SUMMER 2021 | VOL. 6 NO. 2

THE SPOTLIGHT

BROUGHT TO YOU BY ROBINS KAPLAN LLP'S
WEALTH PLANNING, ADMINISTRATION, AND DISPUTES GROUP

THE REALITIES OF LITIGATION: EARLY SEEDS, KEY DECISIONS, AND SOMETIMES UNSETTLED RESOLUTIONS

ROBINS KAPLAN LLP

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Is there a topic affecting your practice that you would like us to discuss in an upcoming issue of the Spotlight? Let us know at TPentelovitch@RobinsKaplan.com.

– Denise S. Rahne and Steven K. Orloff

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INSIDE THIS ISSUE

IN THE BEGINNING: CHOOSING THE RIGHT CORPORATE ENTITY 3

FAMILY FEUD: A CAUTIONARY TALE OF THE COSTS, RISKS, AND UNCERTAINTY OF MINORITY-SHAREHOLDER LITIGATION 5

LIFE AFTER SETTLEMENT: CRAFTING AGREEMENTS TO AVOID FUTURE DISPUTES 6

IN THE BEGINNING: CHOOSING THE RIGHT CORPORATE ENTITY

BY MANLEEN SINGH

Professionals have a wide range of corporate entities to choose from when setting up their businesses, such as corporations, limited liability companies (LLCs), limited liability partnerships, limited partnerships, general partnerships, and sole proprietorships, each with its own advantages and disadvantages. The right entity will depend on the priorities of the owners. Do the owners want to participate in the management of the company? Do they want to customize arrangements with co-owners for a particular endeavor? What about their personal liability, or how much they or the company pays in taxes? It is important to ask and answer these questions at the outset to determine the right fit for the business and its owners. This article explores the characteristics of the two most common forms of corporate entities to inform that analysis: corporations and LLCs.

CORPORATIONS

The traditional corporate form is the corporation, with the usual corporate trappings — shareholders who own the corporation and the board of directors who manage it. Being a shareholder has its advantages. They rarely participate in management of the company, do not owe fiduciary duties to the corporation or anyone else (unless in closely held corporations), and are shielded from personal liability for the corporation's debts beyond the amount of their contributions, all while pocketing the earnings of the corporation. Shareholders can also freely transfer their ownership interests at will, absent any agreement to the contrary. Minority shareholders in closely held corporations are afforded additional protections, which include investment rights, profit rights, and voting rights, among many others. Even though shareholders do not manage the company, they elect the directors who do. Those directors are not free to manage and operate the company as they please, but rather, they must comply with their fiduciary obligations to both the company and the shareholders.

The typical form of a corporation is a C corporation, but it has one significant drawback — it is subject to double taxation. Taxes are first imposed on the corporation itself and then again on shareholders when corporate earnings are distributed via dividends. While the 2017 Tax Cuts and Jobs Act reduced the corporate tax rate from 35% to 21%, the double taxation feature still exists.

The corporate answer to double taxation is the S corporation. S corporations are hybrid entities in that they are pass-through entities for tax purposes (like LLCs and partnerships) but are still corporations that are governed under states' business corporation laws with traditional corporate formation concepts (e.g., incorporation documents, by-laws, shareholder agreements, etc.). Not just any corporation can elect to be treated as an S corporation. Only small-business corporations that can satisfy certain elements, such as having no more than 100 shareholders, qualify as S corporations.

LIMITED LIABILITY COMPANIES

LLCs have become the favored corporate form since Wyoming enacted the country's first LLC legislation, in 1977. The top three benefits of LLCs are single taxation, limited liability, and flexibility. Provided the proper election is made, LLCs are pass-through entities, where taxes bypass the companies themselves and are imposed directly on their owners. Owners also have limited liability, regardless of whether they are involved in management of the company or not. In contrast, partners in certain partnerships are liable for debts and obligations of the company. LLCs also offer flexibility in corporate governance by virtue of the freedom of contract. Owners are free to contract as they wish in the operating agreement (also called "limited liability company agreements"). In fact, the freedom to contract is a key policy consideration for states enacting LLC legislation. For instance, in its Limited Liability Company Act, Delaware confirms that contractual freedom is one of the driving forces — "It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements." 6 Del. C. § 18-1101(b) (2021).

With contractual freedom, business partners can contract as they wish regarding governance in a given LLC. This means that corporate professionals can tailor LLCs to their particular circumstances and business purpose. They can remove protections provided by state law, such as fiduciary duties of loyalty or corporate opportunity or owner approval of certain transactions. They can add restrictions on transfers of ownership interests, or provide for rights of first refusal. Should a dispute arise, they can mandate arbitrations or require resolution by mediation prior to formal court proceedings. The opportunities are endless for what owners in an LLC can agree to regarding corporate governance.

Such benefits, however, are not without risk. Without mandatory protections afforded to corporations, less sophisticated owners in an LLC may contract away desired protections generally afforded to corporations. Contract law, including law regarding contract interpretation, also applies. Thus, careful attention should be paid to drafting operating agreements to ensure no provisions are stricken for ambiguity. Also, an agreement to agree on a certain subject matter in the future is no agreement at all. It is always recommended to identify and confirm as many terms as possible in the present as opposed to punting the issue down the road and risk the very real possibility that an agreement may not be reached.

CONCLUSION

The start of a business is an exciting time for owners and entrepreneurs. But that excitement should not rush the important decision of what corporate form the business should take. It may not be conceivable in the beginning, especially in the flurry of activity for a nascent business, but disputes among owners can arise. The first step in resolving that dispute, whether in litigation or not, is always a review of the corporate formation documents to determine the rights, liabilities, duties, and obligations of the parties involved and to inform strategy moving forward. It is important to get it right at the beginning.

FAMILY FEUD: A CAUTIONARY TALE OF THE COSTS, RISKS, AND UNCERTAINTY OF MINORITY-SHAREHOLDER LITIGATION

BY ANNE M. LOCKNER

There is no shortage of ways in which parties in closely held corporations or partnerships can find themselves at odds. Those shareholders who control the majority of a company's stock generally set the corporate strategies and make key decisions. But their rights to set that strategy and make those decisions are tempered by the fiduciary duty they hold to their other shareholders, even those in the minority. If a minority shareholder believes the majority shareholders are acting in a way that is unfair or "oppressive" to her or that she is being "frozen out," she can bring a suit seeking various relief—up to, and including, dissolving the corporation.

But litigation is an inherently risky game. It is expensive, can last for years, is emotionally tolling on those involved, and offers little certainty on what will happen—especially in the minority-shareholder dispute scenario where valuations of closely held corporations can vary wildly. For these reasons, litigation should be the last resort after every other avenue fails.

The *Lund v. Lund* case serves as a reminder of the challenges, risks, and uncertainty of litigation.[1] In December 2014, one of the four Lund siblings, Kim Lund, brought suit against company CEO Russell T. ("Tres") Lund III (her brother), the Lund entities (a trustee), and directors of the board, alleging breach of fiduciary duty, unfairly prejudicial conduct,[2] and civil conspiracy. In 2016, she brought a buy-out motion seeking to be bought out of her 25% share of the family grocery business. Defendants moved for summary judgment. In October 2016, the court granted the motion, finding that Kim Lund was, as a minority shareholder, "in a particularly vulnerable position."[3] At the same time, the court denied Defendants' summary-judgment motion on Kim's unfairly prejudicial-conduct and equitable-relief claims but granted Defendants' summary-judgment motion on Kim's breach-of-fiduciary-duty and civil-conspiracy claims. In other words, each side won and lost some, but winning the buy-out motion was a big win for Kim. Yet, her battle was far from over.

After the parties were unable to agree on a buy-out price, the court held a one-week trial in February 2017.[4] The parties' experts had wildly diverging opinions on the value of the company and, in turn, Kim Lund's share of the business. Kim Lund's expert opined that her share was worth \$80.4 million, while Defendants' expert opined it was \$21.275 million. In June 2017, the court ultimately decided her share was valued at \$45.2 million—squarely between the two valuations. *Id.* at 284. But the case was still not over.

Both parties appealed the trial court's ruling; Kim appealed the grant of summary judgment on her breach-of-fiduciary-duty and civil-conspiracy claims, as well as the court's denial, in part, of her trustee-removal claims. On January 14, 2018—over four years after she filed suit—the Minnesota Court of Appeals affirmed in large part the trial court's order (it reversed and remanded, holding that the trial court used the wrong standard on the issue of whether Defendants could recover nearly \$800,000 in attorney fees and costs from Kim's trusts). On March 27, 2019, the Minnesota Supreme Court declined to review the Defendants' appeal, finally bringing the legal matter to a close.

And while the legal battle was costly for all in terms of attorney fees, all parties likely incurred greater costs that cannot be quantified. As was reported during the trial, "the two other Lunds siblings … have testified that Kim's deal would unfairly place her interests above theirs, including endangering the full amount of their dividend payouts."[5] While it goes unmeasured, one cannot underestimate the unquantifiable cost of having siblings testify against siblings.

By any legal measure, Kim Lund "won" her case. But she no doubt paid a heavy price and spent years with the uncertainty before obtaining that win. And her adversaries faced the same price and uncertainty during those nearly five years of litigation—and then lost. Thus, this story is a cautionary tale for potential litigants in any litigation, but particularly those considering going to battle against family members. Go into litigation braced for a lengthy, and emotionally and financially fraught, battle. And go into it only if you have exhausted all other options.

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[1] 924 N.W.2d 274 (Minn. Ct. App. 2019).

[2] Minn. Stat. §§ 302A.751, 322B.833.

[3] *Lund*, 924 N.W.2d at 282.

[4] *Judge urges Lund grocery chain heirs to halt feud*, STAR TRIBUNE, Feb. 14, 2017, https://www.startribune.com/judge-waxes-philosophic-at-end-of-trial-over-lunds-supermarket-family-inheritance/413653503/.

[5] *See* n.1.

LIFE AFTER SETTLEMENT: CRAFTING AGREEMENTS TO AVOID FUTURE DISPUTES

BY ERIC MAGNUSON AND TIM BILLION

Wrapping up a settlement often comes with a large sigh of relief. A settlement ends a dispute, usually in a way that is at least tolerable, if not ideal, for all sides. (A good settlement is one that neither side is completely happy about.) But when there are lingering doubts in the minds of one side to the settlement, those doubts might fester, and they can return to haunt the unwary, particularly where fiduciary obligations heighten responsibilities between the parties.

Normally, the maxim *caveat emptor* governs the arms-length settlement of a dispute. If you are unhappy with the results of the agreement down the road, or the agreement fails to live up to your expectations, you are nonetheless bound to the terms of the deal you struck. In certain circumstances, though, a special relationship may impose obligations that can undo a settlement agreement after the fact.

HOYT PROPERTIES – UNWINDING A SETTLEMENT AGREEMENT.

Settlement agreements are contracts. Although the law presumes that settlement agreements are valid, they generally are subject to contract defenses, including mistake, unconscionability, duress, undue influence, and fraud.

Hoyt Properties, Inc. v. Production Resource Group, L.L.C.[1] offers an example of a settlement agreement undone by an alleged misrepresentation during negotiation. *Hoyt* began as a commercial lease dispute. As part of the settlement of that dispute, the tenant (Entolo) asked the landlord (Hoyt) to release Entolo's parent company (PRG) from any liability. Hoyt's CEO stated, "Well, that would be piercing the veil . . . I don't know of any reason why [PRG] would be liable, do you?" PRG's attorneys allegedly responded, "There isn't anything. PRG and Entolo are totally separate."[2] Based on that representation, Hoyt agreed to release PRG as part of the settlement agreement.

Later, Hoyt learned of an unrelated lawsuit alleging, among other things, that Entolo failed to observe corporate formalities, PRG operated Entolo as a division rather than a separate corporation, and PRG undercapitalized Entolo.[3] In particular, PRG allegedly used Entolo to guarantee two of PRG's loans and then arranged for the transfer of all Entolo's

cash and accounts receivable to PRG.[4] If true, all of these facts would support a claim to ignore the corporate form of Entolo, and impose liability on PRG.

Hoyt sought to rescind the settlement agreement with Entolo based on a fraudulent-inducement theory, and sought to pierce the corporate veil to hold PRG liable for Entolo's obligations. The Minnesota Supreme Court ultimately determined that Hoyt could proceed on its fraudulent inducement theory. The statements of PRG's attorneys were actionable, because they implied that there were no facts that would support a veil-piercing claim against PRG. That representation was arguably false, because there were, at the time, a number of facts Hoyt could have alleged to support such a claim.

The *Hoyt* case involved an alleged affirmative misrepresentation, but an omission or negligent misrepresentation can also invalidate a settlement agreement if the other elements of the contract defenses are established. Although nondisclosure alone will generally not support a fraud claim, an attorney or party may be under an obligation to disclose facts if (1) a confidential or fiduciary relationship exists, or (2) the party makes an affirmative representation or takes other steps to conceal the truth.[5] In other words, although there is no general duty to disclose material facts to an adversary, a party could jeopardize a settlement agreement by failing to disclose the truth if a fiduciary relationship exists or a contrary affirmative representation of fact has already been made and the party does not correct it.

AVOIDING PROBLEMS DOWN THE ROAD.

This settlement nuance has significant application to trustees and to closely held businesses. Trustees and members of a closely held business owe a fiduciary duty to the trust beneficiaries and other members of the business entity.[6] Moreover, in both contexts, one party will frequently have superior factual knowledge or access to information unavailable to the other side. Thus, when settling a dispute, a trustee or a member of a closely held business should take care to avoid later attempts to rescind or otherwise unwind a settlement agreement.

How? The most obvious answer is simply to tell the truth.[7] And that is a good rule to follow. Certainly, each party to a settlement agreement should avoid affirmative misrepresentations and should not make statements about facts that it cannot back up or verify, particularly if the other side does not have equal access to information.

But a misrepresentation claim can — and often, will — allege an omission of material facts rather than a commission of an outright and direct lie. In a context where one party has superior factual knowledge, such as a trustee or the manager of a closely held business, such a claim can create particular exposure. Even where a fiduciary has endeavored to act forthrightly, the other side may later discover information it did not know and develop a case of buyer's remorse. Whether such a claim has merit or not, it can lead to further litigation, which is exactly what parties to a settlement hope to avoid.

When entering a settlement agreement, consider including a representation clause in the settlement agreement. A representation clause expressly affirms, as part of the settlement agreement itself, that neither party has relied on any representations made by the other party in entering the settlement agreement. The more specific the clause, the better. This is not carte blanche to lie, but it can undercut the reasonable-reliance element of a subsequent claim that the settlement agreement was fraudulently induced or was the result of a misrepresentation by omission. Coupled with an integration clause and appropriate disclaimers, a well-crafted settlement agreement can be a powerful tool to avoid future litigation arising out of the settlement itself.

Settlement agreements exist to resolve disputes. Fiduciaries, and participants in closely held businesses, should take care when negotiating a settlement that they avoid leaving a door open for further litigation.

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[1] 736 N.W.2d 313 (Minn. 2007).

[2] *Id.* at 317.

[3] *Id.*

[4] *Hoyt Props., Inc. v. Prod. Res. Group, L.L.C.*, 716 N.W.2d 366, 370 (Minn. Ct. App. 2006).

[5] *See, e.g., L & H Airco, Inc. v. Rapistan Corp.*, 446 N.W.2d 372, 380 (Minn. 1989).

[6] *See, e.g., Thomas B. Olson & Assocs., P.A. v. Leffert, Jay & Polglaze, P.A.*, 756 N.W.2d 907, 914 (Minn. Ct. App. 2008) (fiduciary duty of trustee); Pedro v. Pedro, 489 N.W.2d 798, 801 (Minn. Ct. App. 1992) (fiduciary duty of partners).

[7] Of course, every attorney has an ethical obligation not to knowingly make a false statement of fact or law. See Minn. R. Prof'l Conduct R. 4.1.

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