other (and two non-shareholder directors) for breach of fiduciary duty. The Court held that action need not be framed as a derivative claim:

The reasons for requesting a derivative action are not present in this case. There are only two shareholders, and Mink is the sole injured shareholder. There is thus no potential for a multiplicity of shareholder suits; there is no evidence of any creditor in need of protection; there can be no prejudice to other shareholders not a party to the suit since Mink is the only injured shareholder; and Mink would not be adequately compensated by a corporate recovery because W & W is a close corporation with no ready market for the sale of Mink's shares. Because none of the underlying reasons for requiring a derivative action are present here, we hold that Mink was not required to bring a derivative action.

* * *

There was thus only one shareholder who could bring the action on behalf of the corporation. While the better practice would be to bring a derivative action, we will not exalt form over substance in this case.

Id. at 571 (emphasis added).

A similar holding is warranted here. As in *Mink*, this Court should reject a "direct/derivative" assessment that exalts form over substance.

The real parties in interest here are Blohm and Kelly (who have a Shareholders' Agreement). No other shareholders or creditors exist. The corporation is out of business. The issue is whether Kelly violated the Shareholders' Agreement and denied Blohm his fair share of the proceeds. The Court should recognize that this is a direct claim by its nature, rather than a derivative claim.

II. THE TRIAL COURT ERRED IN REFERRING THE CASE TO A SPECIAL LITIGATION COMMITTEE A WEEK BEFORE THE TRIAL.

Standard of Review

Appellate courts review de novo a decision of a district court to dismiss a derivative suit. *Janssen v. Best & Flanagan*, 662 N.W.2d 876, 881 (Minn. 2003) (apparently applying de novo review to the district court's underlying decision to refer the case to a special litigation committee rather than let it proceed to trial).

Argument

If this Court concludes that any of Plaintiff's claims are derivative, it must determine whether the trial court erred in dismissing them. It first must consider whether the court erred in referring the case to a Special Litigation Committee on the eve of trial.

Trial was scheduled for the week of Oct. 29, 2007. The scheduling order set a deadline of Sept. 25, 2007 for filing motions. It also directed the parties to exchange

exhibit and witness lists by Oct. 15, 2007. (See Scheduling Order of June 28, 2007)

Plaintiff filed and served its witness list and a very extensive exhibit list as directed. (See Pl. Exhibit List and Witness List (filed Oct. 12, 2007) and Amended Exhibit List (filed Oct. 15, 2007)) Defendants, however, filed no lists. Instead, their counsel informally sought a stay by letter to the judge, which stated:

On October 10, 2007 the Board of Directors of BNK, Inc. adopted a corporate resolution forming a special litigation committee pursuant to Minn. Stat. §302A.241 to investigate the claims raised by D. Randall Blohm ... in order to analyze the legal rights or remedies of the corporation and determine whether those rights or remedies should be pursued. ...

In light of this corporate resolution, the defendants are requesting that this action, over which you are presiding, be stayed until such time as the special litigation committee issues it's [sic] report. ...

(Letter of Oct. 12, 2007 from Timothy McCarthy to the Hon. Charles Porter (A-14)

(emphasis added))

Plaintiff's counsel promptly objected to this procedure. He stated, in part:

Defendants' request is untimely and improper. We are only two weeks from the week certain court trial in this case. The Court's June 28, 2007 *Scheduling Order, Referral to Mediation and Order Setting Trial* required that any dispositive or non-dispositive motions in this case be heard by September 25, 2007.

This case was commenced in January 2006 and, since that time, extensive discovery has been done on the case. Mediation was held on September 20, 2007. Plaintiff has filed his *Witness List* and *Exhibit List* in accordance with the Court's Scheduling Order. Defendants had ample opportunity to make a motion with their request over the past 20 months. And yet, only on the eve of trial do Defendants submit this informal letter request. ...

(Letter of Oct. 15, 2007 from John Angell to the Hon. Charles Porter (A-16) (emphasis added; italics in original))

The trial court, however, granted the stay. Its very brief order made no assessment of the objections raised by the Plaintiff. See Order of October 22, 2007 (A-18)

This Court should hold that, under the circumstances here, the trial court erred in granting this order. The order unfairly prejudiced the Plaintiff, for these reasons:

- artificiality of the resolution: As argued above, the only real parties in interest are Blohm and Kelly. BNK is an empty shell. The gravamen of the case is Kelly's duty to account to Blohm. A resolution by BNK's Board of Directors (Kelly) to determine whether BNK should join in suing Kelly was contrived and artificial. It was an exercise in forum-shopping to avoid a trial.
- tardiness of the "investigation": BNK and Kelly were served with Plaintiff's Complaint in January 2006. Some 20 months later, on the eve of trial, BNK's Board of Directors (Kelly) abruptly resolved to "investigate" the claims. Were this an authentic investigation, rather than a strategic maneuver, it certainly would have been conducted long before.
- procedural unfairness to the Plaintiff: Plaintiff complied with the Scheduling Order. His counsel obviously put a great deal of time into trial preparation. (See, e.g., Plaintiff's Amended Exhibit List, filed Oct. 15, 2007, which includes scores of items) Defendants' counsel did not comply. There clearly is unfairness in staying the trial under these circumstances, on an application made well after the motion deadline.
- substantive unfairness to the Plaintiff: As will be shown below, Minnesota courts have given extraordinary deference to Special Litigation Committees.

Generally, courts have declined to give substantive review to their recommendations. Thus, the district court's order effectively denied the Plaintiff his day in court. It referred his claims to a tribunal of Defendant's choosing, with minimal prospects for an appeal.

- strategic advantage to the Defendants: Minnesota case law involving special litigation committees suggests that such committees have a tendency to rule against pursuing derivative claims. See the *Janssen*, *Drilling*, *Skoglund*, *Black*, and *In re UnitedHealth* cases, discussed below. BNK's resolution thus gave Defendants an obvious strategic advantage: (1) if the committee followed the tendency in the reported cases and ruled against Blohm's claims, Blohm probably would have no further recourse, but (2) if the committee ruled in favor of pursuing Blohm's claims, Kelly could proceed to trial.

The trial court should not have approved this untimely and unfair procedure. A recent Minnesota Supreme Court decision indicates that the trial court's order should be reviewed de novo and should be held to be in error.

In *Janssen v. Best & Flanagan*, 662 N.W.2d 876 (Minn. 2003) a corporate defendant appointed a special litigation committee which prepared a flawed report. The district court properly rejected the committee's recommendation. However, it "postponed a decision ... to allow [the corporation] an opportunity to remedy the deficiencies." *Id.* at 880-81. The Supreme Court held that the district court erred, and should have brought the case to trial. It stated:

The practice of allowing derivative suits to proceed to trial if a

corporate board's initial attempt at a business decision fails the minimal requirements for judicial deference is supported by the principles underlying the application of the business judgment doctrine. We strike a balance between allowing corporations to control their own destiny and permitting meritorious suits by shareholders and members by limiting a board of directors to one opportunity to exercise its business judgment. ... If the courts allow corporate boards to continually improve their investigation to bolster their business decision, the rights of shareholders and members will be effectively nullified.

Id. at 889-90 (emphasis added)

A similar holding is warranted here. This Court should hold that the district court improperly deferred to a corporate "investigation" which was manifestly tardy, artificial, and egregiously unfair. As in *Janssen*, this Court should nullify the Special Litigation Committee proceedings and remand all Plaintiff's claims for trial.

III. THE TRIAL COURT ERRED IN DISMISSING PLAINTIFF'S CLAIMS PURSUANT TO THE SPECIAL LITIGATION COMMITTEE REPORT.

Standard of Review

Appellate courts "review de novo a decision of a district court to dismiss a derivative suit." *Janssen v. Best & Flanagan*, 662 N.W.2d 876, 881 (Minn. 2003).

Argument

If this Court holds that some of Plaintiff's claims are derivative, and if it approves their referral to the Special Litigation Committee, then it must review the Committee's report. As will be shown below, this Court should hold that the trial court erred in deferring to the Committee's recommendations under the "business judgment rule."

A. Special Litigation Committees and the Business Judgment Rule

The Minnesota Business Corporations Act allows corporate boards of directors to establish special litigation committees. Minn. Stat. § 302A.241, subd. 1 (2006) provides:

A resolution approved by the affirmative vote of a majority of the board may establish committees having the authority of the board in the management of the business of the corporation only to the extent provided in the resolution. Committees may include a special litigation committee consisting of one or more independent directors or other independent persons to consider legal rights or remedies of the corporation and whether those rights and remedies should be pursued. Committees other than special litigation committees ... are subject at all times to the direction and control of the board.

(emphasis added)

Special litigation committees often are appointed to review derivative lawsuits brought by individual shareholders. Courts review the recommendations of such committees under the "business judgment rule," which is analyzed below.

1. Janssen v. Best & Flanagan

In *Janssen v. Best & Flanagan*, the Minnesota Supreme Court discussed the policy of the business judgment rule. *Janssen* stressed that the rule balances interests:

To resolve this case we must strike a balance between two competing interests in the judicial review of corporate decisions. [citation omitted] On one hand, courts recognize the authority of corporate directors and want corporations to control their own destiny. [citation omitted] On the other hand, courts provide a critical mechanism to hold directors accountable for their decisions by allowing shareholder derivative suits. ...

Courts have attempted to balance these two competing concerns by establishing a "business judgment rule" that grants a degree of deference to the decisions of corporate directors. ... [C]ourts are ill-equipped to judge the wisdom of business ventures and have been reticent to replace a well-meaning decision by a corporate board with their own. [citations omitted]

Id. at 881-83 (emphasis added).

In *Janssen*, as in the present case, a corporation appointed an attorney to act as a special litigation committee. As in the present case, the attorney recommended against pursuing derivative claims. The Court declined to defer to the attorney's recommendation under the business judgment rule. It stated, in part:

At a minimum, the board must establish that the committee acted in good faith and was sufficiently independent from the board of directors to dispassionately review the derivative lawsuit.

* * *

[The committee] opined that "the totality of the materials reviewed does not support a finding that Best & Flanagan committed legal malpractice in its handling of the MPRA affairs," and that "to spend money in the pursuit of a legal malpractice claim against Best & Flanagan would not be prudent use of the MPRA funds." The language of his conclusion hints that his decision was that of a special counsel evaluating the likelihood of a legal victory. But a much more comprehensive weighing and balancing of factors is expected in situations like this, taking into consideration how joining or quashing the lawsuit could affect MPRA's economic health, relations between the board of directors and members, MPRA's public relations, and other factors common to reasoned business decisions.

Id. at 888-89 (emphasis added).

A similar conclusion is warranted here. For the reasons explained below, this Court should decline to defer to the Special Litigation Committee.

2. Minnesota Court of Appeals Cases

Appellant recognizes that Minnesota Court of Appeals cases require strong deference to special litigation committee reports. However, the present litigation (viewed in light of *Janssen*) includes issues not resolved by those cases. Moreover, a case now pending in the Minnesota Supreme Court may alter the the business judgment rule.

The leading case of *Black v. NuAire, Inc.*, 426 N.W.2d 203 (Minn. App. 1988) discussed judicial deference to special litigation committee recommendations. It stated:

We interpret section 302A.243 to preclude our courts from reviewing the merits of a recommendation to dismiss a shareholder's derivative action when that recommendation is made by a disinterested committee conducting its investigation in good faith.

Id. at 209-210.

Black dealt with a special litigation committee established under a statute which the legislature afterward repealed. See Minn. Stat. § 302A.243 (1986), repealed by 1989 Minn. Laws ch. 172, §11. After the repeal, special litigation committees were governed by the present statute, Minn. Stat. § 302A.241, subd. 1.

In *Skoglund v. Brady*, 541 N.W.2d 17 (Minn. App. 1995), the Court held that the *Black* analysis should apply to special litigation committees under the present statute. See id. at 21 (rejecting the argument that courts should conduct "a substantive review of a special litigation committee's decisions" (emphasis added)).

Skoglund's holding was reiterated in *Drilling v. Berman*, 589 N.W.2d 503 (Minn. App. 1999). In *Drilling*, the Court rejected the argument that courts should require a corporation to show a "reasonable basis" for a special litigation committee's conclusions:

In *Skoglund v. Brady*, this court determined that the standard set forth in *Black*, limiting judicial review to determining whether the committee was independent and conducted its review in good faith, continued to apply.

* * *

Appellants argue this court should extend the law to more closely scrutinize a special litigation committee recommendation by inquiring into the reasonableness of the committee's decision in addition to the committee's independence and good faith. We disagree.

Id. at 506-07. *Drilling* rejected extensive case law from other jurisdictions which conduct a less-deferential "reasonableness" review. See id. at 508.

It is important to note, however, that the foregoing cases defer to business judgments, not to underlying legal analysis. *Drilling* expressly made this distinction:

[W]hile courts do not possess the expertise required to second guess a business judgment, they are well equipped to determine the "methodologies and procedures best suited to the conduct of an investigation of facts and the determination of legal issues." [citation omitted]

Id. at 509. See also *Janssen v. Best & Flanagan*, 662 N.W.2d at 882, 888-89 ("courts are ill-equipped to judge the wisdom of business ventures" (emphasis added); court closely reviews the committee's legal analysis). In the present case, as will be shown below, the committee's legal analysis is at issue.

3. A Pending Minnesota Supreme Court Decision

As this brief is written, a Minnesota Supreme Court case is pending which may affect the contours of the business judgment rule. *In re UnitedHealth Group Incorporated Shareholder Derivative Litigation* (case no. A08-0114) was argued on May 7, 2008, and very likely will be decided during the course of this appeal.

In *In re UnitedHealth Group*, the federal district court for the District of Minnesota certified a question to the Minnesota Supreme Court. Chief Judge Rosenbaum of the federal court asked the Supreme Court to clarify *Janssen* and to state whether *Drilling*, *Skoglund*, and *Black* correctly express public policy. The certified question is:

Does Minnesota's business judgment rule foreclose a court from a) examining the reasonableness of, or b) rejecting on the merits, a settlement of a derivative action proposed by a Special Litigation Committee duly

constituted under Minnesota Statutes § 302A.241 subd. 1?

In re UnitedHealth Group Incorporated Shareholder Derivative Litigation, 2007 WL 4571127 (D. Minn. Dec. 26, 2007), *7 (emphasis added).

In re UnitedHealth is a derivative action challenging the payment of over a billion dollars in stock options to a corporate executive. A special litigation committee recommended settling the claims on terms very generous to the executive. Judge Rosenbaum observed:

The Special Litigation Committee has apparently made a business judgment favoring settling the Board's and UHG's possible claims against its former officers on terms outlined in its report. But its lack of any findings leaves no tracks showing why or how its business judgment can be considered reasonable. Its business judgment may close the inquiry, leaving a Court mute, and charged only with the ministerial duty to sign off on the deal and dismiss the derivative suit. Or there may be other alternatives. Ultimately, the Court asks whether Minnesota law makes an SLC an impenetrable "black box," whose decisions and evaluative processes are immune from review in a shareholders' derivative suit. Put another way, does the business judgment rule foreclose any action, beyond the Court's rubber stamping an SLC's decision?

Id. at *6 (emphasis added).

Obviously, the Minnesota Supreme Court's decision in *In re United Health* may affect the standards for reviewing the Special Litigation Committee's Report in the present case. In the following section, Appellant therefore notes some points to be considered if the Court authorizes substantive review. Appellant also notes points which can be reviewed under the current standards set out in *Janssen* and *Drilling*.

B. Critique of the Special Litigation Committee Report

1. A Legal Judgment, Not a Business Judgment

In *Janssen v. Best & Flanagan*, as noted above, our Supreme Court rejected the report of a special litigation committee. It held that the report gave only a legal judgment as to derivative claims, instead of a good-faith business judgment. The Court observed:

Murnane ... gave no indication that he had undertaken the careful consideration of all the germane benefits and detriments to MPRA that is indicative of a good faith business decision. Murnane opined that "the totality of the materials reviewed does not support a finding that Best & Flanagan committed legal malpractice in its handling of the MPRA affairs," and that "to spend money in the pursuit of a legal malpractice claim against Best & Flanagan would not be prudent use of the MPRA funds." The language of his conclusion hints that his decision was that of a special counsel evaluating the likelihood of a legal victory. But a much more comprehensive weighing and balancing of factors is expected in situations like this, taking into consideration how joining or quashing the lawsuit could affect MPRA's economic health, relations between the board of directors and members, MPRA's public relations, and other factors common to reasoned business decisions. [citation omitted] We conclude that Murnane's initial investigation of the derivative action instituted by Janssen against Best & Flanagan lacked the independence and good faith necessary to merit deference from this court.

662 N.W.2d at 889 (emphasis added).

A similar conclusion is warranted here. In the present case, the Committee's Report includes one sentence acknowledging that it must "weigh[] and balance[] ... legal, ethical, commercial, promotional, public relations, fiscal and other factors familiar to the resolution of many if not most corporate problems." (Special Litigation Committee Report, p. 18, quoting *Janssen*) But the Report presents no substantive analysis of anything except Blohm's legal claims.

This omission is unsurprising. BNK is an empty shell. It has no ongoing business, and therefore no "commercial, promotional, public relations, fiscal" or other concerns.

The Special Litigation Committee, thus (like the committee in *Janssen*) did not make a "good faith business decision." It made a legal decision, which perhaps was all that it could make. But such a decision merits no deference under the business judgment rule.

In essence, the Committee acted like an arbitrator in binding arbitration. It rendered findings of fact and conclusions of law, and the trial court simply adopted them, without substantive review.

The trial court's action was clearly in error. As *Janssen* shows, the court should not have deferred to a purely legal analysis under the business judgment rule. And, as will be shown below, the Special Litigation Committee erred in its application of the law.

2. Improper Allocation of Burdens of Proof

A plain flaw in the Special Litigation Committee's analysis is imposing burdens of proof on the wrong party. Kelly should have borne the burden of proof on almost every issue. Yet the Committee repeatedly imposed the burden of proof on Blohm.

It is well settled that "[t]he burden of proof is on the officer or director to show that he violated no fiduciary duties of loyalty, good faith, and fair dealings toward the corporation." *Honn v. Coin & Stamp Gallery, Inc.*, 407 N.W.2d 419, 422 (Minn. App. 1987). See also, e.g., *Westgor v. Grimm*, 318 N.W.2d 56, 59 (Minn. 1982) (director, officer, or controlling shareholder must prove that his action was in good faith and is inherently fair to the company). Minn. Stat. § 302A.255, subd. 1 (2004) expressly provides:

A contract or other transaction between a corporation and one or more of its directors, or between a corporation and an organization in or of which one or more of its directors are directors, officers, or legal representatives or have a material financial interest, is not void or voidable because the director or directors or the other organizations are parties ... if:

(a) The contract or transactions was, and the person asserting the validity of the contract or transaction sustains the burden of establishing that the contract or transaction was, fair and reasonable as to the corporation at the time it was authorized, approved, or ratified ...

(emphasis added)

The Special Litigation Committee acknowledged this burden of proof in the recitation of "Legal Standards" in its report. (See Special Litigation Committee Report, p. 9) However, in its "Findings and Analysis of Claims," the Committee repeatedly imposed the burden of proof not upon Kelly but upon Blohm. Specifically:

- With regard to wrongful disbursements of BNK assets, the Committee acknowledged Blohm's list of "\$58,309 ... paid to Kelly or other parties for purposes unsupported by proper business records such as invoices or statements." (Id., p. 12) However, the Committee then held:

[T]he Committee finds that Blohm has failed to provide facts supporting his allegations ... Blohm testified that he assembled this list "because he didn't have supporting documentation for ... and didn't know what they [entries] represented" ... Blohm's own testimony underscores the fact that he has offered no evidence that would otherwise suggest any disbursement by BNK was made for an improper purpose. Indeed, Blohm has testified that he "can't tell whether or not monies were taken out of BNK, Inc. improperly or used in other enterprises" ...

(Id., p. 13 (emphasis added)) As will be shown below, the Committee clearly erred in finding that Blohm produced "no evidence" of wrongful disbursements

by Kelly. The point here, however, is that the Committee improperly put the burden of proof not upon Kelly but upon Blohm.

- With regard to BNK's payments to Kelly's personal credit card account and BNK's commingling of funds with those of Lake Country Classics, the Committee held: "[T]here is no evidence to support a claim that the funds which were the subject of the transactions were not properly allocated and reconciled between Lake Country and BNK by Kelly and the Company's accountants." (*Id.*, p. 14) It cited Blohm's deposition testimony as follows (boldface supplied by the Committee):

"I'm not sure what the status of those related party transactions is until we can analyze the -- debits and credits there and determine what the balance is. **I can't tell you whether or not monies were taken out of BNK, Inc. improperly and used in other enterprises.** But I do know that the agreement said that there aren't to be any transactions like that, and, in fact, there were. And a similar comments [sic] relates to MBNA that was his personal credit card account, the company made payments on that account, and until we get all the records and do a thorough analysis, **I'm not sure whether all the payments made by BNK, Inc. to MBNA were for BNK, Inc. business matters.**"

(*Id.*, p. 15) Again, this analysis put the burden of proof on Blohm, instead of requiring Kelly affirmatively to justify each transaction.

- With regard to excessive compensation and unauthorized payment of personal expenses, the Committee again found that "Blohm has failed to provide facts supporting his allegations." (*Id.*, p. 16) As will be shown below, Blohm did provide such facts, but the point here is that the Committee insistently put the burden of proof on Blohm.

- At several points, the Committee cited general statements by Kelly and by BNK's accountants to the effect that they habitually had used proper methodology. (See *id.*, pp. 13, 14, 15, 16) These general statements do not satisfy Kelly's burden to prove the validity of each interested-party transaction (e.g., specific comminglings of funds, specific payments to Kelly's credit card, specific payments made at the time that BNK's affairs were wound up).

The Committee, thus, clearly misapplied the law in assessing Plaintiff's claims. Even an impeccable legal assessment of those claims would not qualify as a "business judgment," under *Janssen*. A fortiori, the Committee's improper assessment fails the good-faith prong of the business judgment rule.

3. Genuine Issues of Material Fact

In his Memorandum in Opposition to Motion for Summary Judgment in the district court, Plaintiff argued that the record established genuine issues of material fact. He marshaled evidence to demonstrate genuine issues on these points:

(1) Commingling of corporate assets and improper related-party transactions.

Plaintiff cited evidence establishing transactions with Lake Country Classics and BNK's payments to Kelly's personal credit card, without an adequate accounting. (See Pl. Memo., pp. 4-5; e.g., Fromm Aff., Ex. B, C)

(2) Improper refusals to provide Plaintiff with requested documentation. Plaintiff

cited evidence establishing egregious refusals to produce requested documents, extending for over two years. (See Pl. Memo., p. 5; e.g., Sever Aff., Ex. H)

(3) Improper and excessive compensation. Plaintiff cited evidence that Kelly's compensation was excessive, especially after half of BNK's business was sold.

(See Pl. Memo., p. 6; Fromm Aff., Ex. A; Kelly Depo., pp. 67-68)

(4) Denying Blohm his fair share of the equity after sale of the business. Plaintiff cited evidence that (a) Kelly used BNK assets to pay off his personal credit card balance, and did not account for specific credit card charges; (b) Kelly otherwise used BNK assets to pay his personal debts; (c) Kelly arbitrarily paid proceeds of the sale of BNK to himself, and (d) Kelly could not explain how he had calculated the \$2,400 payment to Blohm. (See Pl. Memo., pp. 6-7; e.g., Kelly Depo., pp. 48, 57, 97, 99, 104-109, 112, 115-16)

Neither Defendants' memoranda of law nor the district court's order addressed the foregoing analysis. Defendants and the trial court simply concluded that (1) all the claims were derivative or moot, and (2) the Special Litigation Committee's Report was dispositive as to all derivative claims. (See Def. Memo. In Support of Summary Judgment, pp. 3-9; Def. Reply Memo., pp. 2-6; Order and Memorandum, pp. 5-9)

The trial court plainly erred in granting summary judgment on this basis. It could not properly defer to the Special Litigation Committee. The record clearly established genuine issues of material fact. Thus, the summary judgment should be reversed.

CONCLUSION

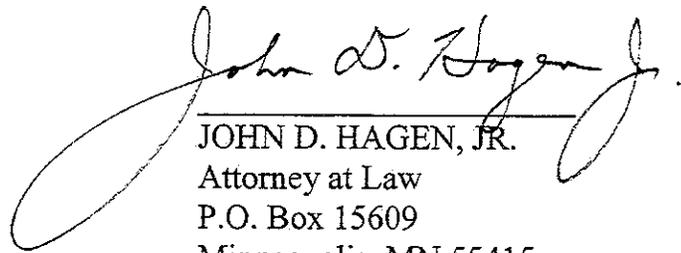
Some or all of Plaintiff's claims are direct, not derivative. These claims include, at a minimum, the egregious denial of access to records and Kelly's breach of fiduciary duty

to Blohm in dividing the proceeds of sale. These claims should go to trial regardless of the analysis concerning the Special Litigation Committee.

If any of Plaintiff's claims are deemed derivative, they also should go to trial. The referral to the Special Litigation Committee was untimely, improper under the facts of this matter, and clearly prejudicial to the Plaintiff. Moreover, the Committee's Report was flawed and did not qualify for deference under the business judgment rule.

The record shows genuine issues of material fact as to all the Plaintiff's claims. This Court, accordingly, should reverse the trial court's entry of summary judgment and remand the case for trial.

Respectfully submitted,

A handwritten signature in cursive script that reads "John D. Hagen, Jr." The signature is written in black ink and is positioned above a horizontal line.

JOHN D. HAGEN, JR.
Attorney at Law
P.O. Box 15609
Minneapolis, MN 55415
(612) 623-0908
Atty. Reg. No. 0039330

Attorney for Appellant