1996


Preethi Gowda

Follow this and additional works at: http://open.mitchellhamline.edu/wmlr

Recommended Citation
Available at: http://open.mitchellhamline.edu/wmlr/vol22/iss1/18

This Article is brought to you for free and open access by the Law Reviews and Journals at Mitchell Hamline Open Access. It has been accepted for inclusion in William Mitchell Law Review by an authorized administrator of Mitchell Hamline Open Access. For more information, please contact sean.felhofer@mitchellhamline.edu.
© Mitchell Hamline School of Law
IV. CORPORATE

A. Direct and Derivative Claims

In *Northwest Racquet Swim & Health Clubs, Inc. v. Deloitte & Touche*, the Minnesota Supreme Court held that a debenture holder’s claims against an issuer’s auditor were not derivative claims that belonged to the issuer. The holder’s claim was related to an injury that was separate and distinct from any claims belonging to the issuer or other debenture holders.

This case arose from the purchase by appellant Northwest Racquet Swim and Health Clubs, Inc. (Northwest) of $15 million in subordinated debentures from the later insolvent Midwest Federal Savings & Loan Association (Midwest). Respondent Deloitte & Touche (Touche) performed audit work for Midwest for several years prior to the debenture transaction. “At the trial court, Northwest alleged that Touche participated in a plan with Midwest that resulted in material misstatements in Midwest’s 1986 year-end audited financial statements, on which Northwest relied in deciding to make the debenture purchase from Midwest.”

The issue presented before the supreme court was whether Northwest asserted any injury separate and distinct from the injury to other debenture holders. The court stated that Minnesota has long adhered to the general principle that an individual shareholder may not assert a cause of action that

---

1. 535 N.W.2d 612 (Minn. 1995).
2. *Id.* at 619.
3. *Id.* at 613.
4. *Id.*
5. *Id.* Touche was involved as an auditor for Midwest and Green Tree Acceptance (“Green Tree”), a wholly-owned subsidiary of Midwest in the business of purchasing, pooling, and servicing loans for mobile homes and recreational vehicles. *Id.* at 613. Through Touche’s recommendation, Midwest purchased the servicing rights and the net finance income receivables (FIR) from Green Tree. However, the FIR did not perform as expected, and resulted in a big loss for Midwest. This alleged miscalculation of the FIR yield by Touche (which made Midwest appear to be in a better financial position than it actually was) ultimately affected Northwest’s decision regarding the debenture purchase from Midwest. *Id.* at 613-15.

209
belongs to the corporation. 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.

To distinguish between a direct and a derivative claim, Minnesota courts consider whether the injury to the plaintiff is separate and distinct from the injury to the other persons in a similar situation as the plaintiff.

The court examined a series of federal cases addressing claims similar to those asserted by Northwest. The court looked at *In re Sunrise Securities Litigation*, *University of Maryland v. Peat Marwick Main & Co.*, and *Hayes v. Gross*.

---

7. *Id.* (citing Singer v. Allied Factors, Inc., 216 Minn. 443, 13 N.W.2d 378 (1944); Seitz v. Michel, 148 Minn. 474, 181 N.W. 106 (1921); Mealey v. Nickerson, 44 Minn. 430, 46 N.W. 911 (1890)).


9. *Northwest Racquet Swim & Health Clubs, Inc.*, 535 N.W.2d at 617 (citing *Seitz*, 148 Minn. at 476, 181 N.W. at 106). In *Seitz*, the Minnesota Supreme Court considered a stockholder's claim that a third party conspired with corporate officers to "freeze-out" the stockholder from participation in the management of the corporation. The court asserted that the "[p]laintiff was injured just as all other stockholders are injured when the officers of a corporation waste or misapply its money." *Northwest Racquet Swim & Health Clubs, Inc.*, 535 N.W.2d at 617. The court noted that "[i]f he has no individual right of action against an officer for misappropriating the money of the corporation, he has none against third persons who persuaded the officer to misappropriate it, and this without regard to the motives which actuated such third persons." *Id.*

10. *Id.* at 618-19.

11. 916 F.2d 874 (3d Cir. 1990). In *Sunrise Securities Litigation*, a group of depositors sought to assert individual Racketeering Influenced and Corrupt Organizations Act (RICO) claims against the directors, officers, auditors, and outside counsel of an insolvent savings and loan association. The depositors' claims arose out of the defendants' alleged misrepresentations of the true financial condition of the institution. *Id.* at 875, 882. The U.S. Court of Appeals for the Third Circuit held that the plaintiffs' claims were derivative and could not be brought individually, despite the plaintiffs' characterization of their claims. Their damages could not be separated from the injury sustained by the institution and by depositors generally. *Id.* at 887-89.

12. 925 F.2d 265 (3d Cir. 1991). In the Third Circuit decision of *University of Maryland*, policyholders of an insolvent insurance company sued the company's independent auditor for damages arising from the auditor's alleged false and misleading certification of the company's financial statements. The plaintiffs alleged that these financial statements induced them into remaining as policyholders with the company. *Id.* at 267. The court held that the plaintiffs' claims constituted a direct rather than a derivative injury, distinguishing the case before it from *In re Sunrise Securities Litigation*, where the plaintiffs claimed that the defendants' misconduct caused the failure of the S & L, an injury common to all depositors. However, in the case before it, the court found that plaintiffs' claim was based on inducement by the misleading financial statements, an injury unique to the plaintiffs. *Id.* at 274.
The court held that Northwest's claims were distinguishable from the plaintiff's claims in *Sunrise Securities Litigation* and were analogous to the plaintiff's claims in *University of Maryland* and *Hayes*. In *re Sunrise Securities Litigation*, the Third Circuit held that although the plaintiffs claimed misrepresentation, the foundation of these claims was the mismanagement and insolvency of the institution. However, in the case before it, the Minnesota Supreme Court reasoned that although Northwest asserted that Touche's misrepresentation to Midwest indirectly affected Northwest, Northwest also alleged specific incidences of misrepresentation in Touche's audit report, upon which Northwest directly relied in purchasing the debentures. The court reasoned it was that claim of direct fraud and the resulting injury that was separate and distinct from any fraud claim belonging to Midwest and from any injury to the debenture holders generally. Therefore, the court held that Northwest's claims were not derivative claims belonging to Midwest.

**B. Securities Decision**

In *Minneapolis Employees Retirement Fund v. Allison-Williams Co.*, the Minnesota Supreme Court held that a company that purchased high-yield, high-risk bonds for its pension plan from a broker did not have a general unsuitability claim under the Minnesota Securities Act. The transactions were consistent with the fund's investment objectives and financial situation, no evidence existed that the broker acted with fraudulent intent or

---

13. 982 F.2d 104 (3d Cir. 1992). In *Hayes*, the plaintiff alleged that the directors and officers of an insolvent savings association misrepresented the financial condition of the association, causing the plaintiff to purchase the association's stock at an inflated price. *Id.* at 105. On appeal, the Third Circuit concluded that the complaint did allege a direct injury to the plaintiff. *Id.* at 106. The court noted that had the plaintiff alleged only mismanagement by the defendants, the plaintiff's claim would be derivative. However, the plaintiff's additional allegation that defendants made affirmative representations regarding the condition of the association constituted an actionable claim of direct injury to the plaintiff. *Id.*
15. *Id.* at 619.
16. *Id.*
17. *Id.*
18. *Id.*
19. 519 N.W.2d 176 (Minn. 1994).
20. MINN. STAT. §§ 80A.01-.31 (1994).
exercised control over the pension fund's account. The court also held that the broker did not violate the regulation imposing a duty to obtain information concerning a customer's financial situation and other security holdings because the securities purchased were not "low-priced" as required by the regulation.

The issue presented was whether the district court properly granted summary judgment to appellants Allison-Williams and Robert Tengdin on claims by respondent Minneapolis Employees Retirement Fund (MERF) that appellants violated the Minnesota Securities Act and were negligent in connection with the sale of securities to MERF.

MERF was a pension fund for retired employees of Minneapolis and for current employees hired before 1978. As of 1990, MERF had an investment portfolio in excess of $800 million. Allison-Williams was a licensed securities broker-dealer engaged in the purchase and sale of securities in the secondary market for private placement. From 1981 until 1990, MERF purchased tens of millions of dollars of high-yield, high-risk bonds from Allison-Williams.

From 1979 until May 1990, John Chenoweth was the Executive Director of MERF. Robert Tengdin, the Chairman of the Board of Directors of Allison-Williams, represented the company in the transactions with MERF. Tengdin and Chenoweth had extensive discussions in which Chenoweth described MERF's investment objectives. Allison-Williams did not exercise discretion over MERF's investments and had no authority to enter into transactions on MERF's behalf without MERF's express authorization. Chenoweth expressly approved...
in advance the purchase of every security sold to MERF by Allison-Williams. MERF did not disclose to Allison-Williams any other investments it purchased from other brokers.

In June 1991, MERF sued Allison-Williams for losses incurred as a result of transactions with Allison-Williams. MERF alleged that Allison-Williams breached a fiduciary duty to MERF, was negligent, and violated the Minnesota Securities Act by selling unsuitable investments and failing to disclose material facts to MERF. MERF's unsuitability claim was based on (1) a violation of the Minnesota Securities Act and (2) a breach of duty to obtain information concerning MERF's financial situation before recommending the sale of speculative securities under Minnesota Rules part 2875.0910, subpart 2.

In determining whether Allison-Williams violated the Minnesota Securities Act, the court looked at federal case law because the Act "is patterned after federal law." The court noted that federal courts have recognized that a broker-dealer may be liable where the dealer recommends the purchase of securities unsuitable for the buyer's investment needs. In a Tenth Circuit decision, O'Connor v. R.F. Lafferty & Co., the court held that to establish an unsuitability claim based on fraud, a plaintiff must prove three elements: (1) that a broker-dealer recommended or purchased securities that were unsuitable in light of the investor's objectives; (2) that a broker-dealer recommended or purchased securities with an intent to defraud or with reckless disregard of the investor's interests; and (3) that the broker exercised control over the investor's account.

The Minnesota Supreme Court applied the O'Connor
standard in determining MERF’s securities fraud claim.\textsuperscript{43} Regarding the first element of the \textit{O'Connor} test, the court held that MERF’s transactions with Allison-Williams were consistent with MERF’s objectives and financial situation as disclosed by MERF.\textsuperscript{44} The court reasoned that the purchase of high-yield speculative bonds by an institutional investor is a common transaction and that Chenoweth had indicated to Tengdin that he was interested in obtaining greater returns by buying privately placed securities.\textsuperscript{45}

Under the second element of the \textit{O'Connor} test, the court held that MERF failed to produce substantial evidence showing fraudulent intent or reckless disregard on the part of Allison-Williams.\textsuperscript{46} The court reasoned that Chenoweth was authorized to communicate MERF’s investment objectives and that no evidence existed that Allison-Williams recommended a security inconsistent with MERF’s objectives.\textsuperscript{47} The court held with regard to the third element of the \textit{O'Connor} test that MERF failed to present substantial evidence that Allison-Williams exercised control over MERF’s account.\textsuperscript{48} The court reasoned that Allison-Williams had no authority to enter into transactions on MERF’s behalf without its advance, express authorization.\textsuperscript{49} Moreover, Chenoweth expressly approved in advance the purchase of all securities sold to MERF by Allison-Williams.\textsuperscript{50} Thus, no unsuitability claim existed under the Minnesota Securities Act.

The court examined the unsuitability claim under Minnesota Rule part 2875.0910, subpart 2 (1991), which provides that a broker-dealer may have a duty to obtain information concerning a customer’s financial situation and other security holdings where the broker-dealer recommends “speculative, low-priced”
Corporations securities. The court held that although it is undisputed that the private placement securities sold by Allison-Williams were speculative in nature, the securities were certainly not "low-priced." The court concluded that a "low-priced" security is one that is low in market value. The court reasoned that no liability existed under Minnesota Rules part 2875.0910, subpart 2, because MERF was a sophisticated institutional investor who purchased securities ranging in price from hundreds of thousands to millions of dollars.

Lastly, the court determined that MERF had no negligence claim against Allison-Williams. The court held that a broker is not a guarantor or insurer against losses sustained by her customer. Thus, absent a special agreement to the contrary, a broker owes her customer only the duty to exercise due care in executing all instructions expressly given to her. The court maintained that the Minnesota Securities Act regulations prohibiting recommendation of unsuitable securities and prohibiting charging of excessive markups did not create a new standard of care for brokers. Thus, the court held that the district court properly granted summary judgment in favor of Allison-Williams.

51. Id.
52. Id.
53. Id.
54. Id. The court stated that Minnesota Rule 2875.0910, subpart 2 was not intended to apply to sophisticated institutional investors like MERF, which had an investment portfolio at one point in excess of $800 million. The court maintained that it is unlikely that an institutional investor would provide information regarding all of its security holdings to a broker-dealer. Therefore, to apply Minnesota Rule 2875.0910, subpart 2 to institutional investors would open the door to lawsuits by such investors against brokers every time the investor lost money on the basis that the brokers failed to acquire sufficient information about the investor. Id. at 182.
55. Id.
56. Id. (citing Rude v. Larson, 296 Minn. 518, 519-20, 207 N.W.2d 709, 711 (1973)). The court stated that a person practicing a profession is bound to exercise the degree of care and skill usually exercised by members of the profession under similar circumstances. Minneapolis Employees Retirement Fund, 519 N.W.2d at 182 (citing City of Eveleth v. Ruble, 302 Minn. 249, 253, 225 N.W.2d 521, 525 (1974)).
57. Minneapolis Employees Retirement Fund, 519 N.W.2d at 182.
58. Id.
59. Id.
C. Minnesota Franchise Act

In Current Technology Concepts, Inc. v. Irie Enterprises, Inc.,\(^\text{60}\) the Minnesota Supreme Court held that a buyer’s payment under a computer software sales agreement was for both the seller’s software program and also for the buyer’s right to enter into the business of becoming a “reseller” of the seller’s software and hardware products. Thus, the payment was a “franchise fee”\(^\text{61}\) under the Minnesota Franchise Act (Act).\(^\text{62}\) The court also held the exception to the Act,\(^\text{63}\) where a “franchisee is required to pay less than $100 on an annual basis,” was intended to apply to “direct sales” to consumers and not to an agreement under which the franchisee was to resell computer hardware and software products.\(^\text{64}\)

The issue presented in the case was whether an agreement between Irie Enterprises, Inc. (Irie), a Michigan corporation, and Current Technology Concepts, Inc. (CTC), a Minnesota corporation, constituted a franchise governed by the Act.\(^\text{65}\)

According to an agreement (CA$H Agreement) dated June 22, 1989, CTC purchased from Irie a computer software program for $125,000.\(^\text{66}\) As part of the consideration for the CA$H Agreement, Irie agreed to enter into a separate agreement (Reseller Agreement) with CTC that allowed CTC to resell Irie’s other software and hardware products.\(^\text{67}\) On December 23, 1990, the two companies renewed their Reseller Agreement for

\(^{\text{60}}\) 530 N.W.2d 539 (Minn. 1995).
\(^{\text{61}}\) Id. at 542.
\(^{\text{62}}\) MINN. STAT. § 80C.01-.30 (1994).
\(^{\text{63}}\) MINN. STAT. §80C.01, subd. 4(f) (1994).
\(^{\text{64}}\) Current Technology Concepts, Inc. v. Irie Enters., Inc., 530 N.W.2d 539 (Minn. 1995). Current Technology Concepts, Inc. (CTC) originally filed suit in the U.S. District Court, District of Minnesota, when Irie terminated an agreement between the two corporations that gave CTC the right to market Irie’s computer software and hardware products. Id. at 540. “The Honorable Judge Donald Lay, presiding, concluded as a matter of law that the Act applied to the agreement and that Irie violated the Act.” Id. “A jury trial was held on the issue of damages and the jury returned a verdict of $1.3 million in CTC’s favor.” Id. Judge Lay responded to Irie’s movement for judgment as a matter of law, a new trial, or remittitur, by certifying questions to the Minnesota Supreme Court. Id. at 540-41.
\(^{\text{65}}\) Id. at 540.
\(^{\text{66}}\) Id. at 541. This software program, which was designed for billing purposes, tracked and monitored the use and distribution of a hospital’s durable, reusable medical equipment. Id.
\(^{\text{67}}\) Id.
thirty-six months. Irie later terminated this Renewal Agreement, justifying the action by stating that CTC’s account was delinquent. CTC brought this lawsuit as a result of Irie’s termination notice.

The first certified question was whether the $125,000 payment required by the CA$H Agreement was consideration for the Reseller Agreement so as to constitute a franchise fee under the Act. Irie argued that paragraphs 6.1 and 8.0 of the CA$H Agreement were in conflict, and therefore the agreement was ambiguous as to whether the $125,000 constituted consideration for the Reseller Agreement in addition to the CA$H System. The court maintained that a contract is ambiguous if its language is reasonably susceptible to more than one interpretation. The court concluded that it did not find paragraphs 6.1 and 8.0 of the agreement in conflict and therefore the agreement was not ambiguous. The court stated that it is well settled that one promise may act as consideration for multiple promises. The court reasoned that the $125,000 payment from CTC was consideration for the promises contained in paragraphs 6.1 and 8.0, as paragraph 6.1 did not indicate the payment was exclusively for the CA$H System. Thus, the

68. Id.

69. Id. CTC believed that Irie terminated the Renewal Agreement to usurp from CTC the market it had created for Irie’s products. Id. at 542.

70. Id.

71. Id. “A ‘franchise fee’ means any fee or charge that a franchisee or subfranchisor is required to pay or agrees to pay for the right to enter into a business or to continue a business under a franchise agreement . . . .” MINN. STAT. § 80C.01, subd. 9 (1994).

72. Current Technology Concepts, Inc., 530 N.W.2d at 542. Paragraph 8.0 of the CA$H Agreement provided: “As part of the consideration for this Agreement, Irie agrees to enter into a Reseller Agreement with CTC allowing CTC to resell other software and hardware products of IRIE.” Id. Paragraph 6.1 provided that “CTC shall pay IRIE for ownership of the CA$H System a sum not to exceed one hundred twenty-five thousand dollars ($125,000).” Id. at n.7.

73. Id.

74. Id. (citing Metro Office Parks Co. v. Control Data Corp., 295 Minn. 348, 351, 205 N.W.2d 121, 123 (1979); Lamb Plumbing & Heating Co. v. Kraus-Anderson of Minneapolis, Inc., 296 N.W.2d 859, 862 (Minn. 1980)).


76. Id. (citing RESTATEMENT (SECOND) OF CONTRACTS § 80 cmt. a (1981)).

77. Current Technology Concepts, Inc., 530 N.W.2d at 541-42. The court further reasoned that to read exclusivity into paragraph 6.1 would leave paragraph 8.0 without meaning, violating the rule that contracts are to be interpreted to give every provision meaning. Id. at 543.
court concluded that the $125,000 payment for the CA$H System served as consideration for the Reseller Agreement and constituted a "fee . . . that a franchise . . . agrees to pay for the right to enter into a business."78

The second certified question was whether the parties' Reseller and Renewal Agreements are excluded from the Act's coverage because of the exception to coverage under Minnesota Statutes section 80C.01, subdivision 4(f).79 Subdivision 4(f) provides that a "'franchise' does not include any contract, lease or other agreement whereby the franchisee is required to pay less than $100 on an annual basis."80 The court found the statute to be ambiguous.81 The court stated that when the language of a statute is ambiguous, the rules of statutory construction, which allow the examination of legislative history should be applied.82

Legislative history indicated that subdivision 4(f) "excludes certain direct sales which were not contemplated by" the Act.83 The court maintained that the term "direct sale" generally involves the concept of selling products directly from the manufacturer to the ultimate consumer without intervening middlemen.84 The court concluded that based on the legislative history and the court's understanding of "direct sale," the exception to the Act under subdivision 4(f) was not intended to apply to the Reseller and Renewal Agreements because the agreements did not contemplate Irie engaging in a direct sale of its products to ultimate users.85 Therefore, the court held the agreements between the two companies were not excluded from the Act's coverage by Minnesota Statutes section 80C.01, subdivision 4(f).86

Preethi Gowda

78. Id. at 543.
79. Id.
80. Id.
81. Id.
82. Id. (citing MINN. STAT. § 645.16 (1994)).
83. Current Technology Concepts, Inc., 530 N.W.2d at 544 (quoting legislative testimony of Mary Brophy, Commissioner of the Securities and Real Estate Division of the Commerce Department).
84. Id.
85. Id.
86. Id.