

NO. A04-2338

State of Minnesota
In Supreme Court

John S. Drewitz,

Appellant,

v.

Motorwerks, Inc., a Minnesota corporation,
R. Jack Walser, Paul M. Walser and Andrew D. Walser,

Respondents.

**BRIEF OF AMICUS CURIAE
MINNESOTA AUTOMOBILE DEALERS ASSOCIATION**

Paul W. Chamberlain (#16007)
CHAMBERLAIN LAW FIRM
1907 Wayzata Boulevard, Suite 130
Wayzata, MN 55391
(952) 473-8444

Attorneys for Appellant John S. Drewitz

David L. Hashmall (#138162)
Ryan A. Olson (#340935)
FELHABER, LARSON, FENLON
& VOGT, P.A.
220 South Sixth Street, Suite 2200
Minneapolis, MN 55402
(612) 339-3621

and

James Schutjer (#9805X)
Minnesota Automobile Dealers Association
200 Lothenbach Avenue
West St. Paul, MN 55118
(651) 291-2400

*Attorney for Amicus Curiae
Minnesota Automobile Dealers Association*

William M. Hart (#150526)
Mary M. L. O'Brien (#177404)
Jeffrey M. Thompson (#197245)
Erica Gutmann Strohl (#279626)
MEAGHER & GEER, P.L.L.P.
33 South Sixth Street, Suite 4400
Minneapolis, MN 55402
(612) 338-0661

*Attorneys for Respondents
Motorwerks, Inc., R. Jack Walser,
Paul M. Walser and Andrew D. Walser*

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INTRODUCTION

The Minnesota Automobile Dealers Association (“MADA”)¹ is a non-profit trade association comprised of franchised new car and truck dealers located throughout the State of Minnesota. The MADA has 470 members. Its membership includes nearly all of the franchised new car and truck dealers in the State of Minnesota.

The MADA has a strong interest in this case because its members, who are primarily close corporations, will be substantially impaired by the Court of Appeals’ decision that an employee-shareholder, who is subject to a stock-redemption agreement that compels the purchase of shares upon termination of the employee-shareholder’s employment, remains a shareholder even after his or her employment is terminated (hereinafter the “decision”).

An automobile dealership’s overall success, as in most businesses, is directly tied to the performance of its employees, especially its general manager. *See Kachadourian, Gayle, Retailer on the Prowl for Talent*, *Automotive News*, Vol. 79 Issue 6155, Page 8-8 (July 2005). Given the highly competitive environment in which automobile dealerships compete, they are generally required to provide general managers an ownership interest in order to attract and retain high-quality personnel. *Id.*

Further, motor-vehicle manufacturers typically require dealerships to give general managers an ownership interest in the dealerships they manage. *See Cottingham v. General Motors Corp.*, 119 F.3d 373, 377 (5th Cir. 1997) (setting forth a typical requirement that the dealer operator or general manager have an unencumbered ownership interest in the dealership).

¹ The Amicus Curiae MADA’s counsel authored this brief in its entirety. The Amicus Curiae is the only entity (or person) that made a monetary contribution to the preparation or submission of this brief.

Consequently, MADA members often provide general managers with an ownership interest in the dealership they manage, and enter into shareholder agreements in doing so. Such shareholder agreements are entered into to further the purpose of attracting and motivating managers, and to comply with manufacturers' requirements that the manager have an ownership interest, while protecting the legitimate concerns and interests of the MADA member-dealer. Both of these purposes are coterminous with the manager's employment. It is not the intent of MADA members to provide managers with status as a shareholder that continues beyond the manager's employment.

The decision incorrectly suggests that such intent can only be achieved by language that "expressly strip[s]" the manager of his shareholder status, or expressly provides that title to the shares "passes . . . automatically or immediately . . ." *Drewitz v. Motorwerks, Inc.*, 706 N.W.2d 773, 784 (Minn. Ct. App. 2005). In this case, the parties' intent that Drewitz's ownership of shares terminate simultaneously with his employment is evidenced by both the language of the Drewitz shareholder agreement and its purpose, even though the parties did not use the exact language apparently preferred by the Court of Appeals. By refusing to give effect to the parties' intent – that shareholder status and employee status be coterminous – the decision frustrates the intent of not only the Drewitz shareholder agreement, but also the intent of shareholder agreements of many MADA members and of countless small and closely-held corporations throughout the State of Minnesota.

STATEMENT OF THE CASE, ISSUES AND FACTS

Amicus Curiae concurs in the Statement of the Case, Issues and Facts presented by Respondents.

ARGUMENT

I. The Court of Appeals' Decision Ignores a Close Corporation's Corporate Structure and The Purpose Of Stock-Redemption Agreements

Close corporations use shareholder agreements to ensure the harmony and cooperation among shareholders that is essential to the successful functioning of a closely-held corporation.² This is especially true where, as in this case, an employee's shareholder status is a direct result of, and therefore integral to, his or her status as an employee. *See* Appellant's Appendix ("A.") 3 (indicating that the Appellant received an ownership interest solely because he was vice president and operated the company pursuant to the shareholder agreement).

The decision ignores the fact that for a shareholder such as Drewitz, shareholder status is inextricably linked to continuation of employment. Close corporations give key personnel an ownership interest because the participation in profits allows them to (1) attract and retain personnel it otherwise could not afford and (2) stimulate high productivity and performance. Thus, "permanent" shareholders utilize stock redemption or purchase agreements not only to ensure that they maintain control of the company but also to encourage productivity and performance of key personnel.³ The Court of Appeals' decision is inconsistent with these essential purposes.

² Attributes of close corporations that are addressed by shareholder agreements include the shareholders' active role in the corporation's day-to-day business, the need for "harmony and cooperation among . . . [shareholders]," and the lack of a market for a disgruntled shareholder's shares. *See* Kleinberger, Daniel S., *Why Not Good Faith? The Foibles of Fairness in the Law of Close Corporations*, 16 Wm. Mitchell L.Rev. 1143, 1148 (1990); *see also* F.H. O'Neal & R. Thompson, *O'Neal and Thompson's Close Corporations and LLCs: Law and Practice* § 1.9, at 1-35 (3d ed. 2005).

³ In such a case, a shareholder agreement ensures that the corporation is controlled by its permanent shareholders – *i.e.*, "those who will continue to contribute to its successes or failures," *Gallagher v. Lambert*, 549 N.E.2d 136, 137 (N.Y. Ct. App. 1989) (*citing* Kessler, *Share Repurchases Under Modern Corporation Laws*, 28 Fordham L. Rev. 637, 648 (1959-

Indeed, it is undisputed that, once he was no longer employed, Drewitz's share ownership would end. The Court of Appeals erred when, in violation of the plain intent of the parties, it prolonged Drewitz's shareholder status even after his employment terminated. And, it reached its erroneous decision notwithstanding the shareholder agreement's plain language that the "event of purchase" occurred on the date Drewitz's employment terminated. To make matters worse, it did so by erroneously concluding that Drewitz needed to be protected from breaches of fiduciary duties, even after the "event of purchase."

II. The Court of Appeals' "Fiduciary Duty" Reasoning Is Unpersuasive

In circular fashion, the Court of Appeals reasoned that Drewitz needed to be protected from breaches of fiduciary duties even after he was no longer an employee and no longer had any right to own shares. To the contrary, where as here a terminated employee has an absolute contractual right – under the shareholder agreement – to receive the agreed payment for his or her shares based upon a predetermined, mutually agreed formula that refers to a prior or contemporaneous point in time, the terminated employee is protected from a breach of the agreement by the same duties any contracting party owes another, but not by heightened

1960)), - and is insusceptible to interference from a disgruntled former employee. Looney, Stephen R. & Ronald A. Levitt, *Shareholder Agreements For Closely Held Corporations, Business Entities*, 50 No. 1 Bus. Entities 20, 2003 WL 356587 (Jan./Feb. 2003) (recognizing that close corporations utilize shareholder agreements, in part, to "establish a control mechanism for . . . exclud[ing] or remov[ing] . . . potentially dissident shareholders . . .," "provide a means of transferring control of a closely held corporation upon . . . termination of employment . . . of a shareholder to other shareholders," and to "greatly reduce the potential for shareholder disputes resulting in litigation that would be both time consuming and costly to the corporation and its shareholders."); George Jackson III and David M. Maloney, *Buy-Sell Arrangements – An Invaluable Tool (Part I)*, Tax Advisor Vol. 34, Issue 4 p. 200 (2003) (recognizing that "[b]uy-sell arrangements can be valuable tools to closely held corporations that seek to protect shareholders' ownership interests and increase the probability of achieving a long and successful operating life."); *Cf. F.H.T., Inc. v. Feuerhelm*, 320 N.W.2d 772, 776 (Neb. 1982) (noting that transfer restrictions are employed to ensure that the management and control of the business remains with the same group of people well known to them).

standards of conduct that presuppose an ongoing close relationship among shareholders. *See* A.14 at §4.04 (“The purchase price shall be determined as of the last day of the month immediately preceding the month in which the termination occurs.”). The right to this payment does not arise from and is not based upon fiduciary duties. And, Drewitz need not continue to be a shareholder to whom fiduciary duties are owed in order to enforce this right to payment. *See* Argument III, *infra*. He has the rights, and is owed the duties, of a party to a contract.

Moreover, it has already been determined in this state that a close corporation’s shareholders do not owe an employee-shareholder a fiduciary duty where the employee-shareholder’s shareholder status is integral to his or her employment. *Harris v. Mardan Bus. Sys., Inc.*, 421 N.W.2d 350, 353 (Minn. Ct. App. 1988). In *Harris*, a terminated employee-shareholder, who did not initially capitalize or form the close corporation and who acquired his ownership interest as a consequence of his employment, sued the majority shareholders alleging, in part, that they breached their fiduciary duty to him by terminating his employment. *Id.*, at 351-52. The court held that the terminated employee-shareholder’s predominant relationship with the close corporation was that of an employee as opposed to a shareholder. Hence, the employee-shareholder’s relationship with the majority shareholder was “not controlled by fiduciary principles.” *Id.*, at 353.

Here, as in *Harris*, Appellant did not aid Respondents in the initial capitalization and formation of Motorwerks, Inc. As in *Harris*, Appellant obtained shares in Motorwerks, Inc. solely because of his employment. A.3; A.4. Therefore, as in *Harris*, Respondents did not owe Appellant a fiduciary duty. Certainly, Respondents did not owe that duty once employment – the fundamental premise for Drewitz’s shareholder status – ended.

III. The Court of Appeals' Adoption of *Stephenson* Does Not Fit Within Minnesota's Statutory Framework

Minn. Stat. §302A.551 and §302A.553 plainly contemplate that shareholder rights can cease *before* payment for redemption of the shares is actually made and received. Section 302A.551, subd. 3(a) states:

In the case of a distribution⁴ made by a corporation in connection with a . . . redemption . . . , the effect of the distribution shall be measured as of the date on which money or other property is transferred, or indebtedness payable in installments or otherwise is incurred, by the corporation, or as of the date on which the shareholder ceases to be a shareholder of the corporation with respect to the shares, whichever is the earliest.

Upon a redemption of a shareholder, his or her former shares cease to be issued and outstanding, when the issuing corporation acquires them, unless the corporation pledges the shares as security for a future payment. Minn. Stat. §302A.553. A corporation "acquires" its shares when it gains control over them in any manner, including pursuant to a shareholder agreement. *See* Black's Law Dictionary 19 (Abridged 7th ed. 2000) (defining "acquire" as "[t]o gain possession or control of"; *see also* Black's Law Dictionary 24 (6th ed. 1990) (recognizing that acquire means "[t]o gain by any means," including by devise even if legal title has not passed) (*citing U.S. v. Merriam*, 263 U.S. 179 (1923))). Therefore, once a corporation's obligation to purchase and a shareholder's obligation to sell his or her shares is unconditional and the price is fixed, a corporation acquires the shares. Once shares are no longer considered issued and outstanding, it is axiomatic that no one can be considered to have shareholder's "rights" based solely on prior ownership of those shares.

⁴ A distribution can include a promise to pay or indebtedness. Section 302A.551, subd. 3(c), refers to "[i]ndebtedness of a corporation incurred or issued in a distribution." Motorwerks' promise to pay was in the shareholder agreement. Also, the general comment to the Reporter's Notes of §302A.551, states that "[i]n an acquisition of its shares, a corporation may pay out property or incur a debt to the former holder of the shares."

Here, under the shareholder agreement, Respondents' obligation to purchase and Appellant's obligation to sell his stock was unconditional and arose immediately upon the "event of purchase" – *i.e.*, the termination of Appellant's employment. A.13 at §4.03; A.14 at §4.04; A.18 at §5.04(b). Thus, upon the termination of Appellant's employment, Motorwerks, Inc. "acquired" Appellant's shares. Accordingly, under §302A.551, subd. 3(a) and §302A.553, Appellant's rights as a shareholder terminated. It is true that actual payment for the shares had not actually been made or received, but Appellant had Motorwerks' unconditional contractual promise and obligation to make actual payment, in a determinable amount and by a date certain. Surely no one could doubt that a corporation "acquired" its shares if it makes payment in whole or in part by issuing its promissory note in exchange for the shares. This is fundamentally no different.

Furthermore, an analysis of §302A.551, subd. 3(a) and §302A.553 demonstrates the serious inequities produced by the decision. Because a former shareholder becomes a creditor on a par with other unsecured creditors after a corporation's promise to buy shares is triggered under a shareholder agreement, *see* Minn. Stat. §302A.551(c), Appellant became Motorwerks, Inc.'s creditor immediately upon the termination of his employment. As a creditor, Appellant no longer shared any risk that the value would decline after his termination. Rather, even if the value per the agreed formula declined, Appellant would remain entitled to the book value of his shares determined as of the month prior to his termination. A.14 at §4.04. But, according to the decision, the employee-shareholder nonetheless continues to enjoy the upside of stock ownership, in this case distributions (and voting rights as a Board of Director⁵), but no "downside" since the buyout price is fixed, and will not be reduced even if the dealership's

⁵ A.7 at §2.02.

assets lose value. In short, the decision provides terminated employee-shareholders with all of the benefits of being a shareholder, without any of the risk.

Further, because Appellant was a creditor of Motorwerks Inc. upon his termination under §302A.551(c) and, as recognized by Judge Klaphake's dissenting opinion, was entitled to accrued interest under the shareholder agreement back to the date of his termination, *Drewitz*, 706 N.W.2d at 789, the decision works an injustice by providing Appellant with a "double recovery" – *i.e.*, interest plus shareholder distributions.

What is more, the decision results in an implicit amendment to Motorwerks, Inc.'s articles of incorporation, to create a second class of stock. That also is inconsistent with the corporation's status as an S corporation under Subchapter S of the Internal Revenue Code. *See* A.7 at §2.04 (indicating that Motorwerks, Inc., is a "Subchapter S" corporation). The logical result of the decision would permit Appellant to claim the rights of a creditor to a fixed amount with interest payable, if the corporation were to liquidate, before distributions to shareholders. *See* Minn. Stat. §302A.725, subd. 3 (indicating that the Appellant, as a creditor, would have the right to receive payment in full before any distribution to "shareholders"). Because of this preferred right to liquidation proceeds, Appellant could well be considered to hold a second class of stock under Subchapter S rules. *See* 26 C.F.R. §1.1361-1(l)(1) ("a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds"); *see also* Minn. Stat. §302A.401, subd. 4(c) (indicating that a "preference" on liquidation of the corporation is the hallmark of a second class of stock). But, because Motorwerks, Inc., is an "S corporation" for federal and state income tax purposes, it can only have one class of stock. 26 U.S.C. § 1361 (a)(1) and (b)(1)(D); Minn. Stat. §290.9725. Therefore, the decision has improperly caused a shareholder agreement,

which was intended to motivate an employee during the course of his employment, to seemingly create a second class of stock, which prevents the corporation from being eligible for "Subchapter S" status under federal and state law. 26 U.S.C. § 1361(a)(1) and (b)(1)(D); Minn. Stat. §290.9725. This unnecessary and unintended result highlights the Court of Appeals' error and is disruptive to the corporate structure of thousands of Minnesota corporations.⁶

CONCLUSION

For the foregoing reasons, the MADA respectfully suggests that the Court of Appeals' decision that Appellant's shareholder status did not terminate contemporaneously with his employment be reversed.

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FELHABER, LARSON, FENLON & VOGT, P.A.

By: 

David L. Hashmall, No. 138162

Ryan A. Olson No. 340935

220 South Sixth Street, Suite 2200

Minneapolis, MN 55402

Telephone: (612) 339-3621

**Attorneys for *Amicus Curiae* Minnesota
Automobile Dealers Association**

⁶ The shareholder agreement itself did not create a second class of stock for Subchapter S purposes. 26 C.F.R §1.1361-1(l)(2)(iii). The occurrence of an event triggering a mandatory purchase and sale under the shareholder agreement did not create a second class of stock for those purposes. What may do so for those purposes is the anomaly that will exist if Drewitz is simultaneously both a creditor as to the shares, with creditor rights on a liquidation of Motorwerks, and a shareholder with rights to participate in ongoing profits (and to receive shareholder distributions).