STATE BAR OF MICHIGAN
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BUSINESS LAW SECTION

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Section Matters

Columns

Articles

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The editorial staff of the *Michigan Business Law Journal* welcomes suggested business law topics of general interest to the Section members, which may be the subject of future articles. Proposed business law topics may be submitted through the Publications Director, Brendan J. Cahill, *The Michigan Business Law Journal*, 39577 Woodward Ave., Ste. 300, Bloomfield Hills, Michigan 48304, (248) 203-0721, bcahill@dykema.com, or through Kanika S. Ferency, ICLE, 1020 Greene Street, Ann Arbor, Michigan, 48109-1444, (734) 936-3432, ferencyk@icle.org. General guidelines for the preparation of articles for the Michigan Business Law Journal can be found on the Section's website at http://connect.michbar.org/businesslaw/newsletter.

Each issue of the *Michigan Business Law Journal* has a different primary, legal theme focused on articles related to one of the standing committees of the Business Law Section, although we welcome articles concerning any business law related topic for any issue. The deadlines for submitting articles are as follows:

Issue	Article Deadline
Summer 2021	March 31, 2021
Fall 2021	July 31, 2021
Spring 2022	November 30, 2021
Summer 2022	March 31, 2022

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MISSION STATEMENT

The mission of the Business Law Section is to foster the highest quality of professionalism and practice in business law and enhance the legislative and regulatory environment for conducting business in Michigan.

To fulfill this mission, the Section shall: (1) expand the resources of business lawyers by providing educational, networking, and mentoring opportunities; (2) review and promote improvements to Michigan's business legislation and regulations; and (3) provide a forum to facilitate service and commitment and to promote ethical conduct and collegiality within the practice.

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From the Desk of the Chairperson

By Julia A. Dale

This fall marks a new fiscal year for the Business Law Section and another insightful issue of the *Michigan Business Law Journal*. As the recently elected Chair of the Section, I am privileged to lead one of the largest, most thoughtful, and active sections of the State Bar. The section has served Michigan Business Law attorneys for over 50 years and will continue to do so diligently in new and innovative ways.

I want to acknowledge our immediate past Chair, Jennifer Consiglio. Under her direction, the section navigated deep and troubling waters with wisdom and grace. Indeed, Jennifer closed her first letter in the Fall 2019 issue of the *Michigan Business Law Journal* by promising that the section would be "poised to nimbly address the unknown challenges, developments and opportunities that are sure to arise this coming year." She honored this commitment, and I am grateful for her prescience and ability to stay the course.

In the midst of the disruption and interruption caused by the pandemic, Jennifer pivoted and worked in concert with the Business Law Section Council, Programs Directorship, State Bar, as well as the Institute of Continuing Legal Education to host both the 2020 Annual Meeting and 32nd Annual Business Law Institute virtually.

As we move toward the new year, I am excited about the team with which I will be serving and the opportunities ahead of us. While the long-term impact of the pandemic on our clients, communities, and businesses remains uncertain, there exists for us the opportunity to usher in a new era. The section's mission to foster the highest quality of professionalism and practice in Business Law and to enhance the legislative and regulatory environment for conducting business in Michigan remains the same, yet today we are uniquely positioned to see this fulfilled with previously unused, underused, and improved technologies.

Now is also an excellent time to focus on growing our section membership, increasing engagement, and broadening our virtual operations as well as our online offerings. Our members know the multitude of resources provided within this rich community, and we are committed to communicating and demonstrating this value to those who are not yet members.

This section's most important asset is found in its membership and their extensive knowledge of Business Law. When the membership is deliberate in their engagement, networking, and mentoring efforts, this asset multiplies and expands beyond our immediate sphere of influence.

Demographics for section membership provided by the State Bar of Michigan make clear that, while our section is one of the largest, there is still plenty of opportunity for growth. In 2019, we had a total of 3,089 members, the vast majority of which were Michigan residents. Only 5.5% of our membership was from outside of Michigan and, of those, very few (12) were from outside of the United States. Of the total membership, only 21% were millennials, and less than one quarter (641) were female. While the number of women within the section is relatively small, I am happy to say that the section has a rich history of elevating women leaders at the committee, council, and board levels.

Available section demographics are not limited to gender and generation. A particularly salient measurement in this moment is the racial and ethnic diversity of the section and the opportunity for growth there. In 2019, approximately 2000 section members provided detail regarding their race/ethnicity. Not surprisingly, nearly 85% of our membership identified as of European origin, but the numbers by group diminish significantly from there. Only 3.2% (63) of the responsive membership identified as of African origin, 3% (60) identified as of Arab origin, 2.6% (52) identified as Asian/Pacific Islander, 1.4% (28) identified as of Hispanic-Latino origin, and 0.4% (8) identified as of American Indian origin.

These numbers contrast greatly with the demographics (from the same time period) for the Young Lawyers Section, which consists of more than 8,000 active members. Almost half of that section (45%) was female, and over 33% identified as something other than of European origin.

The Business Law Section is well represented (with 600 active members) within its ranks. It is closely followed by the Litigation (519 active members), Real Property Law (507 active members), Criminal (496 active members), and Probate and Estate Planning (486 active members) sections.

As Chair, I propose four objectives informed by these demographics: 1) an increase in the breadth and depth of our membership; 2) an expansion of our online membership services/offerings; 3) implementation of a comprehensive social media strategy; and 4) development of a Virtual Operations Plan. Each of these objectives presents a challenging goal in a season of weakened revenues, stretched human resources, and a growing fatigue with all things online. However, I believe the successful implementation of the last three objectives will have a significant impact on the first.

By my count, I will be the ninth woman to serve as Chair of Business Law Section. I am also the first non-White, Hispanic Chair, a mantle I carry with pride.

I remember over ten years ago, I was introduced to the section by former Chair, G. Ann Baker, my mentor and former boss. While at the time I do not believe I appreciated all that the introduction would mean for me, my affinity for the section and its members has grown by leaps and bounds over the last decade. From the early days of my membership to my current role as Chair there have been countless opportunities to lead and serve. I have also built invaluable relationships and connections that will last a lifetime. I am humbled to carry on the tradition of those (especially the women) who have come before me and plan to spend the next year extending a similar invitation to as many as I can reach.

I look forward to hearing from (and hopefully meeting) many of you in the coming year. If you have suggestion on things the section could improve upon, please feel free to contact me at (517) 944-0240.

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 By Alexis Derrossett

An Interview with LARA Director Orlene Hawks

Orlene Hawks is the director for the Michigan Department of Licensing and Regulatory Affairs (LARA). The Corporations Division is part of the Corporations, Securities & Commercial Licensing Bureau under LARA.

How long have you served the state of Michigan?

I have over 20 years of state government experience. Prior to joining LARA, I led the state's Operation Excellence project dealing with Michigan Department of Health and Human Services' (MDHHS) Child Protective Services (CPS) investigations. I previously served five years as the director of the Office of Children's Ombudsman (OCO). Before joining the OCO, I managed the Quality and Program Services section in the Department of Community Health (DCH). I also managed the Child, Adolescent and Family Health Services section, directed the Office of Statutory and Legislative Compliance, and served as Legislative Liaison for DCH.

How many people work at LARA? In CSCL?

There are approximately 1,600 employees in LARA, which is one of the most diverse departments regarding its regulatory oversight responsibilities. As you may know, LARA's work impacts Michiganders in their daily lives—from doctors and nurses to nursing homes and child care centers; from fire services to the skilled trades; from marijuana regulations to liquor control; from hearings and rules to indigent defense; from electric power to telecommunications to natural gas services.

What has been your experience leading the Department of Licensing and Regulatory Affairs?

It has been an amazing experience leading LARA and getting to know all the wonderful people that work so hard day in and day out for the people of the state of Michigan. The wide-ranging nature of our department is reflected in the abilities of LARA employees. We employ so many people who are experts in their fields, and their vast array of knowledge is simply remarkable. Our team made the transition to remote working seemingly overnight in March and did not miss a beat. The professionalism of the LARA team is unmatched, and the quality of the work they do shows their commitment to fulfilling our mission of protecting people and promoting business in Michigan through transparent and accessible regulatory solutions.

What is LARA's mission? Core values?

Our core values create the foundation for everything we do and represent our steadfast principles. These principles represent being open and intentional in our work, both internally and externally: Public Service, Transparency, Accessibility, Workforce, and Responsibility. From our core values, flows our vision: to be national leaders that partner with people and businesses to improve the lives of Michigan residents through an engaged and inclusive workforce. When you put it all together, it really comes down to two main concepts — protecting people and promoting business. While it takes a lot of work and commitment, it truly is that simple. The work we do here at LARA protects people and promotes business in so many facets of their lives.

How can businesses protect themselves from identify theft during the COVID-19 pandemic?

Business identity theft during the COVID-19 pandemic is a very real concern. The well-known, business credit rating company Dun & Bradstreet has reported a 258 percent increase in business identity theft since the beginning of 2020.[1] One of the ways that you can proactively protect a business against identity theft is to monitor an entity's record through the Corporations Division's website at www.michigan.gov/corpentitysearch. Also, an email subscription service is offered through the Corporations Division homepage at michigan.gov/corporations. This service allows you to create an account and designate entities that you would like to receive email notification regarding. When the Corporations Division files a document for one of the designated entities, you will receive an email notification.

What do you think is one of the "best kept secrets" in state government?

Without a doubt, state employees are one of the "best kept secrets" in state government. For example, when you call many of our bureaus—including CSCL and the Corporations Division—with a question, you can speak to a person and receive assistance, which is becoming increasingly rare in the world. Also, 99 percent of LARA's employees transitioned to working remotely when the COVID-19 pandemic hit Michigan in March—and they have been flexible and innovative in meeting these challenges so that we can continue to meet the needs of businesses while protecting the people of Michigan.

Do you have any other thoughts for Michigan business lawyers that you would like to share?

During the pandemic and while Corporations Division staff are working remotely, we strongly encourage you conduct business with us online through our Corporations Online Filing System (COFS) at www.michigan.gov/corpfileonline, instead of by U.S. mail, FedEx, or UPS. Our objective is to continue to provide the best service and support that you expect to receive from the Corporations Division Team. As such, we ask for your understanding during this time and provide your questions by email to CorpsMail@michigan.gov, and our team will respond as quickly as possible. You may also contact the Corporations Division at 517-241-6470.

NOTES

1. Dun & Bradstreet, "Protecting Your Business Identity During COVID-19," June 12, 2020, https://www.dnb.com/perspectives/small-business/prevent-business-fraud-during-covid19.html.

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By Eric M. Nemeth

The Wealthy Facing New IRS Enforcement Programs – The Time Is Now to Prepare

As many of you are no doubt aware, the IRS has been laboring under the combined strain of budget cuts and freezes and the serious reduction of personnel. In past columns, I have written about the increases in time to get responses from the IRS, the significant narrowing of Private Letter Rulings, and other determinations and feedback. Even getting applications for lien releases can be a months-long affair. Yes, the IRS personnel know that your deal is particularly important, which is exactly what the previous three callers said that same day.

As such, the IRS has been formulating some programs to get the biggest bang for the proverbial buck. Over the last several months, the IRS has unveiled a few such initiatives. Some of our wealthier clients or future clients should pay close attention.

The Large Business & International Division (LB&I) has taken the wraps off a new campaign to audit high-net-worth individuals (rich people) and their affairs. Rather than a general program examination, the IRS has coined the Global High Wealth Industry (GHW) of LB&I or the "Wealth Squad." The agents have been receiving specialized training to understand global financial structures and ownership and control techniques marketed and employed to those of elite wealth.

So, what can be expected? First the examination will be aggressive with the liberal use of third-party summons. In fact, by the time the taxpayer is formally contacted, you can expect that the agent will have a "thick file" with lots of background information about the taxpayer. The internet has been a bountiful source of information. Social media accounts can be a treasure trove into the life of a taxpayer behind the closed doors of society. Where and when you travel, latest purchases, and even political commentary can provide invaluable intelligence about a taxpayer.

Expect direct questions about foreign bank accounts, offshore assets, and foreign trusts. The agent will want to know about business interests held directly or indirectly. The IRS will be seeking out evidence of aggressive tax strategies (Tax Shelters) and related activities. At the center of the examination, is likely to be an insistence to interview the taxpayer.

In my experience, taxpayer interviews can be particularly difficult as the taxpayer may have multiple advisors and incomplete information about their affairs. Of course, such uncertainty leads to an inquiry if the taxpayer is negligent, careless, reckless, or willful. The second interview is likely to be the tax return preparer. Again, in my experience, the larger the organization the harder it is to find the person with the requisite knowledge and answers. Professionals may be scattered across jurisdictions with conflicting ethical obligations and disclosure rules.

Other areas of enquiry include overseas assets with by trusts, passthroughs, and other entity ownership and structures. You can likely expect that your business associates in those entities will get at least a review of their own tax compliance. In fact, your client may be an off-shoot from another examination.

Like most problems, early intervention is critical. If your client gets an examination letter, a conversation without the tax return preparer is important; as the preparer could quickly become an adverse witness. An honest and open assessment with the taxpayer can save a lot of grief and misery later and potentially avoid the taxpayer digging an even deeper hole by attempting to hide information or make false statements during the examination.

A simple example: Taxpayer's tax return looks straightforward K-1 income and typical deductions. A review of the taxpayer's home shows it to be within his income and there are interest and dividends again consistent with income. The revenue agent asks to review bank statements. Nothing unusual about the request. The preparer simply turns over the bank records. The agent spots one foreign deposit. The IDR comes next. The deposit traces back to an offshore rental property in a foreign corporation. There is nothing illegal about that, but there are no disclosures for a controlled foreign corporation, offshore assets, or a foreign bank account. To boot, the taxpayer's business partners now get their own examination letters that were, shall we say, much more direct.

Recently, the IRS has listed private foundations as an area of scrutiny. An area of significant examination will be "self-dealing." In the private foundation setting, transactions that otherwise might make great business sense are prohibited, for example, loans to disqualified persons such as major donors, directors, and their families. Now, is the time for your clients with private foundations to have a review of their transactions and procedures.

Lastly, on the high-net-worth front is the non-filer program. Yes, apparently some really wealthy folks do not file a tax return. A treasury report estimates that from the 2011 through 2013 tax years, an estimated $37 billion in taxes were evaded by wealthy non-filers. As such, it is expected that in addition to channeling the overseas leads for U.S. taxpayers (that includes dual citizens), those with interests in passthrough entities will be reviewed. A single thread can lead to serious exposure. The agents conducting the examination have special training to trace entities and ownership, as well as access to significant databases.

Things in the tax and tax enforcement world generally inter-connect. This situation is no different. Some of you may recall previous columns wherein I discussed voluntary disclosures with the IRS. In short, coming to the IRS and coming clean prior to being contacted by the IRS. Recent changes to the program have streamlined the application process and narrowed the potential protections; but the program, nevertheless, provides an important option to be considered by taxpayers that may have exposure to any of the items discussed here or in general. IRS Form 14457 provides important details. The bottom line is, if your client is in for a penny they are in for a pound.

Largest Individual Criminal Tax Case in History

On October 15, the IRS and DOJ announced a 39-count indictment charging Robert Brockman, the CEO of a software company, with tax evasion, money laundering, and other offenses. The government alleges the scheme concealed approximately $2 billion of income from the IRS.

What I toke note of was the companion announcement that the same company's founder, Robert Smith, reached a non-prosecution agreement with the government. The United States Attorney David Anderson was quoted as saying that Mr. Smith has "accepted responsibility for his participation in a tax evasion scheme." He further said that Mr. Smith is cooperating with prosecutors and the IRS.

Apparently, in 2014, Mr. Smith tried to enter the Voluntary Disclosure Program. Although he was rejected, his early attempt to "come clean" appears to have borne fruit. A non-prosecution agreement beats an indictment almost any day of the week. Taxpayers looking over their proverbial shoulder and not sleeping well at night should waste no time discussing their options.

Stay safe and well.

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 By Michael S. Khoury and Stuart A. Panensky

Business Continuity Lessons from the Pandemic

The year 2020 will long be remembered, mostly for things we want to forget. Small and mid-size enterprises and businesses ("SME") in particular will take away many lessons from the COVID-19 pandemic. From our perspective as corporate privacy counsel, significant weaknesses in business continuity ("BC") and resiliency planning by businesses was an issue that repeatedly brought our clients difficulty. Prior columns have discussed business continuity and disaster recovery in detail, including the importance of planning, creating written documents, and testing. In the face of a health pandemic and economic unrest, many businesses found to their dismay that they were either not prepared or that the "off the shelf" business continuity plans they acquired years ago were not worth much in this new business climate.

Business continuity plans should provide a framework about how an organization will continue to function during and after an emergency. It involves planning how an organization's critical services or products can continue to function. This column discusses only some of the primary issues that businesses have faced since the onset of the health crisis related to technology. It is our recommendation to all SMEs that planning for future crises must be more robust. Once the organization works to resolve the immediate problems, it must then respond with its strategies moving forward and then begin the process of rebuilding or improving.

It is important to note that each business' plan is unique to some extent. Your plan needs to focus on the specific risks and threats posed to each unique situation. Preparing now for future contingencies is necessary regardless of the particular kind of crisis that the business may face.

Please note that this column does not address the critically important challenges businesses face in protecting the health and safety of their workforces as that is outside the scope of this topic.

Remote Work Technology

Most BC plans include contingencies for remote work options in the event that working in the office or the field is not an option. Many businesses were caught short early in the pandemic and were compelled to do the best they could with the technology assets they had. Quickly ramping up "virtual" infrastructure may not have been feasible for some SMEs that had no prior cloud-based technology presence. Many cloud based technology services have become easier to deploy to an entire company, but the training, infrastructure and processes necessary to implement these changes and to be able to quickly pivot is no easy task especially if the company had no earlier BC planning. Some organizations found, for example, that the infrastructure did not have the capability to support all users on a remote basis. There are many reasons for this including hardware or software issues or just the practical fact that procedures used inside the business simply did not translate well into the remote era. Addressing technology risks and issues in advance in a BC plan is a sound way to be better prepared in this regard.

Communications

Sound communication strategy and carefully crafted messaging is absolutely crucial during any crisis management situation. BC plans should be careful to identify a chain of communications to manage both the internal resources needed to respond to the crisis as well as a strategy for external communications to other stakeholders. At the outbreak of COVID-19, we counseled businesses on communicating as to whether their products and services would be available during the pendency of the crisis, communicating about companies' contributions to the national effort to combat the coronavirus, and communicating to internal staff about changes to the work environment. We advise companies to maintain a consistent communications strategy and that this should be written as part of the BC planning.

Note that each business must be careful with sending an overly optimistic message to one group, especially if the business may be seeking force majeure protections with its customers or suppliers.

Cybersecurity

Much has been written about the gaps in security faced when people were working remotely. BC plans should emphasize the need for and policies surrounding heightened cyber and information security measures. These include policies about maintaining secure networks, use of public WiFi, use of VPN connections, multi-factor authentication ("MFA"), encryption and backup. The BC plan should also ensure that these measures are appropriately configured and protected.

Planning for the Next Contingency

There are other potential crises and emergencies other than a global viral pandemic. The strategies and procedures in BC plans should be able to be applied in any disaster/peril situation including natural disasters, violence and insurrection, war and terrorism, and ransomware (just to name a few). Think about what might be coming that would impact your business and how you can remain protected.

Testing, Testing, Testing

Another hint: testing is important. Company leadership should require tabletop exercises to think through these issues and see how organizations respond to hypothetical situations and to identify weaknesses. Finding a problem during a hypothetical simulation is more preferable than finding it during a crisis event. We strongly encourage all SMEs to run table top simulations to test the BC planning from time to time.

Working with Outside Counsel

Business continuity planning and disaster preparedness are core functions of corporate governance whose value became very obvious at the onset of the COVID-19 pandemic. These practices compel businesses to think through important issues, identify potential areas of vulnerability, and devise strategies to confront challenging situations. It is also very advisable to work with outside counsel on these issues as SMEs can discuss with counsel opportunities to keep the continuity and disaster planning privileged to the extent possible to prevent future disclosure.

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 By Douglas L. Toering and Emily S. Fields

Many of the Michigan Business Court Judges have been interviewed for this column. The judges have provided invaluable insight and guidance about the courts, their preferences, and how they handle business court cases.

Now, "Touring the Business Courts" turns to the "behind-the-scenes" staff who support the judges and the business courts for their perspectives. Tammi Palmer from the Wayne County Circuit Court and Christopher Smith from the Macomb County Circuit Court share their experiences working for the business courts. We also include helpful information about the Oakland County Business Court.

Macomb County Business Court

Chris Smith serves as the Legal Services Director for the Macomb County Circuit Court. In this role, Mr. Smith supervises the entire legal research staff, who work as a pool.

The Macomb County Business Court is the first business court in Michigan. Its specialized business docket was launched November 1, 2011. Mr. Smith started with Macomb County three months prior to the launch of the specialized business docket. He then worked with Judge John C. Foster on developing the business docket.

Now, Mr. Smith reviews all filings in the business court to ensure that the cases are properly filed in the business court. Mr. Smith also reviews filings on the other civil dockets to make sure those cases do not belong in the business court. Mr. Smith noted that the discovery protocols for the Macomb County Business Court have largely been included in the amendments to the discovery rules, which were effective January 1, 2020. This made for an easy transition into the new discovery rules.

In the nine years he has worked with the Macomb County Business Court, Mr. Smith has seen the overall comfort level with the business court, both with the judges and counsel, increase.

The business court judges like to meet with the lawyers early to get everyone moving with settlement discussions. Mr. Smith is satisfied with how the business courts have progressed over the last nine years. Judge Richard Caretti and Judge Kathryn Viviano are the Macomb County Business Court Judges.

Further, Mr. Smith observed, "Having been here since the business court started, I do think it's been a nice development. The focus on early case resolution and requiring parties to comply with discovery protocols has been successful because it's been adopted on a larger basis now. That alone was a nice improvement."

In 2019, the Macomb County Business Court had 289 filings and 308 total dispositions. Filings are down considerably since the COVID-19 pandemic began. The business court's focus is on resolving the pending cases and scheduling trials for some time in the future. The business court will continue to emphasize early mediation.

The Macomb County Business Court is still using Zoom for hearings, conferences, and case evaluation. For more information please visit: https://circuitcourt.macombgov.org/CircuitCourt-BusinessDocket.

Oakland County Business Court

The Oakland County Business Court began operation July 1, 2013. Initially, Judge James M. Alexander and Judge Wendy Potts were assigned to the business court. When Judge Potts retired, Judge Martha D. Anderson was appointed to take her place. Judge Alexander will retire as of January 1, 2021. The Michigan Supreme Court has appointed Judge Michael Warren as his replacement.

In 2019, the Oakland County Business Court had 962 filings and 1,014 dispositions. As of September 9, 2020, the court has had 635 filings and 606 dispositions.

The Oakland County Business Court uses its own Case Management Protocol.[1] Included in this protocol is a list of the "Standing Protocols" for the business court. The Electronic Service Protocol provides for email service. The Case Management Conference Protocol states the court will conduct a Case Management Conference, or early scheduling conference. Before attending the Case Management Conference, counsel for the parties must confer and submit a Joint Case Management Plan. The Standard Discovery Protocols are quite similar to the 2020 amendments to the discovery rules. (The Standard Discovery Protocols predated the new discovery rules and required initial disclosures and proportional discovery well before the new discovery rules became effective on January 1, 2020.)

The Oakland County Business Court's Model Protective Order is available on the court's website.[2] The Model Order allows a party to designate certain documents as "Confidential" in discovery, and it provides protocol for handling and using confidential documents. The Model Protective Order is the default protective order for many business cases in Oakland County (and elsewhere).

The Oakland County Business Court holds status conferences, motion hearings, bench trials, and case evaluations by Zoom. The judges expect that judicial proceedings by Zoom will continue as the new normal.[3] The volunteer discovery facilitation process as well as the work of the advisory committee for the business court have been suspended due to COVID-19. The volume of discovery motions has declined during COVID-19.

The business court continues to emphasize early and active judicial involvement. As part of this, the judges typically order early mediation. Today, most mediations are typically occurring by video conferencing.

For additional information about the Oakland County Business Court (including court forms), please visit: https://www.oakgov.com/courts/businesscourt/Pages/default.aspx.

Wayne County Business Court

The Wayne County Business Court began on July 1, 2013. At that time, the business court had three judges—Judge Susan Borman, Judge Daniel Ryan, and Judge Brian R. Sullivan. In October 2019, the business court expanded to five judges, who are still on the bench today: Judge Sullivan, Judge David J. Allen, Judge Edward Ewell, Jr., Judge Muriel D. Hughes, and Judge Lita M. Popke.

Tammi Palmer has served as the Director of Case Processing and Court Reporting Services for the Wayne County Circuit Court for approximately five years. Ms. Palmer and her staff are responsible for all 58 judges and their cases. Her role with the business court is a subset of her work. With respect to the business court, Ms. Palmer oversees a staff responsible for scheduling the cases pursuant to the five Wayne County Business Court Judges' personal preferences, which allows them to maximize efficiency. Each judge has a different way he or she likes to schedule the dates and times for settlement conferences, status conferences, and so forth. Ms. Palmer and her staff are also responsible for making sure notices for status conferences, settlement conferences, case evaluation, and mediation are issued, and that scheduling is done timely.

Beyond that, Ms. Palmer reviews the court data to determine the number of filings and dispositions. Lisa Stroud, from the Office of General Counsel, reviews each civil filing to make sure it has been properly coded to belong to the business court. Ms. Stroud works with Judge Sullivan, the Presiding Judge of the Wayne County Business Court, who ultimately decides whether a case belongs in the business court or the general civil docket.

Another one of Ms. Palmer's responsibilities is to perform a quarterly review of the business court judges' caseloads. Wayne County's Business Court Judges take a 75 percent draw of general civil cases and a 100 percent draw of business court cases. Ms. Palmer notes that, "One of the other things that really makes a difference in Wayne County is that our Chief Judge [Judge Timothy Kenny] is very involved in the business court, and the Presiding Judge of civil [Judge Patricia Fresard] is very involved. We meet regularly to make sure everything is on track and address any issues that we have." She adds, "We work hard behind the scenes to make sure that the judges have even caseloads to give business cases the attention that they need." The judges and staff "work very hard to give you the best possible business court."

In 2019, Wayne County's Business Court had 913 total business court filing and 936 dispositions. In 2020, the business court is on pace to reach a similar ratio of total filings to dispositions, with approximately 502 filings and 506 dispositions through September 10, 2020.

Ms. Palmer's advice to business court litigators: "When you file your case, make sure to use the right heading. Double check our website, double check what you should use as a case caption and the codes. It's easier on us so that we don't have to go back and reassign cases and do additional work. And confirm verification of business court eligibility." Ms. Palmer notes that all of the business court protocols can be found on Wayne County's website. According to Ms. Palmer, using the correct headings, codes, and captions "saves us a lot of work and gets you before the judge more quickly."

The Wayne County Business Court continues to hold status conferences, hearings, and bench trials virtually.

For additional information, please visit https://www.3rdcc.org/programs-services/business-court.

One More Thing…

The Michigan State Court Administrative Office continues to be an excellent source for all kinds of information about the business courts in Michigan. This includes local administrative orders and business court opinions (searchable by court, subject, and key words). https://courts.michigan.gov/administration/admin/op/business-courts/pages/business-courts.aspx.

NOTES

1. https://www.oakgov.com/courts/businesscourt/Documents/ocbc-pro-case-management.pdf.

2. https://www.oakgov.com/courts/businesscourt/Documents/mod-bc-pro_ord.pdf.

3. For a fuller discussion of how business courts are using technology to adapt in the COVID-19 era and how this is likely to continue in the future, see Touring the Business Courts, 40 Mich Bus L J 13 (Summer 2020), https://higherlogicdownload.s3.amazonaws.com/MICHBAR/ebd9d274-5344-4c99-8e26-d13f998c7236/UploadedImages/pdfs/journal/Summer20.pdf#page=13.

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 By Gerard V. Mantese and Jordan B. Segal

Contract Issues in Closely Held Companies

The tools of trade for general counsel[1] or outside corporate counsel include the multiplicity of contracts that routinely need to be drafted or reviewed. Some generic agreements (i.e., purchase orders) tend to contain standard language that can often be readily adapted from one scenario to another. Other contracts, such as shareholder agreements or operating agreements, are more likely to have unique or specialized provisions that must be carefully analyzed anew with each new iteration.

This article discusses some of the contract provisions dealing with closely held companies that general counsel must analyze carefully. These include clauses dealing with executive powers; capital contributions; employment and partnership issues; rights to information; exit ramp provisions; shareholder oppression issues; arbitration; and statute of limitations issues.[2]

Executive Powers and Authorities

In general, a corporation has "all powers necessary or convenient to effect any purpose for which the corporation is formed," subject to any limitation in applicable statutes or the corporation's articles of incorporation.[3] The articles of incorporation may provide for the management and conduct of the business and may create, define, limit, or regulate shareholder, director, and corporate powers.[4]

The authority to run a company is vested in a president or CEO in a corporation and in a manager in an LLC (assuming the LLC is manager-managed). Provisions in the shareholder agreement or bylaws for corporations, and in the operating agreement for LLCs, usually repose broad powers in the executive; yet, this does not mean the power is unlimited. MCL 450.1489 (the "shareholder action" statute) prohibits a closely held corporation's officers, directors, and controlling shareholders (i.e., those "in control") from acting in a manner that is illegal, fraudulent, or willfully unfair and oppressive toward the minority shareholder.[5] Conduct is willfully unfair and oppressive when it substantially interferes with a shareholder's interest as a shareholder.[6] In any case, specific corporate/executive powers and any exceptions to executive power should be delineated carefully in the relevant agreements.

If corporate powers are used oppressively, courts may limit them, even where the power is derived from bylaws or governing documents that expressly permit the executive to act on a certain issue. *Berger v Katz*[7] is a good illustration. In *Berger*, the Michigan Court of Appeals upheld the trial court's finding that the defendants engaged in willfully unfair and oppressive conduct even though the conduct at issue was expressly authorized by the corporation's bylaws. The court stated, "Although the bylaws gave defendants the general authority to make business decisions such as setting salaries, issuing capital calls, or approving rental payments, that does not mean that defendants were permitted to act in a manner that was willfully unfair and oppressive to plaintiff, as a minority shareholder."[8]

For an in-house counsel, understanding exactly the contractual bases of executive powers and authorities is an absolute must. A company executive—particularly in closely held companies—may view himself or herself as a unitary executive with unlimited authority. As unenviable a position as it is, it typically falls to the company counsel to disabuse the executive of this notion. In these difficult moments, pointing to express authority provisions in bylaws, operating agreements and/or shareholder agreements, and principles of fiduciary duties in exercising such authority, are useful tools to remind the executive of the limits of his or her authority and his or her responsibilities: to the company and its other members, shareholders, or owners, and also to assure compliance with laws and maintain workforce safety. Of course, the executive's duties and powers in any particular case will be controlled by the particular facts and circumstances of that case.

Capital Contributions

General counsel should consider the entity's source of capital when drafting governing documents. Where will needed capital come from? The fact that owners are willing to make an initial capital contribution when the company is organized does not mean that they will continue to do so in the future. Thus, the agreement should specify precise standards which detail (1) when capital calls are permitted and (2) the consequences of the failure to answer a capital call.

Those in control of an LLC (either managers of a manager-managed LLC or managing members of a member-managed LLC) may enforce a member's written promise to contribute cash, such as those found within an operating agreement.[9] However, capital calls should not be made for improper purposes or without demonstrable necessity. As seen in in the 2018 Michigan Court of Appeals case of *Castle v Shoham*, capital calls that do not comport with a company's operating agreement or are otherwise abusive may constitute oppression.[10]

Here, in-house counsel should be willing to work closely with the company's finance professionals to ensure that, should there be additional capital calls, the contractual triggers for these calls are clear, articulated, contractually justified, and consistent with equity and fair play.

Employment and Partnership Issues

Employment agreements deserve general counsel's critical attention. Non-competition agreements must be reasonable in terms of duration, scope, and geography, and justified by reasonable competitive business interests.[11] The first author, with the late, brilliant James K. Robinson, successfully tried *Kelsey-Hayes v Maleki*,[12] which continues to be an important non-compete case. In *Kelsey-Hayes*, the court held that the non-compete at issue did not encompass the employee's actions with the new employer because the employee was working on a different kind of braking system at his new employer. In order to best preserve enforceability of employee non-compete clauses, counsel should carefully evaluate each employee's specific responsibilities and avoid using draconian "one size fits all" non-compete clauses.

General counsel should also give special attention to the employment status of owners. Terminating the employment of an owner or reducing benefits can constitute oppression if this disproportionately affects that owner's ability to derive benefit from her shareholding interest.[13] Wherever possible, owner-employees should collectively agree in advance on how much of their compensation will come from salaries and bonuses, and how much they expect to receive in distributions or dividends.

Trouble may come when there are no agreements at all. In that vacuum, oral agreements about the founders working together as partners and sharing income may allow for the argument that the founding group agreed to employment protections or even a partnership. *Byker v Mannes*[14] is instructive. In *Byker*, the Michigan Supreme Court held that the existence of a partnership depended on the parties' acts and conduct and not on the parties' subjective intent to form a partnership. Thus, under common law, individuals may be found to have formed a partnership if they acted as partners by engaging in a business and sharing profit, regardless of their subjective intent to form a partnership. Today, many operating agreements include specific language stating that the members do not intend to create a partnership.

A memorable illustration is portrayed in the film *The Social Network*. In one scene, several students discuss forming a business relationship to create a social networking website. There was no written agreement. One of the legally significant moments in the movie included this scene:[15]

> CAMERON: We'd love for you to work with us, Mark. I mean, we need a gifted programmer who's creative.
>
> TYLER: And we know you've been taking it in the shins.
>
> DIVYA: The women's groups are ready to declare a Fatwa, and this could help rehabilitate your image.
>
> MARK: Wow. You'd do that for me?
>
> DIVYA: We'd like to with you.
>
> CAMERON: Our first programmer graduated and went to work at Google. Our second programmer just got overwhelmed with school work. We would need you to build the site and write the code and we'll provide -
>
> MARK: I'm in.
>
> CAMERON: -- the money. What?
>
> MARK: I'm in.
>
> TYLER: Awesome.[16]

It is a distinct possibility that the above dialogue constituted an oral partnership agreement in Michigan. If so, Mark Zuckerberg's subsequent conduct could have been viewed by the court as a breach of the partnership and the fiduciary duties he owed to Cameron and Tyler Winklevoss, in which case the Winklevoss twins would likely have ended up with far more than the settlement they actually received.[17]

To avoid such disputes, counsel should make frequent and liberal use of so-called "No Joint Venture" clauses in any written agreement, including a specification that nothing is intended to create a partnership. Such language, in its simplest form, might read "nothing in this Agreement should be interpreted to create any agency, partnership, joint venture or any like relationship between the parties." Of course, this language should be tailored to the specific transaction.

Rights to Information

Pursuant to MCL 450.1487, a shareholder is entitled to inspect the corporate books and records. Denial of this right may constitute illegal, fraudulent, or willfully unfair and oppressive conduct under MCL 450.1489.[18] An often ignored law, MCL 450.1901 requires each corporation to distribute its financial report for the prior fiscal year "to each shareholder thereof within 4 months after the end of the fiscal year. The report shall include the corporation's statement of income, its year-end balance sheet, its statement of source and application of funds if prepared by the corporation, and any other information as may be required by this act."

Denying an owner financial information—particularly when the company appears to be stockpiling cash for no legitimate business reason—can be frustrating to minority owners and can lead to an oppression claim. Thus, general counsel should be aware of the scope of a shareholder's right to information, both under the statutes and in governing agreements.

Particularly in the information economy, it is generally standard practice to attempt to keep as much company information confidential as possible. Nevertheless, access to company books and records is an important—and statutory—shareholder and member right. As a general counsel, denying a member, shareholder, or other minority stakeholder access to books and records is extremely dangerous territory and care should be taken to strictly comply with statutory and common law on this issue.

Exit Ramps

General counsel should examine contractual provisions describing if and when owners may require the company or other shareholders to purchase their equity interests and, if so, what valuation method would apply. Examples of this may include in instances of death, disability, bankruptcy, or divorce. If shareholders agree on these issues in advance, the likelihood for future disputes will be significantly diminished. The inclusion of tag-along rights (in which, if the majority stakeholder sell its interest, the remaining minority has the right to join the deal and sell its interest on the same terms) can foster trust and prevent power struggles between majority and minority stakeholders.

Further, general counsel should be cautious of proposals for discriminatory, unequal redemptions. Indeed, MCL 450.1301(3) provides that, generally, each share shall be equal to every other share of the same class. In *Schimke v Liquid Dustlayer,*[19] the Michigan Court of Appeals upheld the trial court's finding that the defendants acted oppressively by planning to redeem a director's stock on terms not offered to the plaintiff. It was of no moment that the defendants' proposed redemption "was merely an inchoate dream" and had not yet occurred.[20] The court found that the shareholder oppression statute "does not require a showing that oppressive conduct diminished the value of the shareholder's stock. Rather, § 489(3) requires a showing that the misconduct substantially interferes with the interests of the shareholder as a shareholder."[21] The Court there held that the inchoate plan supported a claim of shareholder oppression.

Violation of Shareholder Agreement or Operating Agreement

A violation of a shareholder agreement may constitute evidence of shareholder oppression under MCL 450.1489(3). *Madugula v Taub,*[22] argued by the lead author, is the landmark case on this issue.[23] In *Madugula*, the Supreme Court of Michigan found "that a breach of the rights and interests contained in the stockholders' agreement could be evidence of shareholder oppression."[24] General counsel should consider the scope of the rights to be conveyed to shareholders before memorializing them in a shareholder agreement—and meet with all shareholders together if possible to ensure that everyone is on the same page. Far too often, important agreements are still often left to emails, scraps of paper, or no paper at all—the so-called "handshake deal." This often leads to misunderstandings and litigation among the owners.[25]

Arbitration Clauses and Statute of Limitations

General counsel should consider whether claims should be arbitrated or litigated. Arbitration offers more confidentiality and often allows a speedier resolution. Historically, such ADR procedures were significantly more cost-effective than litigation. However, in contemporary practice, arbitration can be just as expensive as a lawsuit and may often be just as protracted. Still, the main benefit of arbitration is confidentiality—as arbitration proceedings are not public record, as courts are—and have limited appeal rights.

Statutes of limitations should also be considered. *Frank v Linkner*[26]—which the lead author argued in the Michigan Supreme Court—should be reviewed when considering any statute of limitations issue involving owners of small businesses. In *Frank*, the Michigan Supreme Court held that the three-year limitation period for actions seeking an award of damages for oppressive conduct by managers or members in control of an LLC is a "statute of limitations," rather than a statute of repose. Further, the limitation period ran from the date that the cause of action accrued, allowing plaintiffs to toll running of the limitation period under the fraudulent-concealment statute.[27] The Court also held that financial harm is not essential to start the limitations clock running; actions which substantially interfere with an ownership interest were all that is necessary for liability to be imposed.

Conclusion

A litigator's role is to win the fight. Equally important, however, is the General Counsel's role in preventing a fight before it begins. General counsel should carefully consider all agreements used by the company or its owners. The best time to address these issues is before problems arise. In this regard, clearly and carefully drafted agreements are the "best of all possible worlds"[28]—not only will a court interpret a clear agreement as written[29] but a document with clear requirements and provisions will set expectations among its parties and make litigation less likely to occur at all. On the other hand, ambiguous agreements are often both the cause of, and the subject of, protracted and costly litigation.

NOTES

1. When dealing with disputes among the company's owners, the general counsel (or outside corporate counsel) should be mindful of who the client is (the company) and whether there is any conflict of interest. Further, although this article is directed to general counsel, it can also apply to outside corporate counsel as well.

2. For a discussion of recent developments, see Mantese, Toering, and Bolyea, *Shareholder Agreements, Operating Agreements, and Partnership Agreements: A Survey of Recent Caselaw*, 97 Mich BJ 36 (Sept 2018).

3. MCL 450.1261(q).

4. MCL 450.1209(a).

5. MCL 450.4515 is the analogous member oppression statute in Michigan's LLC Act.

6. MCL 450.1489(3). *Madugula v Taub*, 496 Mich 685 (2014), argued in the Michigan Supreme Court by the author, held that the oppression cause of action is an equitable one, tried to the judge, and that breach of a shareholder's agreement can be evidence of oppression. The author, along with partner, Ian Williamson, represented the plaintiff on remand, where the trial court found that the plaintiff had been oppressed and ordered a buyout.

7. Nos 291663, 293880 at *4 (Mich Ct App July 28, 2011) (unpublished).

8. *Id.* at *4.

9. MCL 450.4302.

10. No 337969 at *5 (Mich Ct App Aug 7, 2018) (unpublished).

11. MCL 445.774a.

12. 765 F Supp 402 (ED Mich 1991), vacated pursuant to settlement, 889 F Supp 1583 (ED Mich 1991).

13. *See* MCL 450.1489 (shareholders); MCL 450.4515 (members).

14. 465 Mich 637, 641 NW2d 210 (2002).

15. Miguel Helft, Court Upholds Facebook Settlement With Twins, N.Y. Times, April 11, 2011, http://www.nytimes.com/2011/04/12/technology/12facebook.html.

16. *The Social Network* (Sony Picture 2010).

17. Miguel Helft, *Court Upholds Facebook Settlement With Twins*, N.Y. TIMES, April 11, 2011, http://www.nytimes.com/2011/04/12/technology/12facebook.html.

18. *See* MCL 450.4515 as to members of LLCs.

19. No 282421 at *3 (Mich Ct App Sept 24, 2009) (unpublished).

20. *Id.* at *4.

21. *Id.*

22. 496 Mich 685 (2014).

23. *See, generally*, Mantese and Toering, The Michigan Supreme Court Speaks: Madugula v Taub and Shareholder Oppression," 93 Mich BJ 42 (Nov 2014).

24. *Id.* at 720.

25. *See also* Mantese and Williamson, Shareholder Oppression, Fiduciary Duty, and Partnership Litigation in Closely Held Companies, Stout Risius Ross, 2014.

26. 500 Mich 133, 894 NW2d 574 (2017).

27. *Id.* at 149.

28. With acknowledgements to Voltaire, *Candide* (Chapter 6, p. 25).

29. E.g. *Rory v Continental Ins Co*, 473 Mich 457, 703 NW2d 23 (2005).

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Oppression Claims and Limitations of Actions

By Justin Klimko, James Bruno, Jonathan Kirkland and Paul Howarah

Both the Michigan Business Corporation Act ("BCA")[1] and the Michigan Limited Liability Company Act ("LLCA")[2] authorize shareholders or members to bring an action seeking redress for conduct that is "illegal, fraudulent, or willfully unfair and oppressive to the corporation or to the shareholder."[3] One question presented in oppression actions is what statute of limitations is applicable to claims. The statutory language contains a limitations period for only one subset of actions, those seeking an award of damages.[4] Michigan courts have held that oppression actions seeking other relief are subject to the six-year limitations period arising under the Michigan Judicature Act.[5]

The Michigan Supreme Court also held in *Madugula v Taub*[6] that all oppression actions (even those seeking an award of damages) are equitable in nature. This raises the question of whether the doctrine of laches may also act to bar an oppression claim in appropriate circumstances.

This article discusses the development of the statute of limitations for oppression actions and the application of the doctrine of laches, and presents the authors' recommendations for a consistent approach to limitations of actions for oppression claims.

Origin of the Oppression Statutes in the BCA and LLCA

The oppression statutes for corporations and limited liability companies are rooted in former Section 825 of the BCA,[7] which was repealed in 1989. Included in the original BCA in 1973, Section 825 was very similar to Section 489[8] but was part of the dissolution chapter. In addition to dissolution, Section 825 afforded courts certain equitable remedies where dissolution was not appropriate, similar to Sections 489 and 515. However, the placement of the section in the dissolution chapter "placed undue emphasis on dissolution, an extreme remedy to be used as a last resort,"[9] and led to the development of Section 489, enacted in 1989 as part of a major revision to the BCA that also repealed Section 825. Section 489 heavily borrowed from Section 825 but also added damages to the non-exhaustive list of relief available, which includes dissolution, liquidation, and purchase of shares at fair value.

Statute of Limitations for Actions under the Shareholder Oppression Statutes

Except for an action seeking damages, to which the 3/2 rule (defined below) applies, the oppression statutes do not expressly prescribe a statute of limitations. For oppression actions other than those seeking an award of damages, the Michigan Court of Appeals, in its *Estes II* decision, held that the "catch-all" six-year statute of limitations under MCL 600.5813 applies.[10] Although the 3/2 rule applies to breach of duty actions brought under the BCA and LLCA against a corporate director or officer or an LLC manager,[11] the Court of Appeals held that an oppression claim creates a cause of action that is separate and distinct from the cause of action for a breach of duty claim.[12] The Court reasoned that, although oppression and breach of duty claims may often be pleaded together, there are differences between the two actions, resulting in oppression cases being a separate cause of action and therefore demanding its own statute of limitations.

Section 489 was amended in 2001 to add a specific period of limitations for an award seeking damages requiring a claimant to bring his or her claim within the earlier of three years after the accrual of the cause of action or two years from discovery.[13] We refer to this as the "3/2 rule." Section 515 of the LLCA contains the same rule as it applies to actions seeking damages.[14]

As a result of the combination of the *Estes II* decision and the 2001 statutory amendment, the 3/2 rule applies to oppression actions seeking damages,[15] and the residual, catch-all six-year statute of limitations rule applies to all other claims brought under the oppression statutes.

Statute of Limitations vs. Statute of Repose

A statute of limitations bars claims after a specified period, establishing a time limit for suing in a civil case, based on the date when the claim accrues (i.e., when the injury occurred or was discovered).[16] A statute of repose differs in that it is unrelated to the accrual of a claim; rather, it bars the commencement of an action after a specified time period has elapsed from a certain event (e.g., a delinquency), even if the specific time period ends before the plaintiff suffers an injury.[17] A statute of repose, therefore, may prevent a cause of action from ever accruing if the injury is sustained after the specified time period has elapsed.[18] A statute of limitations, on the other hand, runs from the time the claim accrues.[19]

In *Frank*, the appellant claimed that the three-year period in the 3/2 rule was a statute of repose while the two-year period was a statute of limitations.[20] The Supreme Court rejected this claim and instead agreed with the Court of Appeals that the statute contains two alternative statutes of limitations, one predicated on the accrual of the cause of action (the three-year period) and the other on discovery of the cause of action (the two-year period).[21] The Supreme Court held the three-year period to be a statute of limitations, not a statute of repose, since it runs from accrual rather than from some other particular event.[22] The Court reasoned that if the Legislature had intended to make the three-year period a statute of repose, it could have done so by defining the period as running from the defendants final act of willfully unfair and oppressive conduct rather than from when the cause of action "accrues."[23]

Reconciling the Limitations Periods under the Oppression Statutes

The *Frank* defendants argued that if both the three-year period and the two-year period are statutes of limitations, the three-year period would be rendered meaningless, since the two-year period would always expire first.[24] The Supreme Court said that this argument presumed that the three-year period would be subject to the *common law* discovery rule under which "a claim does not accrue until a plaintiff knows, or objectively should know, that he has a cause of action and can allege it in a proper complaint."[25] However, the Court said that the accrual of the three-year period is governed by statutory law and thus not subject to the common-law discovery rule, making the defendants' presumption invalid.[26] The three-year period cannot be tolled by the common law discovery rule, but only by the fraudulent concealment statute of MCL 600.5855. Under this construction, if the three-year period expired before a plaintiff discovered its claim, the plaintiff would be time-barred unless it could demonstrate fraudulent concealment under MCL 600.5855, and as a result, the two-year period might never apply.[27]

When Does the Claim Accrue?

MCL 600.5827 provides that a claim generally accrues "at the time the wrong upon which the claim is based was done regardless of the time when damage results." For purposes of determining the date of the "wrong" under MCL 600.5827, the Supreme Court has held that the "wrong" occurs on the date on which the defendant's breach harmed the plaintiff, as opposed to the date of the breach.[28]

The *Frank* Court addressed when a claim accrues under the LLC oppression statute (which should also apply to oppression claims under the BCA). "[T]he 'harm' that that is actionable under MCL 450.4515 is the 'substantial[] interfer[ence] with the interests of a member as a member."[29] The Court added that harm should not be conflated with monetary damages and stated "an action for LLC member oppression does not necessarily accrue when a plaintiff incurs a calculable financial injury. Instead, it accrues when a plaintiff incurs the actionable harm under MCL 450.4515, i.e., when defendants' actions allegedly interfered with the interests of a plaintiff as a member, making the plaintiff eligible to receive some form of relief under MCL 450.4515(1)."[30]

Using this analysis, the *Frank* Court rejected the plaintiff's assertion that its claim did not accrue until the LLC sold its assets in 2012 and the financial injury they asserted could be calculated. The Court said instead that "[o]nce a plaintiff proves that a manager engaged in an action or series of actions that substantially interfered with his or her interests as a member, the "harm" has been incurred, and therefore the claim has accrued."[31] Thus, the Court found that the claim accrued when the allegedly oppressive action—in that case, the subordination of interests despite a promise that they would not be subordinated—occurred, which was

The statutory language contains a limitations period for only one subset of actions, those seeking an award of damages.

in 2009. Plaintiffs could have sought relief against the actions then, and the fact that an additional remedy—money damages—later became apparent or measurable did not "reset" the accrual date.[32]

Can Laches Bar an Oppression Claim?

In *Madugula*, the Michigan Supreme Court held that oppression actions are equitable in nature, rather than legal,[33] even to the extent money damages are sought. This raises the question of whether the doctrine of laches can be interposed as a bar to an oppression action.

Laches is defined as "the equitable doctrine by which a court denies relief to a claimant who has unreasonably delayed in asserting the claim, when that delay has prejudiced the party against whom relief is sought."[34] The Michigan Supreme Court has characterized laches as "an affirmative defense which depends not on mere lapse of time but principally on the requisite of intervening circumstances which would render inequitable any grant of relief to the dilatory plaintiff."[35] Laches "reflects 'the exercise of the reserved power of equity to withhold relief otherwise regularly given where in the particular case the granting of such relief would be unfair and unjust.'"[36] To assert the affirmative defense of laches, a "defendant must prove [1] a lack of due diligence on the part of the plaintiff [2] resulting in prejudice to the defendant."[37]

> The legislature modified the laches and statute of limitations relationship with the enactment of MCL 600.5815[.]

Difference between Laches and Statute of Limitations

"Laches differs from the statute of limitation[s] in that ordinarily it is not measured by the mere passage of time."[38] Instead, laches is measured by the prejudice to the plaintiff occasioned by the delay.[39] "Simply stated, 'laches [is concerned] with the effect of delay', while 'limitations are concerned with the fact of delay.'"[40]

Interplay of Laches and Statute of Limitations

"There is … a relationship between laches and the statute of limitations."[41] Traditionally, laches is viewed as the equitable counterpart to the statute of limitations available at law.[42] It is a well-recognized principle that equitable relief will not be granted where there is an adequate remedy at law.[43] Due to this principle, in equity cases in which corresponding relief was available at law, laches would be evaluated by reference to a statute of limitations for similar actions and the courts adopted the practice of applying a statute of limitations by analogy.[44] In cases that displayed compelling equities or that are "purely equitable" (i.e., for which the law provides no analogous relief), laches would be applied without reference to any statutory period.[45]

The legislature modified the laches and statute of limitations relationship with the enactment of MCL 600.5815, which states:

> The prescribed period of limitations shall apply equally to all actions whether equitable or legal relief is sought. The equitable doctrine of laches shall also apply in actions where equitable relief is sought.[46]

The Michigan Court of Appeals "has held that MCL 600.5815 does not preclude the application of laches to legal actions but "evidences only a legislative intent to subject equity actions to the same statute of limitations available for law actions, thereby modifying the prior judicial practice of applying a statute of limitations by analogy in an equity action.'"[47]

Tenneco Inc v Amerisure Mut Ins Co,[48] confirmed by *City of Fraser v Almeda Univ*,[49] further defined the relationship between laches and the statute of limitations by holding that courts may apply laches to bar an action at law even if the statute of limitations has not expired.[50] Ordinarily, it is presumptively reasonable to file an action at law within the applicable statute of limitations and laches is inapplicable.[51] However, a plaintiff's inexcusable delay bringing suit which results in prejudice to the defendant can create "exceptional circumstances" or "compelling equities" allowing laches to bar a claim even if an applicable statute of limitations has not run.[52, 53]

How Laches Applies to Oppression Actions

These authorities demonstrate that both laches and the statute of limitations may apply to oppression actions under the BCA and LLCA. As discussed above, actions seeking damages will be subject to the 3/2 rule, and both Michigan precedent[54] and MCL 600.5815 indicate that the residual six-year statute of limitations will apply to oppression actions seeking other relief. The *Madugula* Court found that oppression actions are equitable in nature,[55] and MCL 600.5815 further provides that laches will apply where equitable relief is sought. It should be noted, however, that cases (such as *Estes II)* holding the six-year residual period of MCL 600.5813 applicable to oppression actions were decided before the *Madugula* ruling that all such actions are equitable. It remains to be seen whether the result in *Madugula* may lead a court to conclude that laches should apply to all oppression actions (in some cases, perhaps exclusively).[56] In one unpublished opinion delivered shortly after the *Madugula* decision, the Michigan Court of Appeals applied laches to an oppression action not seeking monetary damages based on the "passage of time" and "lack of diligence by the plaintiff," resulting in "prejudice to the defendant."[57]

Due to the relative brevity of the periods prescribed by the 3/2 rule of Sections 489(1)(f) and 515(1)(e), it is unlikely that laches would be applied to bar an action for damages that was brought within the limitations period. However, facts may arise where a court decides to use its "reserved power of equity to withhold relief otherwise regularly given where the granting of such relief would be unfair and unjust."[58]

Proposal for Reconciliation of Statute of Limitation Periods

The authors propose that the limitation of actions period for all oppression claims under both the BCA and the LLCA be standardized at the 3/2 period currently applicable to actions for damages (i.e., three years after the cause of action has accrued or two years after the shareholder discovers or reasonably should have discovered the cause of action, whichever occurs first). We see the following advantages to this approach:

1. It would eliminate any question as to whether a limitations period applies to oppression actions seeking relief other than money damages, and what period should apply. Courts would not need to invoke statutes of general application or to analogize to statutes of limitations applicable to other types of actions.
2. It would harmonize the period for all types of claims and relief under the oppression sections. Currently, a single action is subject to different limitations periods depending on the relief requested, though the conduct underlying the relief remains the same. Further, an award of damages is not the only type of relief that may result in payment of money to a claimant. The purchase of an interest for fair value (as contemplated in Section 489(1)(e) and Section 515(1)(d)) and the dissolution and liquidation of the assets and business of the entity (Sections 489(1)(a) and 515(1)(a)) will each result in payments to a claimant. There is no clear rationale for distinguishing the limitations periods for these types of monetary relief, and the differing periods were not instituted as part of a deliberate statutory design but rather came about in the statutory amendment process.[59]
3. It would harmonize the limitations period for oppression actions with the limitations period for actions for breach of duty against directors under MCL 450.1541a and against managers under MCL 450.4404. Many actions brought under the oppression statutes are combined with breach of duty actions, and often the same acts are alleged as the basis for all such actions. It seems to have become standard practice to add an oppression count to all derivative claims brought by private company shareholders. We see no persuasive policy reason for applying differing limitations periods to the same claimants based on the same underlying conduct.
4. It would promote more expeditious resolutions of disputes. Claims would have to be brought sooner after claimants acquired knowledge of the accrual of the actions, which would aid the efficient disposition of actions. The discovery provision would protect claimants from fraudulent concealment of the underlying acts.
5. It would make the application of the doctrine of laches much less likely, because the period would be relatively short and unlikely to produce circumstances in which a plaintiff's delay in bringing a permitted action would unreasonably or inexcusably prejudice the defendant. This would result in greater certainty of application and result.

The foregoing authorities indicate that both laches and the statute of limitations may apply to oppression actions under the BCA and LLCA.

We understand that the causes of action for breach of duty and for oppression are fundamentally different. As recognized by the Court of Appeals in *Estes II*, both substantive and procedural differences exist between them.[60] Breach of duty actions generally are only available on a derivative basis for damage to the corporation, while oppression actions are personal actions. Derivative actions require pre-suit demand, while oppression actions do not. The range of remedies is different as well. While these demonstrate the appropriateness of a separate cause of action for oppression, they do not, in our view, militate for different limitations periods. Implementing a three year/two year period for all oppression claims would standardize the limitation of actions period for claims for corporate or company misconduct.

NOTES

1. MCL 450.1101 *et seq.*
2. MCL 450.4101 *et seq.*
3. MCL 450.1489(1). *See also* MCL 450.4515(1).
4. *See* MCL 450.1489(1)(f), 450.4515(1)(e).
5. *See* note 10 *infra* and accompanying text.
6. *Madugula v Taub*, 496 Mich 685, 853 NW2d 75 (2014).
7. Formerly MCL 450.1825.
8. In *Madugula*, the Supreme Court noted that "Section 489 is nearly identical in form to its predecessor, former MCL 450.1825 (§ 825), which was considered equitable in nature and was correspondingly tried to a court. Like § 489, § 825 enumerated a nonexhaustive list of various forms of equitable relief that a court could award." *Madugula, supra*, at 703.
9. Schulman, Moscow, Lesser, Michigan Corporation Law and Practice, §4.22 at p. 4-54.
10. *Estes v Idea Eng'g & Fabrications, Inc*, 250 Mich App 270, 649 NW2d 84, 93 (2002), at 285–86, citing MCL 600.5813.
11. MCL 450.1541a(4), MCL 450.4404(6).
12. *See Estes*, *supra*, at 270. In the earlier case of *Baks v Moroun*, 227 Mich App 472, 485, 576 NW2d 413, 419 (1998), the Court of Appeals held that Section 489 did not create a cause of action separate and distinct from a breach of duty action. The *Estes II* decision overruled *Baks* to hold that Section 489 creates a separate cause of action.
13. *See* 2001 PA 57 (adding the 3/2 statute of limitations rule for actions seeking damages under MCL 450.1489(1)(f)).
14. *See* 2002 PA 686 (adding the 3/2 statute of limitations rule for actions seeking damages under MCL 450.4515(1)(e)).
15. Under Section 450.1489(1)(f) of the BCA and the corresponding Section 450.4515(1)(e) of the LLCA.
16. STATUTE OF LIMITATIONS, Black's Law Dictionary (11th ed. 2019).
17. STATUTE OF REPOSE, Black's Law Dictionary (11th ed. 2019).
18. *Frank v Linkner*, 500 Mich 133, 142, 894 NW2d 574, 580 (2017), citing *O'Brien v Hazelet & Erdal*, 410 Mich 1, 15, 299 NW2d 336 (1980).
19. *Frank, supra*, at 143, citing *Sills v Oakland Gen Hosp*, 220 Mich App 303, 308, 559 NW2d 348 (1996).
20. *Frank, supra*, at 142.
21. *Id.*
22. *Id.* at 143.
23. *Id.* at 145.
24. *Id.* at 146.
25. *Id.*, citing *Trentadue v Buckler Automatic Lawn Sprinkler Co*, 479 Mich 378, 389, 738 NW2d 664 (2007).
26. *Id.* at 147, citing *Trentadue*, which held that "courts may not employ an extrastatutory discovery rule to toll accrual…"
27. *Id.* at 147-148.
28. *Id.* at 153, citing *Moll v Abbott Labs*, 444 Mich 1, 12, 506 NW2d 816 (1993).
29. *Id.* at 151.
30. *Id.* at 152-153.
31. *Id.* at 153.
32. *Id.* at 154-155.
33. *Madugula, supra*, at 714-715 (holding that a section "...489 claim, in its entirety, must be tried before a court of equity," since a shareholder oppression claim would have been denominated equitable in nature at the time the 1963 Constitution was adopted).
34. LACHES, Black's Law Dictionary (11th ed. 2019).
35. *Lewis v Poel*, 376 Mich 167, 169, 136 NW2d 7, 8 (1965); *Kelley v Hoogerhyde*, 314 Mich 37, 22 NW2d 63 (1946); *Plasger v Leonard*, 316 Mich 174, 25 NW2d 156 (1946).
36. *Lothian v City of Detroit*, 414 Mich 160, 168, 324 NW2d 9, 14 (1982), quoting Walsh, Equity, § 102, p. 472.
37. *City of Jackson v Thompson-McCully Co, LLC*, 239 Mich App 482, 494, 608 NW2d 531, 538 (2000); *City of Troy v Papadelis* (On Remand), 226 Mich App 90, 97, 572 NW2d 246 (1997).
38. *Lothian, supra*, at 168; *Smith v Sprague*, 244 Mich 577, 222 NW 207 (1928); *Chamski v Wayne County Bd of Auditors*, 288 Mich 238, 284 NW 711 (1939); *Chesnow v Nadell*, 330 Mich 487, 47 NW2d 666 (1951).
39. *Lothian, supra*, at 168.
40. *Id.*, quoting *Sloan v Silberstein*, 2 Mich App 660, 676, 141 NW2d 332 (1966).
41. *Tenneco Inc v Amerisure Mut Ins Co*, 281 Mich App 429, 456, 761 NW2d 846, 863 (2008); *Lothian, supra*, at 165.
42. *Tenneco, supra*, at 456; *Eberhard v Harper-Grace Hosps*, 179 Mich App 24, 35, 445 NW2d 469, 474 (1989); *Lothian, supra*, at 165.
43. *Eberhard, supra*, at 35; *Arnold v Ellis*, 5 Mich App 101, 111, 145 NW2d 822 (1966).
44. *Lothian, supra*, at 170; *Tenneco, supra*, at 456; *Eberhard, supra*, at 36.
45. *Lothian, supr*a, at 170, 174.
46. MCL 600.5815.
47. *Tenneco, supra*, at 456, quoting *Eberhard, supra*, at 36.
48. *Tenneco*, 281 Mich App 429, 761 NW2d 846 (2008).
49. *City of Fraser*, 314 Mich App 79, 886 NW2d 730 (2016).
50. *Tenneco, supra*, at 457; *City of Fraser, supra*, at 102; *Eberhard, supra*, at 35-37; *Citizens Ins Co of America v Buck*, 216 Mich App 217, 228, 548 NW2d 680 (1996).
51. *City of Fraser, supra*, at 102, quoting *Michigan Educ Emps Mut Ins Co v Morris*, 460 Mich 180, 200, 596 NW2d 142 (1999).

52. *Tenneco, supra*, at 457, citing *Eberhard, supra*, at 35-36.

53. *Martin v Trott Law, PC*, 265 F Supp 3d 731, 742 (ED Mich, 2017), discussing *Tenneco*. The *Martin* court stated the United States District Court, Eastern District of Michigan and the United States Court of Appeals for the Sixth Circuit each has a strong presumption "against asserting a laches defense to shorten a statute of limitations." *Martin*, 265 F Supp 3d at 742, quoting *Operating Eng'rs Local 324 Health Care Plan v G & W Const Co*, 783 F3d 1045, 1054 (6th Cir 2015). *Martin* re-emphasizes that the *Tenneco* requirements must be met for a laches defense to bar a claim where an applicable statute of limitations period is running ("[f]or laches to apply, inexcusable delay in bringing suit must have resulted in prejudice.") *Martin*, 265 F Supp 3d at 742, quoting *Tenneco*, 281 Mich App at 457.

54. *See* note 10 *supra* and accompanying text.

55. *See* note 33 *supra*.

56. This seems unlikely. Although *Madugula* held that oppression actions are equitable in nature, the cause of action was created by statute and thus would not seem to be the type of "purely equitable" action to which laches alone would apply.

57. *Roy v Island & Fonda Lakes Ass'n*, No 315124 (Mich Ct App Nov 4, 2014) (unpublished). In *Roy*, plaintiff filed suit against a non-profit summer resort corporation of which he was a shareholder. He contested the validity of a road assessment on a second lot acquired by him, after defendant recorded a lien against that lot for failure to pay the assessment. Plaintiff challenged the validity of the corporate action approving the assessment, as well as corporate organization and other action. Although plaintiff did not plead a cause of action under BCA Section 489, the *Roy* Court, giving the plaintiff the "benefit of the doubt," concluded that his claim resembled an oppression action and thus was cognizable, and that his exclusive avenue for relief was under the BCA oppression provisions. The Court of Appeals barred most of plaintiff's claims by applying the doctrine of laches, citing the Lothian rule that "prejudice caused by some delay … primarily affects whether laches is appropriate." *Lothian, supra*, at 168. The Court noted that Plaintiff had owned his first lot for ten years prior to bringing his action, and could have brought his claims for infirmity in corporate organization and action during that period. In the interim, a material witness had died, and the defendant had expended funds and entered contracts in reliance on the validity of the actions. The Court thus found that plaintiff's delay prejudiced the corporation and justified the application of laches to bar the claims. Though the opinion in *Roy* was issued after *Madugula* was decided, the *Roy* Court did not mention the *Madugula* case or the Supreme Court's holding that all claims under Section 489 are equitable in nature.

58. *Lothian, supra*, at 168, quoting Walsh, Equity, § 102, p. 472.

59. *See* note 9 supra, §4.22 at 4-71.

60. *Estes, supra*, at 270.

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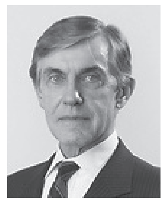

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Shareholders' Ability to Contractually Eliminate Oppression: The Uncertain Meaning of the Last Sentence of the Shareholder Oppression Statute

By Bruce W. Haffey and Michael K. Molitor

Section 489 of the Michigan Business Corporation Act permits a shareholder to sue the directors or those in control of a corporation for actions that are illegal, fraudulent, or "willfully unfair or oppressive." Subsection (3) defines this phrase but specifically excludes conduct or actions that are "permitted by an agreement, the articles of incorporation, the bylaws, or a consistently applied written corporate policy or procedure."[1] The LLC member oppression statute contains similar language.[2] Read literally, this language would exclude from the definition of oppression a great deal of conduct that courts have found to be oppressive. What, then, does this clause really mean?

Consider a closely held corporation with four equal shareholders who work full-time in the business and comprise the board of directors. The organizational documents authorize action by majority vote. There are no employment agreements or buy-sell agreements. If action were taken by majority vote over the objection of one of the shareholders, would that be oppression of the minority shareholder? The statutory language quoted above suggests that any action taken by the majority vote of the shareholders or board of our hypothetical corporation would, by definition, not constitute oppression. After all, that is how the shareholders designed the organizational structure of their business.

But should it matter what the action is or the circumstances in which it is taken? Consider several possibilities:

- Approving a loan from a commercial bank on fair market terms, as opposed to a loan from the majority shareholders on terms favorable to them;
- Hiring and firing unrelated employees and establishing the terms and conditions of their employment, compensation and benefits, as opposed to doing the same for the majority shareholders or their family members;
- Leasing premises owned by a third party on fair market terms, as opposed to leasing premises owned by the majority shareholders on terms favorable to them;
- Issuing shares of stock at fair market value, as opposed to issuing shares to the majority shareholders at less than fair market value to the exclusion of the minority shareholder; or
- Amending the articles of incorporation to add a "call" option by which the corporation may purchase shares from one or more shareholders at a fair market price, as opposed to a discounted price, or using the call option promptly to redeem the shares owned by a minority shareholder.

A reasonable person might find some of these actions to be willfully unfair and oppressive, regardless of whether taken by majority vote in compliance with the organizational documents of the entity and regardless of whether the action may be separately actionable for a breach of fiduciary duty. This may be particularly true where the action was designed to squeeze out the minority shareholder or to enrich the majority shareholders at the minority's expense. Nonetheless, all of these actions could be taken by majority vote, meaning that the literal language of Section 489(3) might exclude them from the definition of "willfully unfair or oppressive." How have courts in Michigan and other states treated these issues?

Michigan Case Law

A number of Michigan cases have found conduct to be oppressive, or have denied summary judgment motions arguing that conduct was not oppressive, notwithstanding the fact that the conduct was taken in compliance with the company's organizational documents.

The leading case on this issue is probably *Berger v Katz*,[3] in which plaintiff owned one-third, and defendants owned two-thirds, of the stock of IPAX Cleanogel, Inc. They also owned API, L.L.C., which leased space to IPAX. Shareholder relationships deteriorated when plaintiff moved to California and ceased active involvement in the company's day-to-day business. Defendants stopped paying distributions to plaintiff, but the parties subsequently reached an interim arrangement whereby monthly payments were resumed as advances of distributions of profits from IPAX and plaintiff's share of API's rental income, to be reconciled at year-end. Unable to reach a final agreement, defendants eventually ceased all payments to plaintiff, claiming that IPAX was unprofitable. Plaintiff countered that defendants had deliberately rendered IPAX unprofitable by increasing their own salaries and sued for, among other theories, shareholder oppression. The trial court found that defendants had oppressed plaintiff by eliminating his salary while giving themselves raises, terminating plaintiff's share of the API rental payments, "issuing a capital call when the corporation was doing fairly well, which diluted plaintiff's stock and shares and forced plaintiff to put his own money into the corporation,"[4] and engaging in certain other conduct intended to squeeze out plaintiff.

On appeal, one of defendants' arguments was that their conduct was not oppressive because it was permitted under IPEX's bylaws. The court rejected this argument, writing:

> Although the bylaws gave defendants the general authority to make business decisions such as setting salaries, issuing capital calls, or approving rental payments, that does not mean that defendants were permitted to act in a manner that was willfully unfair and oppressive to plaintiff, as a minority shareholder. The exception in MCL 450.1489(3) cannot be read as permitting willfully unfair and oppressive conduct under the guise of defendants' general authority to run and manage IPAX.[5]

In ruling that the language of MCL 450.1489(3) excluding from oppression action taken in compliance with a company's organizational documents did not apply to the specific action taken in this case, the court distinguished between general grants of management and decision-making authority and documents which specifically authorize the action in question.

A number of Michigan circuit courts have cited *Berger* in reaching similar results.[6] For example, in *DeYoung v Town & Country Elec*,[7] plaintiff, a minority shareholder of an S corporation, was fired after declining to agree to a discounted buyout of his shares. The company then stopped paying dividends, a change from its prior custom, resulting in the allocation of income to the minority shareholder but no distributions to him to pay the tax. The company also increased its capital expenditures substantially, which depleted funds that would have otherwise been available to pay dividends.

Plaintiff sued, alleging that the company's actions constituted oppression. Following a trial, the court found that the company's refusal to pay dividends after plaintiff was fired together with the increase in capital expenditures constituted oppression. The court noted the S corporation status of the defendant corporation for income tax purposes and the prior history of regular and significant dividends to enable the shareholders to pay their income tax obligations on their shares of the corporation's taxable income. The court rejected defendants' argument that the company's decision not to pay dividends was permitted under "an agreement, the articles of incorporation, the bylaws, or a consistently applied written corporate policy or procedure," and therefore excluded from oppression by the last sentence of Section 489. This decision was based on defendants' failure to identify "a consistently applied written corporate policy or procedure" dealing with the payment of dividends, as opposed to "the generic authority of a corporation." This suggests the court would apply the last sentence of Section 489 only to agreements, charter provisions, or written policies or procedures that specifically refer to the conduct at issue, rather than provisions granting general authority over decision-making.

In *Hammoud v Advent Home Med, Inc*,[8] plaintiff, a 40 percent shareholder and the

> Section 489 of the Michigan Business Corporation Act permits a shareholder to sue the directors or those in control of a corporation for actions that are illegal, fraudulent, or "willfully unfair or oppressive."

daughter of the majority shareholder, sued for oppression, among other theories, for the decision of the majority shareholder to withhold dividends and compensation. In an opinion denying cross-motions for partial summary disposition, the court considered defendant's argument that actions permitted by the corporation's bylaws could not serve as the basis of an oppression claim. Citing *Berger*, and noting that oppression lawsuits are inherently mixed questions of fact and law because the court must examine defendant's motives and intent, the court rejected defendant's argument, noting that it would not "foreclose that a series of events could not, together, constitute oppressive conduct without factual determinations on how and why everything occurred,"[9] even if they were permitted by a charter document.

In *Antakli v Antakli*,[10] plaintiff alleged oppression on the basis of being removed as President and CEO, having her compensation reduced, and being barred from the business premises. Defendants filed a motion for summary disposition on plaintiff's oppression claim. One of defendants' arguments was that plaintiff's claim was insufficient as a matter of law because her removal as an officer of the company was permitted by the company's bylaws. Citing *Berger*, the court rejected this argument, stating that it ignored plaintiff's "allegations that the otherwise authorized actions were done … in an oppressive way. In other words, Defendants cease their analysis at '[the company's] bylaws specifically permitted the Board of Directors to elect a new slate of officers.' But Defendants' flawed argument ignores that they could not do so in a willfully unfair and oppressive manner … ."[11]

These cases preclude reliance on the last sentence of Section 489 as an absolute defense in an oppression lawsuit if the articles, bylaws, shareholder agreement, policy or procedure do not specifically address the defendants' conduct at issue in the case. General grants of decision-making authority are not sufficient.

Moreover, courts have found that if the conduct alleged to be oppressive was included in organizational documents or agreements that the plaintiff approved or to which the plaintiff was a party, the last sentence of Section 489(c) could apply—at least if the language at issue was specific. For example, *Langrill v Diversified Fabricators, Inc.*[12] shows that a plaintiff may not be able to claim oppression based on conduct that complies with an agreement that he or she approved. In *Langrill*, plaintiff appealed from a summary disposition order in favor of defendants. The facts in *Langrill* are not entirely clear from the (unpublished) court of appeals opinion, but involve enforcement of a 1981 Stock Retirement Agreement to which plaintiff was a party to require him to sell his shares of stock to the corporation, a 1988 transfer of stock between the defendants which plaintiff claimed was invalid, and compensation payments to the defendants pursuant to compensation agreements approved by plaintiff but which plaintiff later claimed were excessive. Plaintiff also claimed to have been forced out of the company but introduced no such evidence. The court of appeals found that, because plaintiff had consented in writing to both the 1988 stock transfer and defendants' compensation agreements, he "now cannot complain in this matter … ."[13] The court also dismissed any argument that plaintiff had been forced to sign the agreements by reference to a 1995 proposed agreement that he refused to sign, indicating that his signing of the other agreements must have been voluntary. The court added that its conclusion that plaintiff's "willful consent to the agreements disposes of his oppression claims" was further supported by legislature's recent addition of Section 489's last sentence.

Dart v Cendrowski,[14] a 2016 opinion and order from Judge Potts of the Oakland County Circuit Court, involves a provision that was both specific and agreed to by the parties. In *Dart*, plaintiff, as a member of an LLC, was a party to an operating agreement that prohibited withdrawal without the consent of the manager and prohibited a withdrawal distribution unless approved by the manager. Plaintiff claimed that defendants' refusal to consent to her withdrawal and to pay her a fair withdrawal distribution was oppressive. However, the court granted summary disposition in favor of defendants on this claim, stating:

> … Plaintiff agreed to and executed the … Operating Agreement, which provides that no member is entitled to withdraw from the company without the written consent of the manager, and no member is entitled to a withdrawal distribution unless approved by the manager. In this case, the … Operating Agreement authorizes the conduct of Defendants that Plain-

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> tiff characterizes as willfully unfair and oppressive. … Further, the Court agrees with Defendants' position that Plaintiff has failed to identify any conduct by either Cendrowski or Carson that was illegal or fraudulent and/or in violation of the … Operating Agreement.[15]

Other States

Statutes and cases from other states support the principle that conduct authorized in organizational documents or agreements to which the plaintiff is a party will ordinarily be found not to be oppressive if the authorization is specific and not merely a general grant of authority. For example, Louisiana's shareholder oppression statute provides in part that "[c]onduct that is consistent with the good faith performance of an agreement among all shareholders is presumed not to be oppressive."[16] This statutory presumption appears quite strong; the comments to the statute note that conduct under a unanimously approved agreement should be considered oppressive only if (1) it would be considered oppressive in the absence of the statutory presumption and (2) circumstances "have changed so profoundly" since the agreement that the parties "could not have intended to approve as fair, in context, the conduct being challenged as oppressive."[17]

In Minnesota, the statute (which uses the phrase "unfairly prejudicial" rather than "oppressive") provides that "any written agreements, including employment agreements and buy-sell agreements … are presumed to reflect the parties' reasonable expectations concerning matters dealt with in the agreements."[18] *Gunderson v Alliance of Computer Prof'ls, Inc*,[19] involved a shareholder buy-sell agreement under which a shareholder could be "removed" (that is, have his shares forcibly redeemed) upon a 75 percent vote by the other shareholders. Due to various disagreements, plaintiff in the case was fired as an employee and then the other shareholders voted to remove him as a shareholder. The buy-out price specified in the agreement was $2,300, but plaintiff argued that his shares were worth more than $1 million. The court found that enforcing the buy-sell agreement as written was not unfairly prejudicial under the Minnesota statute, given that plaintiff had "spearheaded it and actively participated in drafting it. In fact, he proposed the very provision that authorized his involuntary removal, and urged the board to adopt it."[20] As a result, it reflected his reasonable expectations "in the absence of evidence that the controlling shareholders used the buy-sell agreement manipulatively to force the sale of [plaintiff's] shares … ."[21]

The North Dakota statute contains language that is nearly identical to the Minnesota statute quoted above, that is, establishing a presumption that written agreements reflect the parties' reasonable expectations concerning the subject matter of the agreements.[22] In *Kortum v Johnson*,[23] a minority shareholder sued after she was fired from her job as a doctor. The trial court dismissed the lawsuit because plaintiff had signed a buy-sell agreement providing for the mandatory repurchase of her shares for $1 if she was terminated for any reason. While the North Dakota Supreme Court remanded the case for a determination of whether the agreement did reflect the parties' reasonable expectations, it observed that:

> In the absence of evidence that controlling shareholders have manipulated an agreement to force the sale of a shareholder's shares, a close corporation shareholder's claim that the shareholder's reasonable expectations were frustrated by the enforcement of a shareholder agreement will fail if the shareholder agreement was made at arm's length, the shareholders had a legitimate business reason for agreeing to the provision at issue, and the shareholders all assumed the same risk. Disparity between an agreed-on share price and current market value alone is not sufficient to invalidate a transfer restriction.[24]

In the absence of a statute, courts often enforce shareholder agreements as written even if they seem unfair in their application. For example, in the New York case of *Gallagher v Lambert*,[25] an employee-shareholder had an agreement with a corporation that provided that upon "voluntary resignation or other termination" before a certain date, he would have to resell his shares to the company at book value; if his employment was terminated later, he would be entitled to a higher value. Plaintiff was fired three weeks before the relevant date and sued for breach of fiduciary duty, arguing in part that the timing of his termination was solely motived so that the corporation could pay him less money for his shares. (He did not sue under

In the absence of a statute, courts often enforce shareholder agreements as written even if they seem unfair in their application.

the New York oppression statute.) The court ruled against plaintiff, writing in part that "[t]hese agreements define the scope of the relevant fiduciary duty and supply certainty of obligation to each side. They should not be undone simply upon an allegation of unfairness. This would destroy their very purpose, which is to provide a certain formula by which to value stock in the future."[26]

Summary

Michigan courts do not hold the exclusionary language of the last sentence of Section 489 of the Michigan Business Corporation Act to be absolute, consistent with courts in other states construing similar statutory language. Many courts have held or ruled that oppression may be found notwithstanding the fact that the challenged action was taken in compliance with a company's organizational documents or agreements.

Greater specificity has the added benefit of increasing the likelihood that the parties will anticipate issues and draft provisions to address them in a mutually satisfactory way.

One distinguishing factor in the cases is that action taken in compliance with general grants of decision-making authority may still be found to be oppressive[27] whereas courts are less likely to find oppression where action is taken in compliance with specific contractual terms. As discussed above, several cases in Michigan rejected the argument that conduct was not oppressive because the bylaws gave the majority shareholders or directors the general authority to manage the business or to take actions by a majority vote. However, conduct taken in accordance with specific provisions, such as those contained in buy-sell agreements or relating to the terms of stock transactions or those relating to termination of employment, seem much less likely to be found to be oppressive. This seems particularly so if the provision at issue is part of an LLC operating agreement, shareholder agreement, or employment agreement that was negotiated and specifically relates to the conduct, rather than merely permitting it to occur by implication.[28]

But perhaps not all "specific" provisions will provide a defense to an oppression claim. Although not directly addressed by the cases discussed in this article, unlike specific contractual terms negotiated and agreed upon by the parties, it seems less likely that specific terms added to articles of incorporation or bylaws by the majority vote of shareholders over the objections of a minority shareholder would avoid an oppression claim. A court might conclude that the oppressive action was taken first pursuant to the general grant of authority to adopt or amend the articles or bylaws by majority vote.

Conclusion

When engaged by a client in connection with establishing the organizational structure of a business and related documents, it is useful for the parties and their respective counsel to engage in a detailed discussion not only of general decision-making authority but also the identification of specific decisions which might require a supermajority vote, the circumstances in which a shareholder might be terminated as an employee and the consequences of termination, and buy-sell terms including triggering events, valuation, and payment terms. These discussions might then be embodied in the recitals to contracts or in separate memos or notes. The specific discussion of such issues will help to avoid later claims that action was taken merely pursuant to general grants of authority. Greater specificity has the added benefit of increasing the likelihood that the parties will anticipate issues and draft provisions to address them in a mutually satisfactory way.

When issues arise, as they often do, the parties should keep in mind that actions taken pursuant to general grants of authority, such as those relating to shareholder voting and director decision-making, will not necessarily avoid a finding of oppression. For example, a change in dividend policy could be oppressive even if adopted by a majority vote pursuant to the company's charter documents. On the other hand, courts appear less likely to find oppression where action is taken in reliance on specific terms related to the termination of employment or the purchase or sale of shares. Additional case law will continue to clarify the line between specific action and general grants of authority and will help parties and practitioners to better draft contracts and documents to avoid oppression claims.

NOTES

1. MCL 450.1489(3). This sentence was added to Section 489 in 2001. 57 P.A. 2001.
2. MCL 450.4515(2).
3. 2011 Mich App LEXIS 1408 (July 28, 2011) (unreported).
4. *Id.* at *12.
5. *Id.* at *12-*13.
6. *Berger* was cited with approval by *Zaske v Keen*, 2018 Mich Cir LEXIS 1911 (Oakland Cty Cir Ct, Aug 1,

2018) at *2-3; *Ambulatory Anesthesia Assoc, PC v Borrego*, No 15-146034-CZ (Oakland Cty Cir Ct, Jan 20, 2016) at p 10 n 4; and *Cavaliere v DRSN Assoc*, 2014 Mich Cir LEXIS 304 at *6 (Oakland Cty Cir Ct, May 14, 2014) at p 4 ("although the Operating Agreement may allow certain actions, said actions cannot be done in a willfully unfair and oppressive manner."). *See also Kojaian v Kojaian*, 2018 Mich Cir LEXIS 3590 (Oakland Cty Cir Ct, Mar 26, 2018) at *16.

7. 2016 Mich Cir LEXIS 189 (Ottawa Cty Cir Ct, Apr 25, 2016).

8. 2018 Mich Cir LEXIS 938 (Oakland Cty Cir Ct, May 1, 2018).

9. *Id.* at *12.

10. 2014 Mich Cir LEXIS 302 (Oakland Cty Cir Ct, Jan 22, 2014). For subsequent history in this case, see 2015 Mich Cir LEXIS 292 (Oakland Cty Cir Ct, Jan 14, 2015).

11. 2014 Mich Cir LEXIS 302 at *6.

12. Nos 225001, 225002 (Mich Ct App, June 25, 2002) (unpublished).

13. *Id.* at *1.

14. 2016 Mich. Cir. LEXIS 57 (Oakland Cty Cir Ct, Feb 29, 2016).

15. *Id.* at *16.

16. La Rev Stat § 12:1-1435(B).

17. Comments—2014 Revision, paragraph (g).

18. Minn Stat Ann § 302A.751(3)(a). Note that Michigan rejected the "reasonable expectations" test for shareholder oppression in *Franchino v Franchino*, 263 Mich App 172, 687 NW2d 620 (2004).

19. 628 NW2d 173 (Minn Ct App 2001).

20. *Id* at 186.

21. *Id. See also Regan v Natural Res Grp, Inc*, 345 F Supp 2d 1000 (D Minn 2004) (no reasonable jury could have found that plaintiff had a reasonable expectation of continued employment when the shareholder control agreement, which plaintiff executed as both chief executive officer and shareholder, clearly explained that he could be terminated without cause).

22. ND Cent Code § 10-19.1-115(5). An Illinois statute provides that "[i]n considering whether equity exists to approve any settlement, the court may take into consideration the reasonable expectations of the shareholders as set forth in subsection (d), including any existing agreement among the shareholders." 805 Ill Con Stat § 5/12.56.

23. 755 NW2d 432 (ND 2008).

24. *Id.* at 445 (citations omitted). On remand, the trial court determined that the buy-sell agreement reflected the parties' expectations and that, therefore, plaintiff did not have a reasonable expectation of continued employment. The North Dakota Supreme Court affirmed. *Kortum v Johnson*, 786 NW2d 702, 705 (ND 2010).

25. 549 NE2d 136 (NY 1989).

26. *Id.* at 138. *See also Evangelista v Holland*, 537 NE2d 589, 592 (Mass Ct App 1989) ("Questions of good faith and loyalty do not arise when all the stockholders in advance enter into an agreement for the purchase of stock of a withdrawing or deceased stockholder."); *Blank v Chemsford Ob/Gyn, PC*, 649 NE2d 1102, 1105 (Mass 1995) ("we are faced with a termination without cause on proper notice, in accordance with the plaintiff's employment contract freely and mutually agreed to at the outset of his employment. The plaintiff received all that he had bargained for, i.e., the book value of his stock and six-months' notice of his termination."). *But see Jensen v Christensen & Lee Ins, Inc*, 460 NW2d 441 (Wis Ct App 1990) (reversing dismissal of fiduciary duty case when shareholder-employee argued that he had been fired early so that the corporation wouldn't have to pay a higher price for his shares upon his retirement, even though defendants argued that their actions were permitted by the agreement); *Jordan v Duff & Phelps*, 815 F2d 429 (7th Cir 1987) (pending merger negotiations were a material fact that should have been disclosed before company repurchased plaintiff's shares at book value pursuant to an agreement).

27. At least one court in another state has rejected the argument that something that is permitted under general provisions in a company's charter documents cannot be oppressive. *Bone v Coyle Mech Supply, Inc*, 2017 WL 2403268 (Ill Ct App, June 1, 2017) (unreported) at *11 ("even where corporate formalities are observed, the payment of a high amount of compensation to corporate officers, while refusing to pay dividends to benefit minority shareholders, can be considered oppressive conduct … .") (citation omitted), *leave denied*, 93 NE3d 1063 (Ill 2017).

28. *See Goldberg v First Holding Mgmt Co*, No 325960 at *5 (Mich Ct App June 21, 2016) (unpublished) (transfer of property by an LLC was not oppressive to minority member when the sale took place upon approval of the holders of a majority of the LLC interests, as permitted by the operating agreement, and was sold for greater than its fair market value); *Karczewski v Market Ctr Title Co*, LLC, 2014 Mich Cir LEXIS 263 (Kent Cty Cir Ct, Aug 25, 2014) at *11 (no oppression when LLC manager repurchased members' units in an LLC pursuant to the "unambiguous language" of the LLC's operating agreement that allowed the manager to do so when members voluntarily left employment with a related entity). *See also Wisner v SB Indiana LLC*, Nos 328867, 333045 at *5 (Mich Ct App Feb 9, 2017) (unpublished) ("There was no [member] oppression if Hardy's actions were permitted under the operating agreements."), *leave denied*, 501 Mich 879 (2017).

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Restoring Balance to the MBCA: Shareholder Oppression and Derivative Actions

By Daniel D. Quick

Introduction

In the world of shareholder litigation under Michigan law, there is oppression and everything else. Oppression actions are attractive because they offer the minority shareholder what it otherwise lacks—power. For most plaintiffs, this involves the power to possibly force the majority to buy its shares, either as a result of settlement or verdict. It also gives the power to sue individuals, take expansive discovery, and second-guess their management decisions, usually without risk of an early dispositive motion.

The traditional cause of action by a shareholder for breach of fiduciary duty, directly or derivatively, has been left in the proverbial dust. For a century, Michigan law required that a shareholder asserting shareholder rights could sue directly, but that a claim that would constitute harm to the corporation must first be offered to the company to decide whether the shareholder should be permitted to proceed derivatively. The oppression statute, as applied, has provided an end-run around these now statutory provisions. As it has developed, oppression has all but rendered obsolete this traditional rubric for standing in shareholder claims.

The oppression cause of action has ascended without much substantive input from the Michigan Supreme Court. The history of the oppression cause of action, and its place within both the common law and the Michigan Business Corporation Act (MBCA), suggests that the Supreme Court may not endorse the approach generally adopted by lower courts. As seen in other states, there is a path to upholding claims for oppression but still requiring derivative claims to comply with the statutory provisions. Restoring balance would serve the apparent intent of the legislature, provide greater certainty, and harmonize the law.

Evolution of a Remedy for Oppression in Michigan

Before 1972, the courts grappled with shareholder oppression under the common law and inherent equitable powers. Representative is *Miner v Belle Isle Ice Co.*[1] Although, like in many early cases, the relief sought was dissolution, the Court reinforced that its equitable powers were broader than that:

> There is no doubt of the power of a court of equity, in case of fraud, abuse of trust, or misappropriation of corporation funds, at the instance of a single stockholder, to grant relief, and compel a restitution; and where the holders of the majority of the stock control the directorate, and are themselves the wrongdoers, without any showing that the directors have been requested, or the corporation has refused, to act.

While the early courts exercised equity jurisdiction to intervene, when to do so, and pursuant to which norms, remained opaque. So, while as later noted by the Supreme Court in *Madugula v Taub*, "courts of equity have long heard shareholders' direct or derivative claims against the majority shareholders or directors for fraud, illegality, or other oppressive conduct" (citing to ten pre-1933 opinions of the Supreme Court[2]), those early decisions offered little by way of clear guidance as to standards.[3]

Early caselaw also saw the evolution of two other significant corporate doctrines—the business judgment rule and the derivative action. The business judgment rule was well-established conceptually: courts generally will not substitute their judgment for that of directors concerning their business judgment in the absence of evidence that they acted fraudulently or in bad faith.[4] The business judgment rule also contributed to a procedural hurdle for shareholder plaintiffs: the derivative action. Styled as a matter of standing, the courts reasoned that if the harm done was to the corporation, by which the plaintiff only suffered secondarily (or derivatively), then the cause of action belonged to the corporation and it, in the first instance, should be able to decide whether to pursue the claim or not. This pre-suit demand requirement for derivative actions was designed to allow this initial decision-making by the corporation and limit judicial interference because "[w]hether to sue or not to sue is ordinarily a matter for the business judgment of directors, just as is a decision that the corporation will make bricks instead of bottles."[5] Early on, the state adopted what became known as demand futility to excuse antecedent demand and an opportunity to act where those who would make this decision were also the accused wrongdoers.[6] Over time, that doctrine evolved with various complexities governing when demand was excused, whether special litigation committees could be used, and standards for evaluating the decision of an authorized reviewing person or entity.[7]

Michigan adopted a statute on the issue of oppression in 1972, MCL 450.1825(1), which provided:

> The circuit court of the county in which the registered office of the corporation is located may adjudge the dissolution of, and liquidate the assets and business of, a corporation, in an action filed by a shareholder when it is established that the acts of the directors or those in control of the corporation *are illegal, fraudulent or willfully unfair and oppressive to the corporation or to such shareholder.* [Emphasis added]

The available legislative history reports that this provision and its use of the word "oppressive" was borrowed from a South Carolina statute, although the word had been used in past Michigan cases:

> The purpose of the provision is to provide a remedy for oppressive acts of majority shareholders or directors. Dissolution as an available remedy, as provided in subsection (a) is widely provided in the United States: e.q., MBCA § 97(a)(2) and (a) (4) , allowing dissolution where "the acts of the directors or those in control of the corporation are illegal, oppressive or fraudulent" and also when "the corporate assets are being misapplied or wasted". The problem with this approach is that it is unduly limited: dissolution may be too drastic a remedy. The alternative approaches of (b) are derived from section 210 of the English Companies Act and section 186 of the Uniform Australian Companies Act. Some favorable experience has developed in England and the Commonwealth countries with these provisions. See Afterman, Statutory Protection for Oppressed Minority Shareholders: A Model for Reform, 55 Va.L.Rev. 1043 (1969). The South Carolina statute, which is an improvement, has had no litigation to date.[8]

At the same time, the Legislature adopted MCL 450.1103, which notes that the act should be construed to, *inter alia*, "give special recognition to the legitimate needs of close corporations," although the act did not define that term nor go as far as some states which adopted specific provisions for close corporations.

Despite this new statute, little happened with minority shareholder oppression cases for several years.[9] Aggrieved shareholders continued to largely rely upon either direct or derivative claims for breach of duty claims.

The 1989 Revision to the MBCA

By the 1980s, courts were beginning to recognize the derivative action was subject to abuse and a threat to established business judgment rule deference. As the U.S. Supreme Court noted, "derivative actions brought by minority shareholders could, if unrestrained, undermine the basic principle of corporate governance that the decisions of a corporation … should be made by the board of directors … ."[10] Moreover, shareholder claims were recognized as often being brought for harassment purposes, and/or "more with a view to obtaining a settlement resulting in fees to the plaintiff's attorney than to righting a wrong to the corporation (the so-called 'strike suit')."[11] At some level, legal theory was having to account for the way in which cases were litigated in practice—they were expensive, personal and a distraction from the main purpose of the business. These real-world considerations about how civil justice worked in this country started driving substantive differences in the law. Cutting the other direction, courts around the country were increasingly noting the plight of the oppressed shareholder, and various jurisdictions were crafting novel approaches (judicially and legislatively) to try and address these issues.[12]

In 1989, the Michigan legislature adopted a formal oppression statute, MCL 450.1489, by moving the existing statute from the dis-

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solution section of the act. At the very same time, it overhauled the MBCA's provisions concerning derivative actions. The new provisions mandated written demand in all cases (thus abolishing demand futility), clarified how a business could investigate a derivative demand and, if it elected not to pursue the matter, cause the shareholder action to be dismissed.[13] These derivative provisions were not limited to "close corporations" but applied equally to all.

There is no known legislative history that discusses both the updated oppression statute and the new derivative procedures. In *Baks v Maroun*,[14] the majority of a Court of Appeals panel found that the oppression statute did not provide a shareholder with independent standing to assert a claim, in part based upon the established direct vs. derivative dichotomy under Michigan law. Judge Hoekstra dissented, which opinion was subsequently adopted by the Court of Appeals in *Estes v Idea Eng'g & Fabricating, Inc*, 250 Mich App 270 (2002). In concluding that the oppression statute provided a new, direct cause of action, Judge Hoekstra mainly emphasized differences between that statute and the traditional fiduciary duty statute, in terms of parties, venue, remedies and the like. He also concluded the statutes had different purposes; the oppression statute was "intended to provide shareholders of closely held corporations special relief from ongoing oppression," *id.* at 504, because shareholders in publicly held corporations can "escape an oppressive situation by dispensing with his or her shares of ownership in the public arena" while shareholders in a closely held corporation cannot, *id.* at 503.

There is no known legislative history that discusses both the updated oppression statute and the new derivative procedures.

While Judge Hoekstra did not need to answer the question of how the derivative action and the oppression action should coexist, his opinion in *Baks* is far from thorough on this point. Under his apparent logic, the oppression statute was an exception to the rest of Michigan law for "close corporations," even though, for example, the derivative demand statute made no exceptions for "close corporations." Moreover, Judge Hoekstra erred in equating "close corporations" with "non-publically traded" corporations. Some of the largest corporations in the world are not publically traded and jurisdictions which have legislatively defined "close corporation" have used a much more narrow definition.[15] Lastly, Judge Hoekstra did not discuss in detail the oppression statute's apparent overlap with derivative actions. He did note: "A § 489 suit seeks to redress oppression that injures either the corporation or the shareholder, whereas a § 541 suit seeks to redress wrongs to the corporation," but did so by citing a case[16] that clearly turned upon oppression and did not attempt to delineate between direct and derivative claims.

The Ascent Of The Oppression Claim

In 2001, the Legislature amended MCL 450.1489(3) to define "willfully unfair and oppressive conduct" as "a continuing course of conduct or a significant action or series of actions that substantially interferes with the interests of the shareholder as a shareholder." The brakes were momentarily applied when the Court of Appeals held that the phrase "as a shareholder" placed a limitation on the rights that were protected: "Shareholders rights are typically considered to include voting at shareholder's meetings, electing directors, adopting bylaws, amending charters, examining the corporate books, and receiving corporate dividends."[17] At issue in *Franchino* was whether termination of employment could give rise to a claim of oppression. The court recognized that in close corporations, shareholders often enjoyed the benefits of their equity through employment, and noted that several states had adopted express statutory provisions to address such claims (ironically, including South Carolina, the state from whence the oppression statute originally came). So when the court held that such rights simply could not be read in to the statute, the legislature revised it in 2006 to add: "Willfully unfair and oppressive conduct may include the termination of employment or limitations on employment benefits to the extent that the actions interfere with distributions or other shareholder interests disproportionately as to the affected shareholder."

The meaning of this language is unclear. If a shareholder has employment, and thus enjoys her equity through that compensation, is employment now a vested right, all other things being equal? One might argue for this interpretation (if taken away disproportionately) but, pursuant to statute, only if the termination "interfere[s] with distributions or other shareholder interests." How does the termination of employment "interfere with distributions"? It certainly might be unfair to terminate a shareholder who had traditionally taken salary rather than a dividend as the court noted in *Franchino*, but that does not necessarily mean that the statute provides a remedy. A shareholder interest must still be implicated; the statute does not simply allow (as erroneously stated in a subsequent unpublished opinion) "a minority shareholder to claim willfully unfair and oppressive conduct as a result of reductions in salary or other employment benefits."[18] Such logic smacks of the "reasonable expectations" test for oppression, but that standard was expressly rejected in *Franchino*. But courts have not worried so much about technical readings of the statute and instead have applied its apparent intent designed to reverse *Franchino*.

The result of these expansive readings of the oppression statute since 2006 has been dramatic: there has been a surge in oppression cases, while the traditional law governing direct and derivative actions has withered.[19] Then, in *Franks v Franks*, the Court of Appeals took head on the issue of the business judgment rule. After being held liable for oppression, appellants argued "that their decision to retain cash and refrain from paying out dividends cannot serve as evidence of shareholder oppression because their decisions are protected by the business judgment rule." The court noted Michigan's historic adoption of the rule, but held that the oppression statute negated the rule. Here the court engaged in semantics by holding that "plaintiffs did not ask the trial court to review the soundness of defendants' business decisions," but rather determine whether those acts were oppressive. That aside, the court reasoned that because plaintiff proved that defendants' actions were taken to oppress plaintiff's interests, those acts were, *a fortiori,* not taken for legitimate business purposes and thus were not entitled to business judgment rule protection.

But What of Derivative Actions?

The logic employed in *Franks* begs the question: what about the traditional dichotomy between direct and derivative causes of action? While the business judgment rule as a direct 'shield' may have been dispensed with in *Franks*, the same rule contributed to the substantive and statutory law governing derivative standing. The derivative statutes do not contain any express exceptions for close corporations, and in fact, they have been held to apply to all companies, even those with one shareholder.[20] Is there a way to put these two statutory remedies and bundles of rights together in a way that is coherent?

A possible answer arises from recognizing that shareholder rights under the oppression statute are the very same rights that are allowed as direct claims in the traditional direct vs. derivative caselaw. Violation of the very same shareholder rights which *Franchino* recognized ("voting at shareholder's meetings, electing directors, adopting bylaws, amending charters, examining the corporate books, and receiving corporate dividends") as viable under the oppression statute are the same sorts of claims which could always have been raised as a direct action under pre-oppression caselaw. For example, a claim to compel a dividend was always recognized as a direct claim.[21]

So if the same set of claims constitute both shareholder "interests" under the oppression statute and would traditionally give rise to a direct cause of action by a shareholder, can one argue that those claims which were traditionally only recognized as derivative similarly cannot be asserted as a shareholder interest under the oppression statute? As recently noted by the Court of Appeals, "While corporate directors and officers owe fiduciary duties to the shareholders, 'a suit to enforce corporate rights or to redress or prevent injury to the corporation, whether arising out of contract or tort, must be brought in the name of the corporation and not that of a stockholder, officer, or employee.'"[22] So, since a derivative claim arises not from the interests of a shareholder as a shareholder, but rather from duty owed to the corporation, anything that was traditionally a derivative claim should not constitute a shareholder oppression claim.

It is important to note that the Supreme Court has never weighed in on these issues—either how strictly the statutory language should be construed or if the oppression statute and derivative statutes are to be given equal weight and read *in pari materia.* But some support can be found in the one meaningful opinion that has been delivered. In *Madagula*, the court determined that the oppression cause of action sounded in equity and therefore did not give rise to the right to a jury trial. In reaching its conclusion, the Court opined:

> A § 489 claim allows a shareholder to bring suit against the directors or those

In *Madagula*, the court determined that the oppression cause of action sounded in equity and therefore did not give rise to the right to a jury trial.

The derivative action statutes do not in themselves constitute a cause of action; they merely specify conditions before a plaintiff may assert a derivative claim.

> in control of the corporation for fraud, illegality, or oppressive conduct. Shareholders have long been able to bring a similar claim for fraud, illegality, abuses of trust, and other oppressive conduct on the part of those in control of the corporation *through a shareholder derivative action*. Whereas a shareholder in a derivative action sues on behalf of the corporation, a shareholder bringing a § 489 claim may sue the directors directly or derivatively—i.e., on his or her own behalf or on behalf of the corporation. However, even when a shareholder brings a claim on his or her own behalf under § 489, the claim is often derivative in nature because the remedies sought affect the corporation. [Emphasis added.]

The emphasized portion of the court's statement is not technically correct—an action for fraud, illegality and the like would have been a *direct* action if affecting the plaintiff's shareholder rights, or a derivative action if seeking to redress a harm to the corporation. While the court was not focused on the issue of defining the parameters and overlap of oppression and derivative claims, this passage focusses on the language in the oppression statute that provides within the cause of action suit for acts that are fraudulent, illegal or oppressive *to the corporation*. According to *Madagula*, this statutory language means that a shareholder may sue "derivatively" under the oppression statute. If so, why wouldn't the express statutory provisions governing derivative actions apply?

If and when the Supreme Court takes up this issue, potentially instructive is the course of shareholder oppression in Texas. In 1988, the Texas Court of Appeals held in *Davis v Sheerin* that minority shareholders in close corporations are entitled to a buy-out of their shares if they are "oppressed" by the majority shareholders.[23] The *Davis* court acknowledged that minority shareholders in close corporations are particularly vulnerable to oppression, as they cannot freely exit an enterprise in the same manner as a member of a partnership or a shareholder of a public corporation.[24] As noted by one commentator, "The test set out in *Davis*—which has rightly been described as 'seminal'—became the prevailing approach in Texas, influenced caselaw in a number of other states, and earned a prime place in black-letter corporations law."[25]

In 2014, the Texas Supreme Court flatly overruled *Davis* in *Ritchie v Rupe*.[26] With no statutory definition, the court considered the meaning of the word "oppressive" in the statute ("that the acts of the directors or those in control of the corporation are illegal, oppressive or fraudulent"). In noted that the statute targets those in control of the corporation, that those persons owe traditional fiduciary duties to the corporation, but that those duties also include the business judgment rule. In that sense, the courts in *Ritchie* and *Franks* reached the same conclusion: one who commits oppression must, by necessity, also be acting in a way unprotected by the business judgment rule. But the *Ritchie* court went further. While attempting to define "oppressive," the court held that actions that are "oppressive" under the statute ordinarily will not give rise to derivative suits: "shareholders may not use a claim under the oppression statute as an end-run around the legislature's detailed rules and procedures for derivative actions."[27]

Much can and has been said about *Ritchie* both as to its impact on Texas law and more generally how it sought to reconcile and balance competing interests.[28] But that does not undermine consideration as to whether part of the balancing adopted in *Ritchie* has merit if applied to the MBCA, given that the MBCA provides for prerequisites for derivative actions. Should the oppression statute be construed such that it permits (in the words of the Texas court) an "end-run around the Legislature's detailed rules and procedures for derivative actions" by allowing a direct cause of action while ignoring those prerequisites?

When faced with derivative claims asserted as oppression claims, courts applying Michigan law have generally allowed them to proceed, usually by noting that since a cause of action under MCL 450.1489 is direct, per *Estes,* that plaintiff has standing to assert what would otherwise be a derivative claim. This was the ruling in *Lozowski v Benedict*,[29] where plaintiffs alleged that "defendants funneled corporate funds to other corporations in which they held interests." Plaintiff maintained that "because he and defendants were the only three shareholders and defendants stood to benefit from their own alleged misconduct, he suffered an injury that the remaining shareholders did not" and thus stated a cause of action for oppression. Notably, there was no dispute that these claims were all derivative claims, and the Court of Appeals affirmed dismissal of direct claims for breach of contract and breach of fiduciary duty. Regardless, the court held that plaintiff had standing under MCL 450.1489, although there was no substantive analysis of the claim.[30] In *Bromley*, the court relied largely on *Lozowski* but also noted the language in MCL 450.1489 that permits a cause of action for oppressive acts "to the corporation." The court did not take the next step and consider how an oppressive act "to the corporation" can (per the statutory definition of that term) be based upon interference with the "interests of a shareholder as a shareholder" nor expressly address the question of whether the statutory prerequisites to a derivative claim should apply even if asserted under the oppression statute.

The interests of a shareholder asserting a direct claim versus a derivative claim are fundamentally different. A plaintiff suing for oppression to herself seeks a personal recovery to vindicate infringement of a shareholder right. A plaintiff suing derivatively seeks to remedy a harm done to the corporation and seeks a recovery to the corporation.[31] This has always been so even when plaintiff would stand to benefit, indirectly, by the company's return of funds. For example, a claim of excess compensation is a derivative claim, even when the person taking the excess compensation is a majority shareholder and the return of that compensation would flow back to the corporate coffers and thus provide additional funds which could then be distributed to shareholders as profits.[32]

Would requiring a plaintiff who is asserting a derivative claim *qua* oppression claim to comply with MCL 450.1492a *et seq* conflict with the language of MCL 450.1489 which permits a shareholder to assert a claim for oppression "to the corporation"? In the absence of a statute, such claims would be analyzed on their substance—not on their characterization in the pleading—as either direct or derivative.[33] One federal court, applying Delaware law, held that whether an oppression claim is direct or derivative depends upon the nature of the claim: "The relevant question in the analysis … is: Can the Plaintiffs prove a claim of oppression without showing harm to" the company?[34]

The derivative action statutes do not in themselves constitute a cause of action; they merely specify conditions before a plaintiff may assert a derivative claim. Derivative claims are typically breach of fiduciary duty, fraud and the like. The fact that a plaintiff has a new cause of action—oppression—does not conflict with also enforcing the statutory derivative prerequisites. And the Court of Appeals has found that the clear language of MCL 450.1493a requires a demand for all derivative claims, without exception.[35]

It should not be an answer that because MCL 450.1489 creates a statutory cause of action in favor of a shareholder that therefore what would otherwise be a derivative claim becomes a direct claim free of the derivative claim prerequisites. The general rule that harm to the company must be sought via derivative claim "is inapplicable where the individual shows a violation of a duty owed directly to him," but "[t]his exception does not arise … merely because the acts complained of resulted in damage both to the corporation and to the individual, but is limited to cases where the wrong done amounts to a breach of duty owed to the individual personally."[36] This returns us to the heart of the matter: is it correct to view MCL 450.1489 as creating a legislative "end-run" around derivative claims by creating a new, statutory, direct "duty" that, within the traditional direct vs. derivative rubric, means that a direct claim is proper? The fact that the derivative procedures were adopted at the very same time as the oppression statute—without any express exception for oppression claims—suggests the statutes must be read to together, rather than read such that oppression nullifies all derivative procedures.

At least one federal court applying Michigan law has ruled that claims seeking recovery for oppression which address harms to the company must be dismissed because they in fact state derivative claims.[37] The Michigan Court of Appeals appears to have done the same thing in *Thomas v Costa,*[38] when it held that direct claims (including a statutory oppression claim) failed because the underlying claims suggested a harm to all shareholders (except the alleged wrongdoer, Hipple) rather than *just* plaintiff:

> As far as we can see, the allegations of fraud, misappropriation, malpractice, misrepresentation, civil conspiracy, conversion, and unjust enrichment noted in the first amended complaint affected all the shareholders, except for Hipple, equally. The facts of this case as related in the first amended complaint are, therefore, distinguishable from the facts of cases in which a

Thirty-one years after adoption of updated derivative standing statutes and a revised oppression statute, how those claims fit together remains to be resolved.

particular set of circumstances affect a single shareholder differently than all other shareholders, thereby justifying an individual claim.

Conclusion

Thirty-one years after adoption of updated derivative standing statutes and a revised oppression statute, how those claims fit together remains to be resolved. The discussion above suggests that strict adherence to statutory language and reading the oppression and derivative standing statutes *in pari material* may restore balance which the legislature seemingly envisioned in 1989 and which might ameliorate some of the abuses of the oppression cause of action.

NOTES

1. *Miner v Belle Isle Ice Co*, 93 Mich 97, 112, 53 NW 218, 223 (1892).

2. *Madugula v Taub*, 496 Mich 685, 709 & n 63, 853 NW2d 75 (2014). Of the ten cases, most were purely derivative actions (seeking recovery to the corporation) and the few that sought a recovery by the plaintiff usually involved defunct companies where the plaintiff was attempting to recover his investment under a theory that the defendant ran the company in to the ground. This is markedly different from the relief usually sought in modern oppression actions.

3. Even as late as the 1950s, our Supreme Court cited much older cases and endorsed flowery but difficult to discern 'standards.' See, e.g., *Levant v Kowal*, 350 Mich 232, 86 NW2d 336 (1957).

4. *Franks v Franks*, 330 Mich App 69, 944 NW2d 388, 404 (2019).

5. *In re Consumers Power Co*, 132 FRD 455, 465 (ED Mich 1990) (internal quotation omitted); *see also Kamen v Kemper Fin Servs, Inc*, 500 US 90, 96 (1991) ("The purpose of the demand requirement is to 'afford the directors an opportunity to exercise their reasonable business judgment and waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right'" and the demand process protects "the directors' prerogative to take over the litigation or to oppose it." (internal quotation omitted)).

6. *Burch v Norton Hotel Co*, 261 Mich 311, 314–15, 246 NW 131, 132 (1933). The 1973 Michigan Business Corporation Act provided for "demand futility."

7. *See, generally*, Pappas, McNeill and Quick, *Michigan Business Torts*, sec. 8.34-8.39 (ICLE).

8. Michigan Law Revision Commission, Fifth Annual Report (1970), available at: http://council.legislature.mi.gov/Content/Files/mlrc/1970.pdf.

9. One published exception is *Moore v Carney*, 84 Mich App 399, 402, 269 NW2d 614, 615 (1978), where the court found oppression under the statute (although the grounds are not described), denied a request for dissolution but ordered defendants to buy out the plaintiff's shares.

10. *Daily Income Fund, Inc v Fox*, 464 US 523, 531 (1984) (citing *Hawes v Oakland*, 104 US 450 (1882)).

11. MODEL BUSINESS CORP. ACT § 7.4, Introductory Comment (1994).

12. *See generally* Robert B. Thompson, *The Shareholder's Cause of Action for Oppression*, 48 Bus Law 699 (1993).

13. MCL 450.1492a, MCL 450.1493a, MCL 450.1495-.1497.

14. *Baks v Maroun*, 227 Mich App 472, 576 NW2d 413 (1998).

15. *See* 1A *Fletcher Cyclopedia of the Law of Corporations*, § 70.10.

16. *Moore v Carney*, 84 Mich App 399, 407, 269 NW2d 614 (1978).

17. *Franchino v Franchino*, 263 Mich App 172, 184 (2004) (citing 12 Fletcher Cyclopedia Corporations, ch 58, §5717, p 22).

18. *Berger v Katz*, No 291663 at *5 (Mich Ct App July 28, 2011) (unpublished). Notably, another panel of the Court of Appeals rejected this very same argument, noting that the plaintiff ignored the "qualifying language" in the sentence added by the legislature. *Arevelo v Arevalo*, No 285548 at *7 (Mich Ct App Apr 6, 2010) (unpublished). Another erroneous statement of the law can be found in *Trapp v Vollmer*, No 297116 at *3 (Mich Ct App June 16, 2011) (unpublished), where the court held: "We believe that the [statutory] amendment's language evinces no such intent [to adopt a reasonable expectations standard]. The Legislature simply expressly defined the circumstances under which two types of majority conduct could be considered 'willfully unfair and oppressive conduct.' In doing so, it expanded with restrictions the type of shareholder interests that could properly be the subject of 'willfully unfair and oppressive conduct' beyond those defined in *Franchino*." But the notion that the legislature "expanded" the types of shareholder interests which could be the subject of a claim runs headlong in to the actual statutory language, which expresses no such intent, but instead references existing, recognized shareholder interests.

19. For a more thorough analysis, see D. Quick & E. Pawlowski, "Tyranny of the Minority," ABA Section of Litigation (2014) (available at http://apps.americanbar.org/litigation/committees/commercial/articles/winter2014-0214-tyranny-of-minority.html).

20. *See Environair, Inc v Steelcase, Inc*, 190 Mich App 289, 292, 475 NW2d 366, 367 (1991), overruled by *Health Call of Detroit v Atrium Home & Health Care Servs, Inc*, 268 Mich App 83, 706 NW2d 843 (2005); *Schaffer v Universal Rundle Corp*, 397 F2d 893, 896 (5th Cir 1968) (cited with approval in *Michigan Nat'l Bank v Mudgett*, 178 Mich App 677, 680, 444 NW2d 534, 536 (1989)).

21. *See, e.g., Sobel v Whittier Corp*, 95 F Supp 643, 645 (ED Mich 1951); *Dodge v Ford Motor Co*, 204 Mich 459, 170 NW 668 (1919).

22. *Murphy v Inman*, No 345758 at *3 (Mich Ct App Apr 30, 2020) (unpublished) (quoting *Michigan Nat'l Bank*, 178 Mich App at 679).

23. *Davis v Sheerin*, 754 SW2d 375, 381-82 (Tex App 1988).

24. *Id.* at 381. *See also* commentary at James Dawson, *Ritchie v. Rupe and the Future of Shareholder Oppression*, 124 Yale LJF 89 (2014), http://www.yalelawjournal.org/forum/ritchie-v-rupe.

25. *Dawson*, *supra* n. 9 (footnotes omitted).

26. *Ritchie v Rupe*, 443 SW3d 856 (Tex 2014).

27. *Id.* at 870 n. 15.

28. *See, e.g.*, Bittle, *Texas Turns A Corner: Resolving Shareholder Disputes in Closely Held Businesses After Ritchie v. Rupe*, 67 Baylor L Rev 339, 340 (2015).

29. *Lozowski v Benedict*, No 257219 (Mich Ct App Feb 7, 2006) (unpublished).

30. A similar claim led to a similar result, based on *Lozowski*, in *Weiner v Weiner*, No. 1:06-CV-642, 2008 WL 746960 (WD Mich Mar 18, 2008), and *Bromley v Bromley*, No. 05-71798, 2006 WL 1662552 (ED Mich June 7, 2006).

31. *Huron City Co v Parcells*, No 335978 (Mich Ct App Feb 8, 2018) (unpublished).

32. *Miller v Magline, Inc*, 76 Mich App 284, 292, 256 NW2d 761, 764 (1977).

33. *See* 12B William M. Fletcher, *Fletcher Cyclopedia of the Law of Private Corporations* §5912 (rev vol 1993).

34. *In re Skyport Glob Commc'ns, Inc*, No 08-36737, 2011 WL 111427 at *36 (Bankr SD Tex Jan. 13, 2011). S*ee also Resh v Bortner*, No CV 16-02437, 2016 WL 6834104, at *5 n.5 (ED Pa Nov 21, 2016).

35. *Karmanos v Bedi*, No 336577 (Mich Ct App Nov 29, 2018) (unpublished).

36. *Michigan Nat'l Bank*, 178 Mich App at 679 (citing *Schaffer, supra*, at 896).

37. *Boutell v WHB Co*, No 11-10617, 2012 WL 380238 (ED Mich Feb 6, 2012).

38. *Thomas v Costa*, No 235031 (Mich Ct App Feb 21, 2003) (unpublished).

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Shareholder Oppression Litigation – A National Perspective

By Gerard V. Mantese and Fatima M. Bolyea*

"*We despise and abhor the bully, the brawler, the oppressor, whether in private or public life ... .*"
Theodore Roosevelt

Introduction and Summary of Findings

In this article, we examine various aspects of shareholder oppression on a national scale, including reviewing more than 15 states' oppression jurisprudence and how Michigan's caselaw fits within this framework. We examine: (1) the conduct that courts typically find to be oppressive, (2) the remedies most commonly awarded upon a finding of oppression, and (3) the propriety of applying a discount to a valuation when a buyout remedy is deemed appropriate.

Methodology

We reviewed caselaw from the country's 15 most populous states: California, Texas, Florida, New York, Pennsylvania, Illinois, Ohio, Georgia, North Carolina, Michigan, New Jersey, Virginia, Washington, Arizona, and Massachusetts. We then sampled cases from other jurisdictions with robust shareholder oppression caselaw, such as Missouri and Oregon. This article presents an overview of findings from these jurisdictions, along with a discussion of Michigan's jurisprudence.

Summary

First, when considering shareholder oppression, courts look to principles of fiduciary duty, including standards of honesty, disclosure, loyalty, and fair play. Courts have held that, among other things, termination of employment, denial of dividends, self-dealing and financial abuse, such as overpaying compensation to oneself, removal of the minority shareholder from positions of management, uneven redemption schemes, and amendment of governing documents with an oppressive result can constitute shareholder oppression.

Second, the more favored remedies for oppression or breach of fiduciary duty are a buyout of the oppressed shareholder's interest or dissolution of the company. In cases where a dissolution is ordered, this allows the defending parties to effectuate a buyout to avoid a dissolution. These remedies provide certainty and peace to warring parties and prevent future litigation. Other remedies may also be ordered.

Lastly, valuation discounts for marketability and minority status are commonly *not* applied when a buyout of the oppressed shareholder is the ordered remedy.

Defining Shareholder Oppression

Certain states, including Michigan and Oregon, apply a definition of "shareholder oppression" pursuant to the "fair dealing" concept of oppression. Other states, such as New York, apply the "reasonable expectations" test of shareholder oppression.[1]

Some states, such as Washington, apply a mix of the two tests depending on the facts of the case.[2] And, Texas rejects both the "fair dealing" test and the "reasonable expectations" test; instead applying a four-factor test of its own, articulated in the 2014 case of *Ritchie v Rupe*.[3]

"Shareholder Oppression" Pursuant to "Fair Dealing" Test

Although the definition of "shareholder oppression" pursuant to the "fair dealing" test differs slightly from state to state, generally, shareholder oppression means conduct by individuals in control of the company which, when viewed objectively, departs from the standards of fair play and good faith that are inherent in every fiduciary relationship.[4] "Oppression" suggests harsh, burdensome, dishonest, or wrongful conduct, or a visible departure from the standards of fair dealing.[5]

The term "oppression" is broad, and covers a myriad of behaviors and situations, including conduct which is neither "fraudulent" nor "illegal."[6] Shareholder oppression under this standard is often measured by an

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analysis of the fiduciary duties owed by majority shareholders and others in control of a company to minority shareholders.[7]

"Shareholder Oppression" Pursuant to the "Reasonable Expectations" Test

States that use a "reasonable expectations" test generally apply a version of the following analysis: shareholder oppression arises when a minority shareholder's expectations, which were (1) reasonable under the circumstances and (2) central to the minority shareholder's purpose for joining the venture; and (3) which the majority knew or should have known about; were (4) frustrated by the majority.[8] Generally, the complaining shareholder must also show that this frustration of his expectations (5) was not the product of his own fault, and that the specific circumstances (6) warrant some form of equitable relief.[9]

Michigan's Test: Fair Dealing

Michigan follows the "fair dealing" test.[10] Under *Frank v Linkner*, Michigan does not require financial harm to be an essential element to prove oppression.[11]

Michigan courts have squarely rejected the "reasonable expectations" test, citing the existence and applicability of Michigan's shareholder oppression statute, MCL 450.1489. In *Franchino v Franchino*, the Michigan Court of Appeals rejected the "plaintiff's invitation to define the term 'oppression' to include 'conduct that defeats the reasonable expectations of a minority shareholder,'" reasoning that a reasonable expectations approach that "places the focus on the rights or interests of a minority shareholder would be inconsistent with a statute like MCL 450.1489 which places the focus on the actions of the majority."[12]

A few years later, in *Trapp v Vollmer*, the Court of Appeals again rejected the reasonable expectations test, this time declining to find that the post-*Franchino* amendments to MCL 450.1489 negated the *Franchino* ruling regarding the reasonable expectations test.[13]

The Role of Fiduciary Duties in Shareholder Oppression Cases

Many states recognize that controlling shareholders in close corporations owe fiduciary duties to minority shareholders, including "duties of loyalty, good faith, fair dealing, and full disclosure."[14] Courts that consider the shareholder oppression issue have held that "allegations of oppressive conduct are analyzed in terms of fiduciary duties owed by directors or controlling shareholders to minority shareholders."[15] As such, conduct that violates fiduciary duties in a closely held corporation is also likely to be considered "oppressive."[16]

Analyzing shareholder oppression through the prism of fiduciary duties permits abused shareholders and courts to harness centuries of fiduciary caselaw. As Justice Cardozo famously pronounced in *Meinhard v Salmon*, when harkening to the "unbending and inveterate" tradition of fiduciary law:

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.[17]

Thus, when examining conduct of corporate directors and officers and others in control of an entity, it is important to judge their acts in light of high and strict fiduciary duties. Conduct that might be permitted by the morals of the marketplace are not tolerated of fiduciaries.

> [W]hen considering shareholder oppression, courts look to principles of fiduciary duty, including standards of honesty, disclosure, loyalty, and fair play.

Types of Conduct Found to be Oppressive

Irrespective of the test used to gauge oppression, certain recurring fact patterns tend to emerge as inequitable and oppressive conduct. The following actions are generally considered to be oppressive:

Awarding Those in Control Excessive Compensation. Excessive compensation is a hallmark of oppressive conduct, especially when coupled with self-dealing and failure to pay dividends. In *Baron v Pritzker*,[18] for example, a breach of fiduciary duty claim sounding in shareholder oppression survived defendant's motion to dismiss where the plaintiff minority shareholder pled that the majority shareholder froze plaintiff out of management, cut his compensation, and paid himself excessive compensation.[19]

Self-Dealing or Misapplication of Corporate Funds. As with inflated compensation, self-dealing and interested transactions

As in Michigan's *Magudula v Taub*, many states hold that a claim for oppression is an equitable claim, which allows courts to use their vast equitable powers.

by those in control will also raise red flags in oppression litigation.

In *Meyer v Brubaker*,[20] oppression was found where majority shareholders personally cashed checks made out to the company; used company funds for automobiles and to repay loans they made to the business in disproportionately larger amounts than used to repay loans made by minority shareholders; overcompensated themselves; refused to pay distributions; and lied about the company's financial health. The court ultimately granted dissolution of the company, along with compensatory and punitive damages.

Likewise, in *Twin Bay v Kasian*,[21] shareholder oppression was found where the majority shareholders held annual meetings without notice; awarded themselves annual bonuses not contingent on performance; issued shares to themselves at a depressed price and without paying for them; amended the by-laws with an oppressive result for the minority shareholders; forced minority shareholders to sell their shares at less than fair value; and moved company cash into personal bank accounts. Among other things, the court ordered that the company be dissolved.

Failure to Pay Dividends. Furnishing of inadequate or no dividends is also widely considered oppressive, as the receipt of dividends is a fundamental aspect of shareholder status. As explained by the Michigan Supreme Court in *Dodge v Ford Motor Co* in holding that Ford's refusal to issue dividends was actionable: "a business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end."[22] The Oregon Court of Appeals agreed, holding that: "withholding of dividends or other return on one's participation in a business enterprise is an *essential* part of most squeeze-out efforts."[23] This is particularly problematic where the control group prevents the company from paying dividends despite its ability to do so without harming the corporation.[24]

Termination of Employment with the Company. Courts often find termination of employment with the company to be oppressive because "a person who buys a minority interest in a close corporation does so, not only in the hope of enjoying an increase in the value of the shareholder's stake in the business, but for the assurance of employment in the business in a managerial position."[25] Indeed, if the company is not issuing dividends, receipt of a salary via employment in the company may be the sole way in which an employee receives an economic return from the company.[26] As such, cutting off employment to a minority shareholder can be oppressive, especially when those in control retain employment and thereby receive, in effect, "disguised dividends." Therefore, in *Riggle v Seaboard Envelope Co, Inc*, the court found oppression and ordered dissolution where the majority shareholder: terminated the minority shareholder's employment and denied him access to company facilities; fired his children; and ceased compensating him.[27] Additionally, in *Gallagher v McKinnon*, the court found oppression where the majority shareholder removed the minority shareholder as secretary of the company, demoted his employment, reduced his salary, ultimately terminated his employment, and issued himself additional shares of stock to give himself the controlling interest in the company.[28]

Freeze-Out of the Shareholder from the Company. As explained by the Mississippi Court of Appeals, "the ability of majority shareholders to 'squeeze out' or 'freeze out' minority shareholders through various tactics…contributes to the minority shareholder's vulnerability" in a close corporation.[29] Freeze-out tactics may include conduct discussed throughout this article, such as termination, lock out from company facilities, excluding the shareholder from operating the company, and failing to disclose information to the minority shareholder.[30]

Locking the Shareholder Out of Company Premises. Part of a majority shareholders' freeze-out technique may be to literally "lock" a minority shareholder out of the company's physical or virtual premises. This includes changing locks on the company's buildings, changing computer passwords, and removing shareholder access to the company's bank accounts. Such conduct has been found to be oppressive, especially when coupled with other freeze-out actions such as termination and refusal to provide information.[31]

Failure to Provide Information or Access to Company Records. A vital shareholder right is the right to remain informed about the company. Many states' statutes protect this right, including Michigan's MCL 450.1487. Courts have held that failure to provide such information to minority shareholders constitutes shareholder oppression.[32]

Unfair, Disproportionate, or Discounted Redemption Scheme or Buyback. Shareholder oppression may occur where those in control attempt to acquire a minority shareholder's shares at a deep discount. In *Twin Bay*,[33] the court found oppression where the majority shareholders forced the minority shareholders to accept a buyout of their shares at below fair value. Adding to the oppression there, the control group utilized a bylaw provision against the minority shareholders to force the buyout, but had not used the provision against a member of the control group when that member had been in a similar situation, thus treating the minority disproportionately.

In *Royals v Piedmont Elec Repair Co*,[34] oppression was found and dissolution of the company ordered where the minority shareholder sought to sell his shares but the majority shareholders offered to purchase them for less than half their value, and then terminated his employment. The court explained:

> PERCO has refused to offer fair market value for Glenn's shares (or any other minority shareholder's shares for that matter). In fact, PERCO essentially continues to hold these shares captive, forcing the minority shareholders to either redeem them for significantly less than market value or hold on to them until the majority shareholders decide to dissolve the company.[35]

In *Keating v Keating*,[36] shareholder oppression was found where the majority shareholder terminated the minority shareholder's employment, ceased providing him compensation from the company, and offered him a buyout of his interest at a discounted rate. The court ordered a buyout of the minority's shares.

Removal of the Shareholder from Positions of Management. Shareholder oppression may include removal or exclusion of a minority shareholder from management positions. This is because, "[i]n addition to the security of long-term employment and the prospect of financial return in the form of salary, the [shareholder] expectation includes a voice in the operation and management of the business and the formulation of its plans for future development."[37] This is particularly true where the minority shareholder was previously in management, and was then removed by the majority shareholders for some specific reason or seemingly no reason.[38] For example, in *Hager-Freeman v Spircoff*, the plaintiff sufficiently alleged shareholder oppression where the defendants refused to hold meetings of shareholders or directors, the minority shareholder was removed as a director and employee, and deprived of an opportunity to participate in management and business decisions.[39]

Amendment of the Bylaws or Governing Documents. Those in control cannot amend the company's bylaws or governing documents in a way that oppresses or targets the minority. In *Bromley v Bromley*,[40] the oppressing majority shareholders allegedly undertook all of their challenged actions (including amending company bylaws to change the number of directors to remove plaintiffs from the board) pursuant to the company's governing documents. Nonetheless, the court found evidence of oppression, holding that, "the circumstances surrounding the [bylaws] amendments look suspiciously like a corporate freeze-out … . Individually, the amendments are legal, yet collectively they could be used oppressively. This substantially affects Plaintiffs' rights as shareholders."[41] This and other cases teach that having a general grant of authority, even in a company's governing documents, does not authorize the party in control to abuse its authority and commit oppression.[42]

What Is the Most Common Remedy Upon a Finding of Oppression?

As in Michigan's *Madugula v Taub*,[43] many states hold that a claim for oppression is an equitable claim, which allows courts to use their vast equitable powers. Thus, once shareholder oppression is found, courts generally have broad discretion to fashion an appropriate remedy. Indeed, scholars and courts consider that the "breadth of remedies for shareholder oppression provides the courts with great flexibility to choose a remedial scheme that most appropriately responds to the aggrieved shareholder's harm."[44] This has become particularly true with the implementation of oppression statutes, which courts see as "intended to *expand* the shareholder remedies."[45]

The remedy of a stock buyback appears to be the most frequently ordered remedy where shareholder oppression or breach of majority shareholders' fiduciary duties is found.[46] (This includes the similar, although more drastic remedy of dissolution, which courts are increasingly willing to order to

The remedy of a stock buyback appears to be the most frequently ordered remedy where shareholder oppression or breach of majority shareholders' fiduciary duties is found.

terminate an untenable situation. Of course, the oppressing parties are in a position to avoid dissolution by effectuating a buy-out and this is a common scenario in New York, for example.) In *Meiselman v Meiselman,* the court spent significant time discussing various state statutes, cases, and commentary espousing the benefit of total dissolution rather than forcing oppressed shareholders to remain in continued contact with their oppressors.[47]

Courts have articulated the following rationales for ordering a buyout of oppressed shareholders:

Maintaining the status quo between hostile shareholders is unsustainable and could lead to continued conflict, oppression, and further litigation. "Stagnation or maintenance of the *status quo* will ill-satisfy the expectations of the minority investor, and, if the majority investor wants to keep things as they are, he may do so by buying out his brother, making him sole owner of the properties. To continue to permit the *status quo* to exist … would serve neither of the litigants in this matter."[48]

> [T]he majority of courts are inclined to reject applying discounts when the oppressing shareholder is ordered to buy out the oppressed shareholder.

A buyout resolves the instant conflict, maximizes the benefit to both parties, and preserves a viable business as a going concern. "The buy-out of one co-owner by the other seems to me to present the greatest possibilities of resolving this matter in the near future, of maximizing the benefit to both parties, and in preserving [the company] and its business to the greatest extent possible."[49]

An oppressed shareholder cannot escape an oppressive situation by selling his or her shares in a public market. "In a closely held corporation, such as this one, 'a shareholder ... is unable to escape an oppressive situation by dispensing of his shares of ownership in the public arena."[50]

Other remedies for shareholder oppression and breach of fiduciary duty in this context imposed by courts across the country include:

(1) **compensatory damages** (e.g., as compensation for breach of fiduciary duty, lost wages, or loss of value of interest in the company),

(2) **rescission** of the oppressive transaction or action (e.g., undoing issuance of shares or bylaws amendments),

(3) **punitive damages**, and

(4) other **equitable relief** (e.g., restoring employment, rehabilitative receivership).

Please see endnote 52 for a compendium of caselaw discussing various remedies by state.[51]

Do Courts Apply Minority and Marketability Discounts to the Valuation of a Minority Shareholder's Interest?

When courts order a buy-out remedy for oppressive conduct, the method by which the minority shareholder's interest is to be valued is often disputed. Specifically, should the valuation be discounted due to the shares' minority status or lack of marketability? Most courts say no.

Courts acknowledge that they have discretion to determine whether to apply discounts, and they are generally hesitant to issue a universal dictate that discounts can *never* be applied. Indeed, courts often note that discounts may be appropriate where equity requires it (for example, if the oppressed shareholder is buying out the oppressor) or in exceptional circumstances. Beyond this, the majority of courts are inclined to *reject* applying discounts where the oppressing shareholder is buying out the oppressed shareholder. This is especially so with respect to minority control discounts, but it is also the prevailing rule for marketability discounts.[52]

Courts have offered the following justifications for rejecting the application of discounts:

1. **The majority shareholder already has control of the corporation, so the minority shares effectively become controlling shares when the majority acquires them**. As explained by leading commentator Professor Douglas Moll:

> When the corporation is the buyer of the minority's shares, a minority discount remains inapposite. Stock repurchased by the corporation is often characterized as 'treasury stock' that is no longer outstanding. The corporation, as an entity, does not become a shareholder that now owns a minority stake in itself. Instead, the effect of the corporation's purchase of its own shares is to raise the percentage ownership of the remaining shareholders. The control already possessed by a majority shareholder, in other words, simply increases as a result of the corporation's purchase.[53]

2. **Discounts deprive minority shareholders of their proportionate interest in a going concern.**[54] As explained by one court in discussing the inappropriateness of discounts: "had the corporation then been dissolved, it is clear that upon distribution of the dissolution proceeds each of the shareholders would have been entitled to the exact same amount per share, with no consideration being given to whether the shares had been controlling or noncontrolling."[55]
3. **Discounts encourage majority shareholders to manipulate statutory protections for minorities, encourage oppressive behavior, and punish minority shareholders for exercising their statutory rights.** As the North Carolina Business Court explained:

> It would be inequitable under the circumstances of this case to impose a minority discount for lack of control or a discount for lack of marketability of the minority shares. Hilliard made the final decision to change the arrangement under which the business was organized. He had the leverage to do so and the minority shareholders did not … . It would also be inequitable to impose a minority discount where the minority shareholders' loss was more than simply being forced to sell their shares.[56]

4. **Majority shareholders should not receive a windfall for oppressive conduct.** A common consideration in courts' refusal to apply minority and marketability discounts is acknowledgment that doing so would result in a windfall to the oppressing majority shareholders. "The statute clearly does not contemplate such a windfall for majority shareholders, nor should it be interpreted in such a way as to provide an incentive for majority shareholders to oppress minority shareholders and force them to sell."[57]
5. **Majority shareholders who acquire minority shares at a discount can turn around and sell them to a third-party at full value**. Some courts are concerned that:

> the majority shareholders are thus in a position to have the company buy the shares which could then be resold with the majority shares at a value based upon 100% control value. They should not be allowed to buy at a discounted price that which they could immediately turn around and resell at full value. The statute clearly does not contemplate such a windfall for majority shareholders, nor should it be interpreted in such a way as to provide an incentive for majority shareholders to oppress minority shareholders and force them to sell.[58]

6. **Discounts are not appropriate where a sale of the company is not anticipated.** Some courts hold that "a marketability discount … presupposes a probable sale of the stock. If a sale is improbable, the discount need not be applied."[59]
7. **"Fair value" is distinct from "fair market value."** When statutes or cases state that an oppressed or dissenting shareholder's interest shall be valued at "fair value," this is distinct from "fair market value," and must be treated as such.[60] Courts considering the matter have held that "fair value" does *not* include discounts.[61] "'Fair value' means the shares' value at the moment just before the majority committed misconduct. The valuation appropriately reflects the then existing intention of the minority to continue as a participating shareholder. And it should fully compensate the shareholder forced out and avoid giving a windfall to the party committing misconduct."[62]
8. **Unique use of discounts for equitable purposes.** New Jersey courts have, at times, ordered that the *oppressing* majority shareholder will be bought out by the oppressed minority shareholder. In these situations, New Jersey courts have held that equity demands the imposition of a discount *on the majority shareholder's* shares so that the oppressor is not rewarded for his/her conduct. "In cases where the oppressing shareholder instigates the problems, as in this case, fairness dictates that the oppressing shareholder should not benefit at the expense of the oppressed."[63]

Majority shareholders and officers and directors should act in scrupulous compliance with fiduciary duties, and not "use their power to control corporate activities to benefit themselves alone or in a manner detrimental to the minority."

Conclusions

The verdict is in. The consensus in the most populous states is that:

1. Whether a state has an oppression statute, a common law oppression scheme, or handles oppression under fiduciary duty law, the control group's actions are likely to be measured against the fiduciary standard: including the duties of honesty; disclosure; loyalty; and good faith;
2. certain recurring fact patterns constitute oppression: terminating employment, not issuing dividends, overpayment of compensation, uneven redemption schemes, and cutting out a minority from information and involvement (particularly when occurring in combination with other actions such as overcompensating majority owners); and
3. a buyout without discounts is the favored remedy.

Majority shareholders, and officers and directors should act in scrupulous compliance with fiduciary duties, and not "use their power to control corporate activities to benefit themselves alone or in a manner detrimental to the minority."[64] Otherwise, based on our research, those in control may face a redemption of the oppressed shareholders' shares without discounts, damages, or, potentially, even dissolution of the company.

NOTES

1. *Twin Bay v Kasian*, 153 AD3d 998, 1002, 60 NYS3d 560, 565 (2017).

2. *Scott v Trans-Sys, Inc*, 148 Wash 2d 701, 711, 64 P3d 1, 6 (2003).

3. *Ritchie v Rupe*, 443 SW3d 856, 870 (Tex 2014).

4. § 5820.11. Oppressed shareholders—Oppressive conduct defined, 12B Fletcher Cyc. Corp. § 5820.11.

5. *See e.g., Robinson v Lagenbach*, 599 SW3d 167 (Mo 2020) (en banc); § 5820.11. Oppressed shareholders—Oppressive conduct defined, 12B Fletcher Cyc. Corp. § 5820.11; *Gidwitz v Lanzit Corrugated Box Co*, 20 Ill 2d 208, 170 NE2d 131 (1960) (word "oppressive" as used in statute is not synonymous with "illegal" and "fraudulent" and does not require mismanagement or misapplication of funds); *Baker v Commercial Body Builders, Inc*, 264 Or 614, 628–29, 507 P2d 387, 393 (1973) (oppression defined as "burdensome, harsh and wrongful conduct; a lack of probity and fair dealing in the affairs of a company to the prejudice of some of its members; or a visual departure from the standards of fair dealing, and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely."); *White v Perkins*, 213 Va 129, 134, 189 SE2d 315, 320 (1972) ("oppressive means 'a visible departure from the standards of fair dealing, and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely.' … It has also been held to mean '… a lack of probity and fair dealing in the affairs of a company to the prejudice of some of its members.'").

6. *See e.g.*, § 5820.11. Oppressed shareholders—Oppressive conduct defined, 12B Fletcher Cyc. Corp. § 5820.11; *Gidwitz v Lanzit Corrugated Box Co*, 20 Ill 2d 208, 170 NE2d 131 (1960); *Bonavita v Corbo*, 300 NJ Super 179, 194, 692 A2d 119, 127 (1996) ("Under that approach, the oppression to which a vulnerable minority shareholder may be subjected is not limited to illegal or fraudulent actions"); *Hager-Freeman v Spircoff*, 229 Ill App 3d 262, 276, 593 NE2d 821, 830 (1992) ("Shareholder oppression has not been limited to actions defined as 'illegal' or 'fraudulent' or necessarily including misapplication of corporate assets or mismanagement of funds.").

7. *Id.*

8. *See e.g., Straka v Arcara Zucarelli Lenda & Assoc CPAs, PC*, 62 Misc 3d 1064, 92 NYS3d 567 (2019) (majority shareholders of closely held corporation engaged in "oppressive actions," which frustrated minority shareholder's reasonable expectations, and could provide basis to dissolve corporation, by failing to treat female minority shareholder with equal dignity and respect as male shareholders forming the majority); *Baur v Baur Farms, Inc*, 832 NW2d 663, 674 (Iowa, 2013) ("majority shareholders act oppressively when, having the corporate financial resources to do so, they fail to satisfy the reasonable expectations of a minority shareholder by paying no return on shareholder equity while declining the minority shareholder's repeated offers to sell shares for fair value."); § 5820.11. Oppressed shareholders—Oppressive conduct defined, 12B Fletcher Cyc. Corp. § 5820.11.

9. *Royals v Piedmont Elec Repair Co*, 137 NC App 700, 705, 529 SE2d 515, 518 (2000).

10. MCL 450.1489; *Franchino v Franchino*, 263 Mich App 172, 186, 687 NW2d 620, 629 (2004).

11. *Frank v Linkner*, 500 Mich 133, 153, 894 NW2d 574, 585 (2017). (Mr. Mantese and Ms. Bolyea represented the plaintiffs in *Linkner* in the Michigan Supreme Court.)

12. *Franchino v Franchino*, 263 Mich App 172, 186, 687 NW2d 620, 629 (2004) (superseded by statute in part: following *Franchino*, the Michigan Legislature amended MCL 450.1489(3) to specifically provide that willfully unfair and oppressive conduct could include termination of employment or other acts that disproportionately interfered with a shareholder's interests).

13. *Trapp v Vollmer*, No 297116 at *3 (Mich Ct App June 16, 2011) (unpublished).

14. *Hickey v Hickey*, 269 Or App 258, 266, 344 P3d 512, 518 (2015); *Kirtz v Grossman*, 463 SW2d 541, 544 (Mo App 1971); *O'Brien v Pearson*, 449 Mass 377, 383, 868 NE2d 118, 124 (2007).

15. *Virgil Kirchoff Revocable Trust Dated 6/19/09*, 482 SW3d 834 (Mo App 2016).

16. *Hickey*, 269 Or App at 266, 344 P3d at 518 (2015).

17. *Meinhard v Salmon*, 249 NY 458, 463–64, 164 NE 545, 546 (1928).

18. *Baron v Pritzker*, 2001 WL 1855054, 52 Pa D & C4th 14 (Pa Common Pleas, 2001).

19. *See also Muellenberg v Bikon Corp*, 143 NJ 168, 180, 669 A2d 1382, 1388 (1996).

20. *Meyer v Brubaker*, No G026361, 2002 WL 110411, at *1 (Cal Ct App, Jan 29, 2002), as mod on denial of reh (Feb 25, 2002).

21. *Twin Bay v Kasian*, 153 AD3d 998, 1003, 60 NYS3d 560, 566 (2017).

22. *Dodge v Ford Motor Co*, 204 Mich 459, 507, 170 NW 668 (1919). *See also Smith v Smith*, No 19-10330,

2020 WL 2308683, *12 (ED Mich May 8, 2020) ("This evidence, viewed as a whole, could support a finding that Defendants acted with the intent to interfere with Martin's interest in receiving dividends. The fact that E&E's profits appear to flow to Wallace, Joan, and their children, to the exclusion of Martin, is suspect. The evidence also suggests that Defendants reduced E&E's net income—by paying Wallace's compensation and rent to the JAW Smith Entities—for the express purpose of avoiding a dividend distribution to Martin. And while starving Martin of any dividend payments, Defendants consistently asked him to sell his shares "at a reasonable price.") (Mr. Mantese and his partner, Ian Williamson, represent the Plaintiff in *Smith v Smith*).

23. *Cooke v Fresh Exp Foods Corp, Inc*, 169 Or App 101, 109, 7 P3d 717, 722 (2000).

24. *See also Muellenberg*, 143 NJ at 180, 669 A2d at 1388 (1996); *Miller v Magline, Inc*, 76 Mich App 284, 306-7, 256 NW2d 761 (1977); *Blankenship v Superior Controls, Inc*, 135 F Supp 3d 608, 620 (ED Mich 2015) (Michigan law) (refusal to declare dividends where company had financial means do to so constitutes shareholder oppression).

25. *See e.g., Muellenberg*, 143 NJ at 180, 669 A2d at 1388 (1996).

26. *See e.g.*, § 4.22 Oppression, Mich Corp L & Prac § 4.22 (A plaintiff has a claim for oppression where "a termination of employment deprived a shareholder of an economic return while the other shareholders received disguised dividends through large salaries and bonuses."); *Knights' Piping, Inc v Knight*, 123 So3d 451 (Miss Ct App 2012), cert denied, 123 So3d 450 (Miss 2013) (Majority shareholder could be held personally liable for his breach of minority shareholder's employment contract with closely held company; majority shareholder unilaterally terminated minority shareholder and offered no legitimate business purpose for the termination; majority shareholder's actions effectively guaranteed that minority shareholder would not receive a return on his interest in the company, as earnings were distributed in the form of salaries and other benefits, rather than dividends.).

27. *Riggle v Seaboard Envelope Co, Inc*, No B253109, 2014 WL 5469928, at *1 (Cal Ct App, October 29, 2014).

28. *Gallagher v McKinnon*, 273 Ga App 727, 731, 615 SE2d 746, 750 (2005).

29. *Knights' Piping, Inc v Knight*, 123 So3d 451, 458 (Miss Ct App, 2012).

30. *See e.g., Riggle*, 2014 WL 5469928, at *1; *In re Dissolution of Clever Innovations, Inc*, 94 AD3d 1174, 1176, 941 NYS2d 777, 780 (2012); *Viener v Jacobs*, 834 A2d 546, 551 (Pa Super Ct, 2003); *Baron v Pritzker*, 52 Pa D & C4th 14 (Pa Common Pleas, 2001).

31. *See e.g., Riggle*, 2014 WL 5469928, at *1 (Cal Ct App, Oct 29, 2014) (minority shareholder locked out of company building); *Hager-Freeman v Spircoff*, 229 Ill App 3d 262, 275, 593 NE2d 821, 829 (1992) (locks changed on building).

32. *See e.g., Madugula v Taub*, 496 Mich 685, 853 NW2d 75 (2014) (oppression may include denying a shareholder access to corporate books and records); *In re Dissolution of Clever Innovations, Inc*, 94 AD3d 1174, 1176, 941 NYS2d 777, 780 (2012) (oppression where majority failed to disclose information); *Viener*, 834 A2d at 551; *Stickley v Stickley*, 43 Va Cir 123 (1997) (oppression where majority stockholder denied minority shareholder access to company records, paid himself excessive compensation, and stacked board with individuals favorable to majority shareholder).

33. *Twin Bay*, 153 AD3d at 1003, 60 NYS3d at 566 (2017).

34. *Royals v Piedmont Elec Repair Co*, 137 NC App 700, 529 SE2d 515 (2000).

35. *Id.* at 708.

36. *Keating v Keating*, No 00748, 2003 WL 23213143 at *1 (Mass Super, Oct 3, 2003).

37. *Muellenberg*, 143 NJ at 180, 669 A2d at 1388 (1996).

38. *See e.g., Blankenship v Superior Controls Inc*, 135 F Supp 3d 608, 618 (ED Mich 2015); *Viener*, 834 A2d at 551 (oppression found where majority shareholder, in retaliation for criticisms made against him, removed minority shareholder from corporate governance, blocked access to company financials, squandered corporate assets and opportunities for personal benefit.).

39. *Hager-Freeman v Spircoff*, 229 Ill App 3d 262, 276, 593 NE2d 821, 830 (1992).

40. 2006 WL 2861875, at *6 (ED Mich Oct 4, 2006).

41. *Id. See also Twin Bay*, 153 AD3d at 1003; 60 NYS3d at 566 (2017).

42. *Berger v Katz*, 2011 WL 3209217 (Mich App 2011).

43. *Madugula v Taub*, 496 Mich 685, 853 NW2d 75 (2014). (Mr. Mantese represented the plaintiff in *Madugula*, both before the Michigan Supreme Court, and on remand, where the trial court made a finding of oppression.)

44. Moll, Douglas, *Reasonable Expectations v Implied-in-Fact Contracts: Is the Shareholder Oppression Doctrine Needed?*, 42 BC L Rev 989, 1018 (2001).

45. O'Neal & Thompson, 2 Close Corp and LLCs: Law and Practice § 9:32 (Rev 3d ed).

46. *See also* Douglas K. Moll, *Shareholder Oppression and "Fair Value": Of Discounts, Dates, and Dastardly Deeds in the Close Corporation*, 54 Duke LJ 293, 318 (2004) ("The most common remedy for oppression … is a buyout of the oppressed investor's stockholdings."); C. Moskow, N. Ankers, *Oppression of Minority Shareholders*, 77 Mich BJ 1088, 1094 (Oct 1998) ("A frequent remedy ordered in dissolution and oppression cases is the buyout of the minority shareholder.").

47. *Meiselman v Meiselman*, 307 SE2d 551, 560 (NC 1983).

48. *Kassab v Kassab*, 2017 WL 3324804 (NYS Ct 2017); *Robinson*, 599 SW3d 167 (Mo 2020).

49. *Balsamides v Protameen Chems, Inc*, 734 A2d 721 (N J 1999).

50. *Schimke v Liquid Dustlayer, Inc*, 2009 WL 3049723 (Mich App 2009).

51. California: *Goles v Sawhney*, 210 Cal Rptr 3d 261 (Cal Ct App 2016) (statutory buyout); *O'Brien v AMBS Diagnostics, LLC*, 2016 WL 94241 (Cal Ct App 2016) (dissolution); *Meyer v Brubaker*, 2002 WL 110411 (Cal Ct App 2002) (dissolution, compensatory damages, punitive damages). Texas: *Ritchie v Rupe*, 443 SW3d 856 (Tex 2014) (rehabilitative receivership); Florida: *Williams v Stanford*, 977 So2d 722 (Fla App 2008) (rescission of a transfer of assets available as a remedy beyond statutory appraisal); *Foreclosure FreeSearch, Inc v Sullivan*, 12 So3d 771 (Fla App 2009) (though relief beyond appraisal is available for breach of fiduciary duty, a minority shareholder cannot prevent the elimination of their interests and prolong corporate strife where plaintiff demands an appraisal). New York: *Straka v Arcara Zucarelli Lenda & Associates CPAs, PC*, 92 NYS3d 567 (NYS Ct 2019) (buyout); *Matter of Kemp & Beatley (Gardstein)*, 473 NE2d 1173 (NY 1984) (buyout); *Twin Bay v Kasian*, 153 AD3d 998 (NYS Ct App Div 2017) (dissolution, rescission of corporate action); *Pappas v Fotinos*, 2010 WL 2891194 (NYS Ct 2010) (dissolution). Pennsylvania: *Viener v Jacobs*, 834 A2d 546 (Pa 2003) ("compensatory damages," in amount of fair value of minority shareholder's interests); *Linde v Linde*, 220 A3d 1119 (Pa 2019) (buyout). Illinois: *Vizcarra v LMR Home Healthcare, Inc*, 2019 WL 2323796 (Ill App 2019) (buyout); *Bone v Coyle Mechanical Supply, Inc*, 2017 WL 2403268 (Ill App 2017) (buyout); *Fleming v Louvers Int'l, Inc*, 2019 WL 4805182 (Ill

App 2019) (retroactive compensation); *Bone v Coyle Mech Supply, Inc*, 2017 WL 2403268 (Ill App 2017) (retroactive compensation). Ohio: *Estate of Schroer v Stamco Supply, Inc*, 482 NE2d 975 (Ohio App 1984) (buyout); *Vontz v Miller*, 111 NE3d 452 (Ohio App 2016) (restoration of voting power); *Edelman v JELBS*, 57 NE3d 246 (Ohio App 2015) (right of inspection); *Franks v Rankin*, 2012 WL 1531031 (Ohio App 2012) (constructive trust); *Edelman v JELBS*, 57 NE3d 246 (Ohio App 2015) (compensatory and punitive damages for excessive compensation of majority shareholders). Georgia: *Gallagher v McKinnon*, 615 SE2d 746 (Ga App 2005) (rescission of issuance of shares, restoration of employment); *Monterrey Mexican Rest of Wise, Inc v Leon*, 638 SE2d 879 (Ga App 2006) (lost profits, deprivation of interest in company). North Carolina: *Vernon v Cuomo*, 2009 WL 690242 (NC Bus Ct 2009) (dissolution with statutory buyout option); *Garlock v Southeastern Gas & Power, Inc*, 2001 WL 34054523 (NC Bus Ct 2001) (dissolution with statutory buyout option); *Brewster v Powell Bail Bonding, Inc*, 2020 WL 1220992 (NC Bus Ct 2020) (allegations sufficient for dissolution if proved at trial). Michigan: *Berger v Katz*, 2011 WL 3209217 (Mich App 2011) (alternative remedies of buyout of oppressing shareholders and receivership available); *Moore v Carney*, 84 Mich App 399 (1978) (buyout). New Jersey: *Parker v Parker*, 2019 WL 1253348 (N J Super Ct App Div 2019) (court-ordered buyout of oppressing shareholder); *Wisniewski v Walsh*, 2013 WL 1296067 (NJ Super Ct App Div 2013) (court-ordered buyout of oppressing shareholder). Virginia: *Colgate v Disthene Grp*, 2012 WL 9391675 (Va Cir Ct 2012) (dissolution); *Stickley v Stickley*, 1997 WL 33622770 (Va Cir Ct 1997) (dissolution). Washington: *Prentiss v Wesspur*, Inc., 1997 WL 207971 (Wash App 1997) (receivership, but company was sold in full to majority shareholder). Massachusetts: *Brodie v Jordan*, 857 NE2d 1076 (Mass 2006) (rejecting a buyout – after this case, court-ordered buyouts no longer allowed in Massachusetts absent a requirement by contract or by company's by-laws); *Donahue v Rodd Electrotype Co of New England, Inc*, 328 NE2d 505 (Mass 1975) (rescission of stock redemption by majority shareholder proposed as alternative to buyout of minority shareholder); *Selmark Assocs, Inc v Ehrlich*, 5 NE3d 923 (Mass 2014) (lost wages); *O'Connor v U S Art Co, Inc*, 2005 WL 1812512 (Mass Super Ct 2005) (lost wages and loss of interest in company).

52. *See* C. Moskow, N. Ankers, *Oppression of Minority Shareholders*, 77 Mich BJ 1088, 1094 (Oct 1998) ("No discount should be applied as a matter of policy in most cases where oppressive conduct is found under section 1489."). In *Franks v Franks*, 330 Mich App 69, 944 NW2d 388 (2019), the Court of Appeals held that trial courts have discretion on whether to impose discounts. Mr. Mantese, Ms. Bolyea, and Mr. Williamson represent the Plaintiffs in that case.

53. Moll, 54 Duke LJ at 328-329; *Goles v Sawhney*, 210 Cal Rptr 3d 261 (Cal App 2016) ("The rule justifying devaluation of minority shares in closely held corporations for their lack of control has little validity when the shares are to be purchased by someone who is already in control of the corporation.").

54. *Matter of Friedman v Beway Realty Corp*, 661 NE2d 972 (NY 1995).

55. *Brown v Allied Corrugated Box Co*, 154 Cal Rptr 170 (1979).

56. *Garlock v Southeastern Gas & Power, Inc*, 2001 WL 34054523 (NC Bus Ct 2001).

57. *Royals v Piedmont Elec Repair Co*, 1999 WL 33545516 (NC Bus Ct 1999).

58. *Royals*, 1999 WL 33545516.

59. *See e.g., Owens v Owens*, 589 SE2d 488 (Va App 2003); *Hoebelheinrich v Hoebelheinrich*, 600 SE2d 152 (Va App 2004).

60. *See e.g., Murchie v Sorensen*, 2015 WL 728310 (Ill App 2015) (fair value does not include discounts).

61. *See e.g., Murchie v Sorensen*, 2015 WL 728310 (Ill App 2015); *In re Dino Rigoni Intentional Grantor Tr for Benefit of Rajzer*, 2015 WL 4255417 (Mich App 2015); *Matthew G Norton Co v Smyth*, 51 P3d 159 (Wash App 2002).

62. *Prentiss v Wesspur, Inc*, 1997 WL 207971 (Wash App 1997).

63. *Parker v Parker,* 2019 WL 1253348 (NJ Super Ct App Div 2019).

64. *See e.g., Meyer v Brubaker*, No G026361, 2002 WL 110411 (Cal Ct App, Jan 29, 2002), as mod on denial of reh (Feb 25, 2002) citing *Jones v H F Ahmanson & Co*, 1 Cal 3d 93, 460 P2d 464 (1969).

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Can Michigan Courts Apply Discounts When Determining the "Fair Value" of Minority Shares in a Share Buyback Remedy Under Michigan's Shareholder Oppression Statutes?

By Matthew P. Allen

Introduction

This Article discusses whether Michigan courts can apply valuation discounts when ordering the purchase of closely held minority shares "at fair value" as a remedy for shareholder oppression under Michigan's Business Corporation Act ("Corporation Act"), MCL 450.1489(1)(e), and Limited Liability Company Act ("LLC Act"), MCL 450.4515(1)(d). Because the Corporation and LLC Acts contain the same substantive definition of oppression and the same fair value purchase remedy, both are collectively referred to in this Article as "Michigan's oppression statutes." Courts that have applied discounts to determine "fair value" of minority shares have discounted those shares by over 50 percent. So whether a court can or should apply discounts is a significant issue.

Michigan's oppression statutes do not define "fair value." Which means they do not say whether the "fair value" of an oppressed shareholder's shares should be reduced by various potentially applicable discounts, the two most common of which are discounts based on the lack of a public market on which to sell the shares ("marketability discount"), and discounts based on the lack of control the shares command within the organization(s) ("control discount"). The Corporation Act contains a separate statute that permits a shareholder dissenting from a corporate transaction to obtain "'fair value' with respect to a dissenter's shares … ." MCL 450.1761(d). This section defines when "fair value" of the shares is determined under this "dissenter's rights" statute, but is silent about whether discounts should be applied. This is markedly different from the Model Business Corporation Act ("Model Act"), wherein "fair value" is defined in the dissenter's rights chapter as excluding marketability and control discounts, while the "fair value" remedy for oppression in the Model Act does not exclude discounts.

Michigan appellate courts have upheld trial court decisions that have both applied, and declined to apply, discounts to shares subject to a court's fair value sale remedy for oppression. *See, e.g., Schimke v Liquid Dustlayer, Inc*, 2009 WL 3049723 at *6-7 (Mich Ct App Sept 24, 2009) (unpublished) ("Michigan has not adopted the requirement that fair value be ascertained without a discount for lack of marketability or minority status. Conversely, the definition contained in § 761 [the dissenter's rights statute] does not *require* a court to discount the value of minority shares."); *Lardner v Port Huron Golf Club*, Nos 138038, 139092 (Mich App Aug 4, 1994) (applying a 50% reduction in value of the plaintiff's stock to reflect both a minority control and marketability discount). In late 2019, the Michigan Court of Appeals attempted to more directly grapple with the question of whether discounts could be used to determine "fair value" in Michigan's oppression statutes, but arguably left some gaps to fill in its analysis and the application of its holding. *See Franks v Franks,* 330 Mich App 69, 944 NW2d 388 (2019).

The short answer is that Michigan trial courts likely have broad discretion to decide whether to apply discounts when determining fair value of minority shares in a specific case. Indeed, whether discounts apply in a given case is partly a fact specific analysis since oppression claims in Michigan are equitable. *See Madugula v Taub*, 496 Mich 685, 720, 853 NW2d 75 (2014). But lawyers should understand the nuances of the reasoning behind the application (or not) of these discounts in order to best position their clients on whatever side of the argument they are on. To that end, this Article raises and discusses issues and arguments to consider when litigating whether discounts apply when valuing the shares of a minority shareholder under Michigan's oppression statutes.

The Attributes of Discounts for Lack of Control and Lack of Marketability

Lack of Marketability Attributes

A shareholder in a closely-held, non-publicly traded company is generally not able to liquidate her shares as quickly as she would if those shares were trading (and thus salable) on a public stock exchange. Therefore, anyone who purchases these shares will be locked into an illiquid and long-term investment. As a result, a purchaser of private company shares will seek price concessions for buying shares that are not readily liquid. The diminution in value associated with this factor is referred to as a discount for lack of marketability.[1]

Michigan's oppression statutes do not define "fair value."

Lack of Control Attributes

An owner of a non-controlling interest in a private company (a minority shareholder) cannot exert control over operations and governance of the company compared to a controlling shareholder. A controlling shareholder, on the other hand, can influence key decisions and operations of the company, including but not limited to daily operations, investment decisions, management compensation, disposition of assets, and declaration and payment of distributions. Because these factors of control impact the value of the company (and therefore its stock), a non-controlling, minority share is worth less than a controlling share.[2]

* * * *

The methodologies employed to determine these valuation discounts, the studies used to support them, and the dates on which the shares are valued are outside the scope of this Article, which is focused on the legal question of whether discounts can or should be employed when determining fair value in oppression cases. But the methodologies, studies, and valuation dates underlying a valuation and any discounts applied are important to supporting, or undercutting, a valuation expert's qualifications and opinions.[3]

Should Fair Value in the Oppression Statutes Mean the Same Thing as Fair Value in the Dissenter's Rights Statute?

If a company undertakes a dramatic change in its business that results in changes to the nature of the shareholder's interests, a shareholder has a right to dissent to the corporate action and demand that her shares be appraised for purchase by the company at "fair value."[4] Classically, the corporate action is a merger or acquisition. These "dissenter's rights" protect a shareholder from being unwillingly forced into an investment that is substantially different from the one she originally made. The dissenter must formally object and observe certain statutory requirements before she can file suit.[5]

Dissenter's rights actions need not implicate oppression at all. Typically, the company's controlling shareholders did nothing wrong; the dissenter simply does not wish to participate in the changed company. In other words, the dissenter's right cause of action did not originate to penalize a corporate actor or controlling shareholder, but rather as a way to compensate a shareholder for giving up their veto right with respect to major corporate actions.[6] Moreover, in typical dissenter's rights cases the corporate transaction at issue affects all shareholders, not just minority shareholders. This is contrary to the typical oppression case, where the fair value sale remedy affects only the minority shareholder's interests.

Section 761 of the Corporation Act provides a definition of "fair value" that is limited to appraising dissenter's shares, though that definition only addresses the timing of the share valuation and does not mention discounts.[7] Because this fair value definition is expressly limited to the dissenter's rights statute, a textual interpretation precludes application of section 761's definition of "fair value" in the oppression context. However, many courts analyzing the application of discounts in a fair value determination in the oppression context refer without explanation—and many times by mistake—to fair value determinations in dissenter's rights cases. The Michigan Court of Appeals in the *Franks* decision cited mostly cases analyzing fair value under dissenter's rights statutes from other states while writing that the interpretations occurred under "shareholder oppression statutes."[8] But does it really matter? Another Michigan Court of Appeals panel a decade earlier openly used the dissenter's right statute as a basis to analyze discounts in an oppression case.[9]

A review of the Model Business Corporation Act ("Model Act"), upon which Michigan and other state's corporation acts are based, reveals an argument about why this may be an issue. As in Michigan, the Model Act has separate sections for oppression remedies (Chapter 14(C)) and dissenter's rights remedies (Chapter 13). And as in Michigan, both the oppression and dissenter's rights sections provide for the remedial purchase of the aggrieved shareholder's shares at "fair value." However, unlike in Michigan, the Model Act includes a definition of "fair value" in the dissenter's rights Chapter that expressly excludes the application of marketability and control discounts: '"Fair value' means the value of the corporation's shares determined … without discounting for lack of marketability or minority status … ."[10] Interestingly, the Model Act does not define "fair value" when discussing the option of a company or shareholder to purchase the shares of an oppressed shareholder at "fair value."[11] In other words, the Model Act does not import the discount exclusion of its dissenter's rights definition of "fair value" into its use of "fair value" as a remedy for oppression.

It is interesting that the Michigan Legislature choose not to expressly exclude application of discounts in its dissenter's rights statute. A party looking to apply discounts could argue that the Legislature's failure to exclude discounts like the Model Act does reflects an intent by the Legislature to apply discounts in dissenter's rights cases.[12] The Model Act's Official Comment to its definition of Fair Value provides the policy rationale for prohibiting discounts:

> Valuation discounts for lack of marketability or minority status are inappropriate in most appraisal actions, both because most transactions that trigger appraisal rights affect the corporation as a whole and because such discounts may give the majority the opportunity to take advantage of the minority shareholders who have been forced against their will to accept the appraisal triggering transaction. [T]he definition of "fair value" adopts the view that appraisal should generally award a shareholder his or her proportional [pro rata] interest in the corporation after valuing the corporation as a whole, rather than the value of the shareholder's shares when valued alone.[13]

Courts following the policy rationale of the Model Act essentially presume dissolution or a complete reorganization will occur, and thus find that a minority should not receive less than they would in a complete liquidation of the company's assets. In a full liquidation, all members would receive a pro rata share, and so the court will not discount the minority's share to less than its pro rata value.[14]

However, this policy rationale for excluding discounts does not typically apply in oppression cases because the acts of oppression usually do not "affect the corporation as a whole" as does an appraisal-triggering corporate transaction. Moreover, the oppression at issue in most cases does not affect the value of the company as a whole, and thus the fair value purchase remedy is focused on valuing the minority shareholder's shares alone rather than the corporation as a whole. This argument is supported by the fact that the Model Act does not import the discount prohibition in its dissenter's rights chapter into the chapter containing the fair value purchase remedy for oppression.

Given these observations, a party could argue that applying dissenter's rights statutes and interpretative caselaw in oppression cases is inapposite, especially if those authorities stand for the proposition that discounts are inapplicable when determining "fair value." This is in addition to the textual argument in Michigan and other states that do not expressly exclude discounts from the definition of "fair value" in their dissenter's rights statutes, as does the Model Act.

However, there are other policy and equitable arguments a party can use in arguing against application of discounts in a fair value calculation under the oppression statutes. For example, because oppression cases are equitable, the court could find that imposing a financial burden on the majority by purchasing majority shares above market value (i.e. with no discounts) is warranted based on the court's view of the acts of oppression by the majority.[15] Conversely, if the court orders the oppressed shareholder to purchase

It is interesting that the Michigan Legislature choose not to expressly exclude application of discounts in its dissenter's rights statute.

the interest of oppressive shareholder, the court may nonetheless apply marketability discounts to the oppressed shareholder's fair value price.[16]

Franks v Franks:[17] Michigan's Most Recent Statement on Applications of Discounts in Oppression Cases

In *Franks*, the majority owners in a family business controlled all the voting shares of the company, had an active role in management, and controlled stock distributions to shareholders. The minority shareholders owned non-voting shares and had no role in management of the company.[18] The majority shareholders stopped paying dividends and proposed to buy the minority shares for $62 a share, though this number was not based on any valuation. The court ultimately valued the shares at $712 per share. The minority shareholders deemed this conduct oppressive and sued for oppression under section 1489 of the Corporation Act.[19] The trial court found oppression and ordered as a remedy that the majority purchase the minority shares at fair value as set forth in section 1489(1)(e) of the Corporation Act. At a hearing on valuation, the trial court selected the valuation of the minority shareholder's expert valuing their shares at $712 a share, and held that the court was prevented from applying "a discount to lower the fair value of the shares."[20] One of the questions on appeal was whether the trial court erred in determining it was prevented from applying discounts in determining fair value when ordering a stock buy-back remedy under the Michigan's oppression statute.

The Michigan Court of Appeals ultimately determined that courts in Michigan have discretion to apply discounts when determining the fair value of oppressed shares under Michigan's oppression statute. But first, the court conducted an analysis of what it said were foreign court interpretations of "their respective shareholder-oppression statutes" to conclude that "fair market value" has a "technical meaning" that is different than "fair value."[21] On this point, the court concluded that "fair market value" inherently includes discounting while "fair value" inherently does not: "A fair market value would, therefore, take into consideration the fact that a ready, willing, and able buyer might discount the value of the shares on the basis of limitations in the shares."[22]

The Michigan Court of Appeals ultimately determined that courts in Michigan have discretion to apply discounts when determining the fair value of oppressed shares under Michigan's oppression statute.

Based on its analysis of non-Michigan legal authority, the *Franks* panel set forth its "opinion" that the Michigan Legislature "used the term 'fair value' to distinguish the remedy from purchase at 'fair market value.'"[23] So in its opinion, the *Franks* court concludes that the Michigan Legislature intended to use the term "fair value" as opposed to "fair market value" in Michigan's oppression statute, which based on the court's reasoning connotes a legislative intent that determining "fair value" under Michigan's oppression statute does not include discounts.

But as discussed above, most of the case law the *Franks* court relied on to reach this conclusion analyzed fair value under the dissenter's rights statutes in other states, not shareholder oppression statutes. And as previously discussed, there are arguments going both ways about whether a fair value analysis under a dissenter's rights statute can or should be the same under a shareholder oppression statute, especially where Michigan's dissenter's rights statute declines to adopt language excluding discounts like the Model Act and other states do.[24]

Despite its opinion that the Legislature used fair value to distinguish that term from fair market value because the latter term included discounts, the *Franks* court "[n]everhteless" found that "nothing within the statute precludes a trial court from considering fair market value when determining fair value."[25] In other words, the court held that trial courts can consider discounts even though it thought the Legislature intended to use a term that precluded the use of discounts. In support of this latter holding, the *Franks* court relied on a Michigan Court of Appeals decision valuing stock under Michigan's dissenter's rights statute using various valuation methodologies, though the case did not discuss fair value or the use of discounts.[26]

As further support for its holding that trial courts can use discounts when determining fair value, the *Franks* court said the "statutory scheme as a whole" in section 1489 "does not preclude a trial court from applying discounts when crafting a remedy."[27] The court's reasoning is anchored in the broad, permissive discretion afforded the courts by the Legislature to fashion remedies for oppression under section 1489:

> In providing for relief under MCL 450.1489(1), the Legislature stated that a trial court could "order or grant relief

> as it considers appropriate[.]" The Legislature further provided that the relief "may" include "without limitation" the "purchase at fair value of the shares of a shareholder[.]" MCL 450.1489(1)(e). The Legislature did not define "fair value." However, by stating that the trial court "may" order the purchase of the shares at issue at "fair value" "without limitation," the Legislature indicated that trial courts were not required to order such relief, but may do so if appropriate. Stated differently, the Legislature gave the trial court broad authority to fashion its remedy to suit the equities of the case—that is, to fashion a remedy that was "appropriate" under the circumstances. MCL 450.1489(1). Therefore, while the trial court has the authority under MCL 450.1489(1)(e) to order that defendants purchase plaintiff's respective shares at "fair value," nothing within the statutory scheme requires the trial court to value the shares in any particular way. Given the Legislature's broad grant of authority to craft a remedy for shareholder oppression under MCL 450.1489(1), we conclude that a trial court is required to order an "appropriate" remedy, which may include an order to purchase shares at "fair value" or at any other value that the court concludes is appropriate under the totality of the circumstances. In this case, the trial court had the authority to value the shares without discounts under MCL 450.1489(1)(e) but was not required to do so. Because the trial court had authority to value the shares in any way that was equitable under the totality of the circumstances, the trial court erred to the extent that it felt compelled to value the shares without any discounts.[28]

This same rationale was used by another Michigan Court of Appeals panel a decade earlier when finding that trial courts had discretion to apply discounts when determining fair value when ordering a share redemption under section 1489.[29] In *Schimke*, the court affirmed the trial court's refusal to apply discounts in its fair value analysis because the ownership interests of the oppressed and non-oppressed shareholders "were so close together."[30] To protect the trial court's discretion, the *Schimke* court cited the same broad, permissive language in section 1489 that the *Franks* court cited, though *Schimke* was not cited or discussed in *Franks*. The *Schimke* court openly analyzed the definition of fair value in Michigan's dissenter's rights statute to conclude in that oppression case that the trial court was not required to apply discounts: "Michigan has not adopted the requirement that fair value be ascertained without a discount for lack of marketability or minority status. Conversely, the definition in § 761 [the dissenter's right statute] does not *require* a court to discount the value of minority shares. The trial court correctly recognized this principle."[31]

The Model Act is not cited by *Schimke*, but, as discussed *supra*, the Model Act's dissenter's rights provision requires that discounts *not* be applied. Michigan has not adopted this discount prohibition in its dissenter's rights statute. So *Schimke* may lend support to an argument that discounts are appropriate in oppression and dissenter's rights cases because Michigan rejected the Model Act's express prohibition of discounts in its dissenter's rights statute.

In 1994, the Michigan Court of Appeals in *Lardner v Port Huron Golf Club* affirmed the trial court's 50 percent marketability and control discounts when determining the fair value of minority shares in a court-ordered buy back under the oppression statute.[32] In support of its holding the court cited the same Michigan dissenter's right case as the *Franks* panel, though it did not provide any further substantive analysis.[33] The *Franks* panel did not cite or discuss the *Lardner* case.

What if the Company's Governing Documents Provide Buyout Valuation Terms Requiring Discounts?

Michigan courts have not addressed the application of discounts in an oppression case where the entity's governing documents address application of discounts in calculating buyout prices for shares. What if a company's governing documents require the application of discounts when calculating the buyout price for the company's shares?

Michigan courts have not addressed the application of discounts in an oppression case where the entity's governing documents address application of discounts in calculating buyout prices for shares.

Michigan courts uphold corporate bylaws as contracts "between a corporation and its shareholders."[34] And so an operating agreement is also a "written contract between the members of a limited liability company …."[35] According to the Corporation Act, bylaw contracts "may contain any provisions for the regulation and management of the affairs of the corporation not inconsistent with law or the articles of incorporation."[36] Likewise, the LLC Act permits LLC operating agreements wide latitude in determining when and how LLC members can be removed: "An operating agreement may provide for the expulsion of a member or for other events the occurrence of which will result in a person ceasing to be a member of the limited liability company."[37] Furthermore, if conduct is approved by the operating agreement of an LLC, courts will not find that conduct oppressive.[38] And if the operating agreement sets forth the methodology to calculate the share price of a withdrawing member, that calculation governs.[39] Commentators on the LLC Act recognize that shareholders should use methods to liquidate membership interests that "may allow a shareholder to use a minority discount in valuing the LLC membership interest" in order to reduce tax liabilities in connection with the liquidation.[40] Given these corporate principles, one commentator suggested courts "first consider" a company's governing documents when determining whether to apply discounts.[41]

Given the deference Michigan legislation and courts give to corporate governing documents, there is support for courts deferring to an oppressed minority shareholder's freely contracted methodology of using discounts if the company's governing documents require them. However, given the flexibility Michigan courts have in fashioning remedies under Michigan's oppression statutes, a court could find support for ignoring the contract between a company and its minority shareholder requiring discounts in valuing minority shares if the court determines the oppressive shareholder's conduct was fraudulent, in bad faith, or other special circumstances applied. But if the court fails to apply discounts to punish an oppressive shareholder, an argument could be made that these are punitive damages that a court in equity has no authority to award.[42] Another consideration is whether the oppressed shareholder claims she was fraudulently induced to agree to governing documents containing mandatory discounts in pricing shares.

Conclusion

While legal practitioners and commentators may be able to quibble with technical interpretations about whether discounts are permitted under Michigan's oppression statutes, it may be that the discretion afforded trial courts by the *Franks* opinion lands in the right spot since the Michigan Supreme Court in *Madugula* confirmed that oppression is an equitable claim and remedy. Indeed, because the facts and circumstances of an oppression claim will be unique in every case, it may make sense for a trial court to have maximum flexibility in determining whether to apply discounts when ordering the sale of shares as a remedy for oppression. But the trade-off for flexibility is a lack of certainty as to how a particular court in a particular case will decide the "discount issue." Until the Michigan Legislature decides to opt for legislative certainty, parties will need to be guided by the principles in this Article in crafting their positions on the application of discounts in oppression buyback cases.

NOTES

1. *See generally* Research Institute of Am., Tax Advisors Plan. Sys. 9:8.01 – 05, *Valuation of a Closely Held Business: Discounts and Premiums, RIATAPS* s 9:8.01-05 (Thomson Reuters 2020); Matt C. Courtnage, *Valuation Discounts in Dissenting Shareholder Appraisal Rights and Shareholder Oppression Claims*, Insights, Willamette Management Associates, Issue 120 (Spring 2019); *Cox Enters, Inc. v News-Journal Corp*, 510 F.3d 1350, 1354-57 (11th Cir. 2007); Sandra K. Miller, *Discounts and Buyouts in Minority Investor LLC Valuation Disputes Involving Oppression or Divorce*, 13 U. PA. J. BUS. L. 607, 612-16 (2011); Douglas K. Moll, *Shareholder Oppression and "Fair Value": Of Discounts, Dates, and Dastardly Deeds in the Close Corporation*, 54 DUKE L.J. 293, 315-18 (2004).

2. *See id.*

3. *See, e.g.*, Moll, supra note 1 at 298 ("Given how quickly a company's fortunes can change, the question of when to measure fair value is a critical inquiry in and of itself, as the choice of date can have a significant impact on the ultimate fair value conclusion.").

4. *See* Corporation Act, Chapter 7, MCL 450.1761(d); 1762; 1772(1).

5. *See generally* MCL 450.1754-74.

6. *See, e.g., HMO-W Inc v SSM Health Sys*, 228 Wis 2d 815, 827 (1999); *Pueblo Bancorporation v Lindoe, Inc*, 63 P3d 353 (Colo 2003).

7. *See* MCL 450.1761(d) ("'Fair value,' *with respect to dissenter's shares*, means the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporation action unless exclusion would be inequitable" (emphasis added)).

8. *See Franks v Franks*, 330 Mich App 69, 99, 944 NW2d 388 (2019) (four of the six cases cited for interpretations of their state's "shareholder oppression statutes" were actually cases interpreting a dissenter's rights statute, including the one Michigan case cited, *Morley Bros v Clark*, 139 Mich App 193 (1984)).

9. *See Schimke v Liquid Dustlayer, Inc*, No 282421 (Mich Ct App Sept 24, 2009) (unpublished).

10. Model Act, Chapter 13.01, "Fair Value." The definition provides a narrow exception to the discount prohibition in circumstances where a company amends

its articles of incorporation to reduce a shareholder's shares for a fraction of a share and then give the company a right to repurchase the fractional shares created. And even in this circumstance the exception to the Model Act's discount prohibition is only applicable "if appropriate." The American Law Institute defines "fair value" in the dissenter's rights context to exclude control discounts, but permits marketability discounts only in "extraordinary circumstances." American Law Institute, *Principles of Corporate Governance*, § 7.22. The Revised Uniform Partnership Act avoids using "fair value" but talks instead about a "buyout price," which it says should exclude control discounts but that marketability discounts "may be appropriate." Revised Unif. P'ship Act § 701 (cmt 3).

11. *See* Model Act, Chapter 14, section 14.34.

12. *But see Pueblo Bancorp v Lindoe, Inc*, 63 P3d 353, 368 (Colo 2003) (rejecting this argument for Colorado's dissenter's rights statute, which was identical to Michigan's until July 1, 2020, and adopting instead the policy rationale of the Model Act in excluding discounts when determining fair value under Colorado's dissenter's rights statute: "Because the legislature has consistently relied on the [Model Act] when fashioning the corporate laws of this state we find the views of the [Model Act] on this issue to be persuasive."). However, in 2019 the Colorado Legislature amended its dissenter's right statute and adopted verbatim the Model's Act's definition of "fair value" that expressly excludes discounts. *See* 2019 Colo. Legis. Serv. Ch. 166 (S.B. 19-086), CRSA 7-113-101(3) (eff. July 1, 2020). *See also Schimke v Liquid Dustlayer, Inc*, No 282421 (Mich Ct App Sept 24, 2009) (unpublished) (finding that trial court had discretion not to apply discounts in an oppression fair value determination because Michigan's dissenter's right statute does not expressly require discounts).

13. Model Act, Official Comment 2(B) to section 13.01.

14. *See, e.g., Brown v Allied Corrugated Box Co*, 91 Cal App 3d 477, 486 (1979).

15. *But see Ferolito v Arizona Beverages USA, LLC*, 2014 WL 5834862, *21 (NY Sup 2014) (applying 25% marketability discount to dissenter's shares because New York statute did not exclude discounts, and doing so despite alleged "bad acts" because "there was no credible evidence that these acts caused any damage to … the company.").

16. *See, e.g., Parker v Parker*, 2016 WL 7484852 (NJ Super Dec 22, 2016), *aff'd* 2019 WL 1253348 (NJ App Mar 18 2019).

17. 330 Mich App 69, 944 NW2d 388 (2019).

18. *See id.* at 76.

19. MCL 450.1489.

20. *Franks, supra* at 84.

21. *See id.* at 110.

22. *Id.*

23. *Id.* at 111.

24. *See* discussion *supra*.

25. *Franks*, 330 Mich App at 111-112.

26. *See id.* (citing *Morley Bros v Clark*, 139 Mich App 193, 197-98 (1984)).

27. *Id.* at 112.

28. *Id.* at 112-113.

29. *Schimke v Liquid Dustlayer, Inc*, No 282421 (Mich Ct App Sept 24, 2009) (unpublished).

30. *Id.* at *6.

31. *Id.*

32. *Lardner v Port Huron Golf Club et al*, Nos 138038, 139092 (Mich Ct App Aug 4, 1994) (unpublished).

33. *See id.* at *6 (citing *Morley Bros v Clark*, 139 Mich App 193 (1984)).

34. *Ward v Idsinga*, No 302731 at *3 (Mich Ct App Aug 15, 2013) (unpublished) (citing *Cole v Southern Michigan Fruit Ass'n*, 260 Mich 617, 621-22 (1932)).

35. *S-S, LLC v Merten Bldg Ltd P'shp*, No 292943 at *2 (Mich Ct App Nov 18, 2010) (unpublished).

36. MCL 450.1231.

37. MCL 450.4509(2).

38. *See S-S, LLC, v Merten Bldg Ltd P'shp*, No 292943 at *6 (Mich Ct App Nov 18, 2010) (unpublished).

39. *See, e.g., Bellwether Cmty Credit Union v CUSO Dev Co, LLC*, 566 F App'x 398 (6th Cir 2014); *Kyle v Apollomax, LLC*, 987 F Supp 2d 519, 528 (D Del 2013) (rejecting claim that company owed fair market value of shares because operating agreement provided for a different share valuation).

40. *See* Cambridge, *Michigan Limited Liability Companies*, §8.36 (ICLE 2020).

41. *See, e.g.,* Miller, *supra* note 1 at 648.

42. A penalty is punitive, meant to punish. It is not equitable. *See Tull v United States*, 481 US 412, 422 (1987) (noting that a "punitive damages remedy is legal, not equitable, relief." (citing *Ross v Bernhard*, 396 US 531, 536 (1970))). "A 'penalty' is a 'punishment, whether corporal or pecuniary, imposed and enforced by the State, for a crime or offense against its laws.'" *Kokesh v SEC*, 137 S Ct 1635, 1642 (2017). Before the State can impose a penalty it must afford a defendant the right to a jury trial, is bound by shorter limitations periods in which to seek the penalty, among other constitutional protections. *See Tull*, 481 US at 525; *Gabelli v SEC*, 568 US 442 (2013); *Kokesh v SEC*, 137 S Ct 1635 (2017). More to the point, courts cannot impose a penalty without express statutory authority to do so. *See Decorative Stone Co v Building Trades Council*, 23 F2d 426, 427-28 (2d Cir 1928) ("Courts of equity do not award as incidental relief damages penal in character without express statutory authority."). In *Madugula v Taub*, 496 Mich 685, 853 NW2d 75 (2014), the Michigan Supreme Court held that the option of awarding damages (a traditional legal remedy) in the Michigan oppression statutes was not sufficient to overcome the holding that an oppression claim sounds in equity with no entitlement to a jury. *See id.* at 703-04, 714. *Madugula* did not address whether declining to apply discounts in order to punish an oppressive shareholder was possible or lawful.

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Insider Trading – Fed's Employ More Effective Weapon

By Stuart Sinai[1]

Introduction

On December 29, 2019, the government fortified its fight against insider trading by prevailing in the federal Second Circuit Court of Appeals on the basis of a statute infrequently used with regard to insider trading matters. In *United States v Blaszczak*,[2] the court found that elements that had to be proven in most prior cases dealing with insider trading involving "tipping," almost always prosecuted under Title 15's section 10(b) and Rule 10b-5, are now perhaps irrelevant under an infrequently used law that was adopted in 2002.[3]

Although the U.S. Department of Justice has accumulated over 100 criminal convictions during approximately the last decade, including recently a congressman, and maybe more to come, whose recent trading is suspicious, it could have had more wins if not hampered by the principal law used to prosecute. The Securities and Exchange Commission ("SEC") used that same law to bring literally several hundred civil actions alleging insider trading. Section 10(b) and its Rule 10b-5[4] were included as part of the Securities Exchange Act of 1934 ("Exchange Act"),[5] and although banning manipulative, deceptive behavior, and any "device, scheme or artifice to defraud," it did not address specifically insider trading. Accordingly, it remained for the federal courts to determine the contours of "insider trading" including essential elements of the offense that had to be present before one could be found criminally guilty or civilly liable.

Traditional Forms of Insider Trading

"Classical Insider Trading" occurs when an "insider," i.e., officer, director or other executive or employee of a publicly-traded company uses undisclosed, non-public, confidential information acquired in her fiduciary capacity concerning a material event, that is likely to effect the price of its publicly trading securities, to buy or sell those securities.[6]

For there to be a "crime" of insider trading under the Exchange Act, the government must prove, for instance, that the accused company officer abused her "fiduciary duty" to the company. That is, such officer had violated an official policy/duty to the company and its shareholders by using, stealing, and then trading on the basis of the confidential information for her own personal profit.[7]

Then there is also the "misappropriation theory" catching those who are not employees of the company but engaged as outside services such as attorneys, auditors, consultants, frequently to work on special matters or upcoming events that may have a significant impact on the company's business and on the price of its trading securities. When that category of people, "outsiders" use ("misappropriate") confidential information belonging to the company to trade or tip, they are also subject to prosecution.[8]

Then There Are "Tippees"

That same officer, or misappropriator, might also be charged with leaking that confidential information to a so-called "tippee" who often was a close relative, friend or business associate in return for what is deemed to be a "personal benefit."[9]

To convict such a tippee under the Exchange Act's section 10(b) and Rule 10b-5, she must know that the tipper/leaker, e.g., the officer, breached her duty when disclosing the non-public confidential information by receiving a "personal benefit," e.g., a bribe, a share of the profits, some other *quid pro quo*[10] or, in some cases, just intending to benefit the tippee.[11] However, sometimes tippees do not receive their tip directly from the company tipper, but from the tipper's original tippee or from some tippee down the line, e.g., the tippee's tippee ("remote tippee").[12]

These "remote tippees" often do not know the identity of the original tipper/leaker nor whether such tipper received any personal benefit for her leak. Without knowing there was a personal benefit, courts have ruled that such remote tippee could not have known that there was a "breach of fiduciary duty" and could not be convicted of section 10(b) and Rule 10b-5 violations.[13]

Background

As mentioned above, almost all Justice Department prosecutions in the past have relied upon Title 15, section 10(b) and Rule 10b-5 to prosecute insider trading charges. As we have also indicated, the *Blaszczak* case tried another route, it sought conviction for violation of section 1348. The 2002 Sarbanes-Oxley Act enacted Title 18's section 1348 to also deal with securities fraud. However, interestingly, section 1348 was not even mentioned in four relatively recent, but prior to *Blaszczak*, insider trading court opinions.[14]

According to the *Blaszczak* decision, section 1348 does away with several court-made elements otherwise necessary for a section 10(b) and Rule 10b-5 prosecution, especially with respect to tippee cases. It makes the government's burden for insider trading prosecutions especially for "tippees" much easier. The *Blaszczak* decision cited *United States v Mahaffy,* a 2012 prior case, which provides precedent for the position that section 1348 can independently support an indictment for securities fraud, i.e., insider trading.[15]

The *Mahaffy* court stated: "[t]he district court's jury charge, which the defendant's do not challenge in this respect, instructed the jury to find each defendant guilty if the jury unanimously concluded beyond a reasonable doubt that he knowingly and intentionally violated, or aided and abetted the violation of, either subsection 1348(1) or 1348(2)."

In fact, the *Mahaffy* court indicated that "the government introduced sufficient evidence," "the evidence was sufficient to establish … ."[16] "Taken as a whole, the evidence against Nwaigue [defendant] was sufficient for the jury to find that he knew … [the information] … received were confidential and that he knowingly agreed to participate in a scheme … ."[17] There was no mention of Exchange Act violations or its required elements, and the defendants did not challenge that jury charge. Again, there was no mention of the need to find that the tipper had received a personal benefit in exchange for his tip, an otherwise essential element of a section 10(b), Rule 10b-5 prosecution.

District Courts

Few cases at the federal district court level have involved prosecuting insider trading charging violation of section 1348. In *United States v Jun Ying*,[18] Ying was charged with two counts of insider trading. Ying challenged the sufficiency of the indictment. The district judge upheld the Magistrate's Report and Recommendation that the indictment adequately contained the essential elements of an insider trading charge under §1348, i.e., that he "knowingly possessed" material non-public information and "traded on the basis of that information."[19] There is no mention of the need for a breach of fiduciary duty nor of the necessity of a personal benefit. Furthermore, the defendants did not challenge the general applicability of section 1348 to insider trading fitting within the meaning of its "securities fraud" rubric. Ying's challenge was that to be charged with insider trading "willfulness had to be alleged." The District Court agreed with the Magistrate that although prosecution under Title 15's section 10(b) required proof that defendant acted willfully, that Title 18 USC 1348 does not.[20]

Concerning the Requirements of Section 10(b) and Rule 10b-5

United States v Newman,[21] decided in 2014, also a Second Circuit Court of Appeals decision, charged violation of section 10(b) and Rule 10b-5. It held that tippees (in this case " remote tippees"—those who were down the line from the original tippee) must know that not only that it was an insider-tipper that disclosed (leaked) the confidential, non-public information, but also had to know that the insider had breached a fiduciary duty in doing so by receiving some sort of "personal benefit" in exchange for her leak(s). Newman and his co-defendant were members of a group of managers of different hedge funds that had worked together to seek out as-of-yet undisclosed confidential material information (often improperly from insiders such as officers or employees of various publicly-traded companies) that they could use to make securities trades. The co-defendants often learned from second or third hand sources about such information as it was passed from one member of their group to another, and depending where they were in the line of tippees, they frequently did not know the original source of that information or whether that source had received any type of personal benefit.

Newman and his co-defendant were convicted in the District Court and appealed. Newman argued that the government did not provide sufficient evidence to show that he or his co-defendant knew the original source of the information, i.e., the identity of the insider-tipper, or knew whether that tipper

For there to be a "crime" of insider trading under the Exchange Act, the government must prove, for instance, that the accused company officer abused her "fiduciary duty" to the company.

had breached a fiduciary duty or knew if such tipper had received a "personal benefit" of some kind for his disclosures. The Second Circuit held that the government's lack of proofs as to these necessary elements of the alleged crimes required reversal of the convictions.[22]

Had the government charged Newman under section 1348, as will be discussed hereafter, and had yet come around to the Second Circuit's later views in *Blaszczak*, Newman would today be in prison.

Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act[23] that was adopted in 2002 incorporated a new provision that was also to deal with "securities fraud," i.e., section 1348, that was added to Title 18 to deal with, among others, "scheme or artifice to defraud."[24] This new section portended an expansion of prosecutorial weapons. However, Title 18, similarly to Title 15, also did not define or include in the statute a definition of "insider trading."

> Few cases at the federal district court level have involved prosecuting insider trading charging violation of section 1348.

Precursors to Blaszczak

The *Mahaffy* court, citing, *United States v Motz*,[25] stated that the only necessary elements to prove "securities fraud" under §1348(1) are "(1) fraudulent intent, (2) scheme or artifice to defraud, and (3) nexus with a security." As stated earlier herein, there was no mention of the need to prove the elements required in section 10(b) and Rule 10b-5 prosecutions.

In *United States v Slawson*,[26] the remote tippee defendant was charged with several Title 18 violations; section 1343 (wire fraud), section 1348 (securities fraud), and section 1349 (conspiracy to commit wire and securities fraud). Slawson argued,[27] citing *Dirks*, that the elements necessary to convict for violations of Title 15's section 10(b) and its Rule 10b-5 should also be applicable to alleged section 1348 violations.[28]

Slawson argued that the indictment did not allege that he, as a remote tippee, "knew the insiders [the tippers] knew that the insiders breached their [fiduciary] duty by making the disclosures, and knew that the insiders received a [personal] benefit for their actions."[29] The government argued that the defendant's reliance on the elements necessary for a conviction under section 10(b) and Rule 10b-5 did not apply to a Title 18 crime.[30] The court responded by indicating that "defendant has not offered a single legal authority applying that [section 10(b) and Rule 10b-5] caselaw to the Title 18 securities fraud violations alleged in this indictment."[31]

The Magistrate further stated:

> Absolutely nothing in the language of §1348 or any case this court found setting forth the elements … for that section makes reference to [the need to] proving … that a defendant … *knew* the identities of individuals providing material, non-public information, *knew* that these individuals breached their duty by making the disclosures and *knew* that these individuals received a [personal] benefit for their actions.[32]

The *Slawson* court was emphatic that there was no need to prove Title 15's section 10(b) and Rule 10b-5 jurisdictional judge-made elements in order to find a violation of Title 18, section 1348.

This *Slawson* 2014 Order and Report and Recommendation of the Magistrate was certainly a precursor to *Blaszczak*.

Accountant—Misappropriator and Tipper

In *United States v Thomas D Melvin*,[33] defendant, a CPA, disclosed confidential information that he discussed with a client who was a board member of a publicly traded company. That company was about to be acquired in a tender offer. Although the client told Melvin that the matter was confidential and that he was seeking Melvin's advice as a CPA, and although Melvin purchased no securities himself, he tipped several people who made profitable purchases and then sales. The SEC had filed a civil suit pursuant to section 10(b) and Rule 14(e) (regarding tender offers) of the Exchange Act. The defendant, Melvin, paid fines in the civil matter and was barred from practice before the SEC. In the meantime, the Justice Department instituted criminal proceedings alleging violation of section 18 USC 1348, by participating in a scheme to defraud.[34] He plead guilty to six counts of section 1348 securities fraud but subject to the right to challenge the statute's constitutionality and the sufficiency of the indictment. He had been charged with aiding and abetting his tippees' illegal trades.

As indicated, the *Melvin* defendants challenged the constitutionality of section 1348 for its alleged vagueness.[35] The court held that the language "scheme or artifice to defraud is not vague and has a well-established meaning."[36]

The *Melvin* defendants also argued that even if section 1348 was constitutional, the indictment failed to allege the essential elements required to prove insider trading, i.e., those elements required for a conviction under section 10(b) and its Rule 10b-5.[37] The court stated that "[f]irst, defendants have not offered any authority that expressly indicates the elements required to prove an insider trading violation under§10(b) and Rule 10b-5 should be imported into §1348."[38]

The defendants also argued that the board member of the public company that informed Melvin was the "tipper" and accordingly he was the one required to have received a personal benefit.[39] The court stated that even if personal benefit was a factor in a section 1348 charge, that the "misappropriation theory" dictates that the misappropriator (Melvin) becomes the prime leaker and even if personal benefit were an essential element of a section 1348 crime, it is he who is to be looked at.[40] The defendants then alleged that Melvin received no personal benefit. The court citing *Dirks* indicated that the definition of personal benefit was very broad, including "where the tipper sought to enhance his reputation (which would translate into future earnings) … ."[41] The court made it clear even if there were an element of personal benefit required, it was present.

Unlike *United States v Jun Ying*, *United States v Melvin*, and the *Mahaffy* case,[42] although before the *Blaszczak* case, there were some other cases in lower and appellate courts alleging "securities fraud" pursuant to section 1348, most were not insider trading cases.[43]

United States v Blaszczak—Justice Department Realizes Its Weapon

It was the *Blaszczak* decision in December 2019,[44] pursuant to a conviction under Title 18 USC 1348, for insider trading involving remote tippees, that appears to have made the Justice Department finally realize just how powerful this weapon is.

The *Blaszczak* case involved several defendants. Worrall was an employee of the government agency, The Centers for Medicare and Medicaid Services ("CMS"). He was the tipper. In 2012 Worrall disclosed confidential information concerning proposed rules that were about to be announced by CMS to Blaszczak, the original/direct tippee, who was a health care consultant to several hedge funds. Blaszczak in turn disclosed the confidential non-public information to two employees of a health care-concentrated hedge fund. That fund then used the information to trade in companies that would likely be affected by such information when it finally became publicly known. The information indeed affected those companies and the hedge fund made substantial profits from its securities transactions that been executed prior to the time of the public disclosures. In fact, Blaszczak from his "sources" at CMS had been providing information since 2009 to several hedge fund managers.

The Charges and Jury Instructions

All the defendants were charged with a number of counts, including, among other violations, Title 15 securities fraud (section 10(b) and Rule 10b-5) (again enacted as part of the Exchange Act of 1934)[45] and various Title 18 wire and securities fraud (section 1348) counts.[46]

As section 10(b) and Rule 10b-5 caselaw presently require, to convict defendant Worrall, the CMS employee and original tipper/leaker who disclosed the information to the first (direct) tippee, Blaszczak, the trial court instructed the jury that:

> (1) In order to convict Worrall of Title 15 securities fraud, it needed to find that he [Worrall] tipped confidential CMS information in exchange for a "personal benefit;" (2) in order to convict Blaszczak of Title 15 securities fraud, it [the jury] additionally needed to find that he [Blaszczak] *knew* that Worrall disclosed the information in exchange for a personal benefit; and (3) in order to convict [the remote tippee - defendants to whom Blaszczak in turn had passed the confidential information] of Title 15 securities fraud, it needed to find [the remote tippees] *had to know* that the CMS insider [who was the original source of the information] tipped the information in exchange for a personal benefit."[47]

However, the trial court did not give such instructions for the 2002 SOX Title 18 counts, including counts based upon section 1348. In effect, indicating that being aware of the original source of the information and whether that source received a personal benefit were not necessary to be convicted of insider trading under Title 18 USC 1348.[48]

It was the *Blaszczak* decision in December 2019, pursuant to a conviction under Title 18 USC 1348, for insider trading involving remote tippees, that appears to have made the Justice Department finally realize just how powerful this weapon is.

The *Blaszczak* decision presumably makes it much easier for the Justice Department to prevail in insider trading cases, especially those involving tippees by charging the crime under section 1348.

A jury found all the defendants guilty of, among other counts, violation of section 1348 securities fraud, deciding that insider trading, although not defined in section 1348, fit within its meaning(s) of "securities fraud." However, the jury also acquitted the defendants of all Title 15 securities fraud counts (i.e., section 10(b) and Rule 10b-5). The defendants appealed the Title 18 convictions, including those pursuant to section 1348.

The Elements of the Title 15 and Title 18 Charges

The Second Circuit in *Blaszczak* explained the requirements for conviction under section 10(b) and Rule 10b-5.[49] The court indicated, "[u]nder *Dirks*, an insider [the tipper/leaker] may not be convicted of Title 15 securities fraud unless the government proves that he breached a duty of trust and confidence [fiduciary duty] by disclosing material, nonpublic information in exchange for a 'personal benefit.' 463 US at 663. Similarly, a tippee may not be convicted of such fraud unless he utilized the inside information knowing it had been obtained in breach of an insider's duty" [i.e., knowing the tipper-source of the information, and that such tipper received a personal benefit].[50]

Although the defendants did not question the validity of application of section 1348 to insider trading, the dispute was whether elements that had to be present to support a section 10(b) and its Rule 10b-5 conviction also had to be present for a section 1348 securities conviction (i.e., whether a tipper received a "personal benefit" and whether a tippee was aware of such personal benefit). The court in *Blaszczak* indicated "… we hold that the personal benefit test does not apply to … Title 18 securities fraud statutes."[51]

The Second Circuit related that the trial court had instructed the jury that, to convict pursuant to Title 18 securities fraud counts—i.e., 18 USC 1348—it had to find the existence of a scheme to defraud. It had to find that the defendants' "participated in a scheme to embezzle or convert confidential information … by wrongfully taking that information … to his own use or the use of someone else." And "knowingly and willingly participated in the fraudulent scheme."[52] There was no mention in the section 1348 jury instructions of the need to find the defendants had to know who the tipper was or whether he had received some personal benefit for providing such tips to the original tippee (Blaszczak).

The Defense

Defendants argued that the requirements the courts developed under Title 15 should also apply to the alleged criminal insider trading under Title 18 as neither Title 15 nor Title 18 specifically defined insider trading. Since both these statutes were essentially dealing with the same undefined securities fraud/alleged crime of insider trading, defendants argued therefore that prior court-developed law defining the elements of insider trading should be applied equally to each. That is, the defendants argued an insider could not breach her fiduciary duty to her employer unless she disclosed the information for a personal benefit.[53] The defendants' argument would also mean that especially a remote tippee could not violate section 1348, unless she knew that the source of that information had received a personal benefit.[54]

Defendants' argued in effect that under Title 18 even though a tippee may obviously be aware that she is trading based upon confidential non-public material information, if she did not know the original source (the tipper) had received some *quid pro quo*, a personal benefit of some sort, the tippee could not be found guilty of insider trading/securities fraud (again, because she was unaware whether the tipper had received a personal benefit and therefore could not know that such tipper breached a fiduciary duty).

The Second Circuit Disagreed with Defendants

The Second Circuit stated: "… we decline to extend *Dirks* [requiring a personal benefit] beyond the context of that [Title 15, Exchange Act] statute.[55]

The Dissent in Blaszczak

The Dissent in *Blaszczak* argued that the CMS confidential information, which the officer/tippee (Worrall) leaked, was not "property" within the meaning of section 1348 and other Title 18 provisions[56] and that all counts should be vacated.[57] However, the Dissent did not challenge or question or even discuss at all the applicability of section 1348 to insider trading, apparently assuming its applicability if government information was deemed "property," with which he disagreed.[58]

Implications from *Blaszczak* and *Martoma* II

The *Blaszczak* decision presumably makes it much easier for the Justice Department to prevail in insider trading cases, especially those involving tippees by charging the crime under section 1348. Notwithstanding the apparent efficacy of employing section 1348 to find securities fraud, e.g., insider trading, it would appear from *Martoma II* that section 10(b) and Rule 10b-5 could still be an effective tool to prosecute. Even though Title 18, section 1348, according to *Blaszczak,* may require lesser elements to convict (e.g., irrelevance of personal benefit to the tipper), *Martoma II's* interpretation of prior section 10(b) and Rule 10b-5 caselaw found that a mere "intention to benefit" the tippee may be sufficient to imply a personal benefit to the tipper, and to find a breach of fiduciary duty.[59] Accordingly, indictments charging violation of section 10(b) and Rule 10b-5 are still likely.

Willfully v. Knowingly

As indicated previously, in *United States v Jun Ying*,[60] defendant, an employee of a publicly traded company, traded in its securities on the basis of material non-public information and was charged with violation of section 10(b) and Rule 10b-5 and section 1348. He sought to have the indictment dismissed.

The defendant did not challenge the general applicability of section 1348 to insider trading fitting within the meaning of section 1348's "securities fraud rubric." Ying's challenge was that to be charged with insider trading under that section 1348 "willfulness had to be alleged."[61]

The District Court's Order Opinion discussing the elements of "willfulness" indicated that defendant had cited no legal authority to find that section 1348 required proof of willfulness and that "the Magistrate Judge determined that a violation of §78j(b) (1934 Exchange Act, §10(b)) and §§78ff requires among other things, proof that the defendant acted willfully, whereas a violation of §1348 does not."[62] In the District Court's Order, the Judge stated, agreeing with the Magistrate that:

> … the actual language of the statutes (§1348) does not include the word willful or willfully. This omission of the word willfully in §1348 lies in contrast to the language of §§78ff [the penalties provision for violation of Title 15 sections, including §10(b)] which explicitly includes the word willfully. Compare 18 U.S.C. 1348 with 15 U.S.C. 78ff.[63]

The "willfulness" v. "knowingly" issue, along with whether the court-adopted elements defining insider trading applicable to section 10(b) and Rule 10b-5, are equally applicable to section 1348 cases are likely to persist for some time.[64]

Civil Cases v. Criminal Prosecutions

The SEC has the authority to bring only civil actions for violation of various securities laws, e.g., section 10(b) and Rule 10b-5. The SEC has no criminal prosecutorial power. Title 18 and its various provisions, including section 1348, also intended to cover "securities fraud," are criminal provisions that only the United States Department of Justice prosecutes. That is why the SEC will continue to bring civil actions respecting insider trading under section 10(b) and Rule 10b-5. However, it now appears the Justice Department may bring more criminal prosecutions alleging not only violation of section 10(b) and Rule 10b-5 but of Title 18's section 1348.

> If not clear before, it is now certain that if *Blaszczak* survives review, section 1348 is going to be a powerful weapon against securities fraud and, particularly, insider trading.

Conclusion

Section 1348 only applies to companies registered under section 12 of the 1934 Exchange Act or required to file reports under its section 15(d), i.e., publicly-traded companies.[65] Section 10(b) and Rule 10b-5 apply both to publicly-traded securities registered with the SEC and to any security not so registered, that is, non-publicly traded companies.[66]

The *Blaszczak* decision seems to foretell that all that 18 USC 1348 requires for conviction is that the trading-tippee knew, or obviously should have known, that the information was confidential and as of yet undisclosed, and material, important enough to move markets,[67] and that such tippee traded while in possession, using that confidential information.

If not clear before, it is now certain that if *Blaszczak* survives review, section 1348 is going to be a powerful weapon against securities fraud and, particularly, insider trading. However, one cannot write off section 10(b) or Rule 10b-5 because *Martoma II*, decided in 2018, with its mere "intention to benefit" criteria as a simplification of the "personal benefit" element, seems equally dangerous for tippers and tippees.

Since the SEC cannot use 18 USC 1348 to prosecute civil cases, it must still prove defendants acted "willfully," in order to have violated section 10(b) and Rule 10b-5, and additionally prove all the elements indicated in *Dirks* and *Newman*, i.e., breach of fiduciary duty, a personal benefit, and in tippee cases, that the defendant knew about the breach and was aware of the tippee presence of a personal benefit. Strangely, this is a higher bar of proof than section 1348 requires. If *Blaszczak* stands as good law, it may be easier to prosecute criminal cases than civil cases in the future because of section 1348's requirement to clear only the lesser bar of "knowingly" and, in remote tippee cases, a lack of need to bring proofs of breach of fiduciary duty, personal benefit and awareness of such personal benefit. That is, the elements or proofs will be less for conviction in a Justice Department criminal case, than the SEC must prove in its civil cases where no imprisonment is possible, and this makes no sense.[68] It is expected that *Blaszczak* defendants will be filing for Certiorari to the Supreme Court.

NOTES

1. The author gratefully acknowledges Jay Morse for his superb assistance and editing , and Administrative Assistant Leslie Tanghe for her invaluable and tireless efforts.

2. *United States v Blaszczak*, 947 F3d 19 (2nd Cir 2019) (reconsideration denied April 2020).

3. 18 USCA 1348 (Title 18 "Securities Fraud").

4. 15 USC 78(j)(b), 17 CFR 240.10(b)-5.

5. Pub L 73-291, 48 Stat 881, enacted June 6, 1934, codified at 15 USC 78(a) et seq.

6. *See United States v Newman*, 773 F3d 438, 445 (2nd Cir 2014) abrogated on other grounds by *Salman v United States*, ___ US ___, 137 S Ct 420 (2016); *United States v Martoma*, 894 F3d 64, 73 (2nd Cir 2017), amended June 25, 2018. ("Martoma II"), citing *United States v O'Hagan*, 521 US 642, 651-52 (1997). *See also, United States v Jun Ying*, slip opinion, 2018 WL 7016349, at 4 (citations omitted), adopted by District Court 2018 WL 6322308 (ND GA Atlanta Division, December 4, 2018); also see interestingly a classical insider trading Criminal Complaint premised on Title 15, section 10(b) and its Rule 10b-5, filed in Feb. 2019 charging an ex-Apple attorney whose duties included ensuring compliance with Apple's insider trading policies of, ironically, engaging himself in insider trading prior to public release of Apple highly confidential information, *United States v Gene Levoff*, Mag. No. 19-3507 (USDC, D NJ).

7. *Newman*, 773 F3d at 445; *O'Hagan*, 521 US at 651-52.

8. *O'Hagan*, 521 US at 652-53 (*O'Hagan* was an attorney employed by a law firm that was handling a corporate transaction); *Newman*, 773 F3d at 445-46.

9. For more of what is considered to be a "personal benefit" important in Title 15, 10(b) and Rule 10b-5 prosecutions, *see Martoma*, 894 F3d at 67, 70-71, 73-76, 78 (2nd Cir amended 2018) (known as *Martoma II*); *Dirks v SEC*, 463 US 646, 659, 662 (1983); *United States v Newman*, 773 F3d 438, 446 (2nd Cir 2014), abrogated on other grounds by *Salman v United States*, ___ US ___, 137 S Ct 420 (2016).

10. The *Dirks*' Court, 463 US 646, 659, 662 (1983), held that for the tipper to breach a fiduciary duty, such tipper had to receive some kind of "personal benefit" for the leak to the original tippee, that is, without a personal benefit there was no breach of the fiduciary duty.

11. *See Martoma II*, 894 F3d at 68, 75-76.

12. *See again Newman*, 773 F3d at 446-47, and *United States v Jiau*, 734 F3d 147, 152-53 (2nd Cir 2013) indicating that for a remote tippee, that is one who received the information from a prior tippee, to be guilty they had to know, i.e., be aware, that the original source of the information, the original tipper, had received some kind of personal benefit.

13. *Newman*, 773 F3d at 447; *Martoma II*, 894 F3d at 67-68.

14. *Newman*, 773 F3d 438 (2nd Cir 2014), *Salman v United States*, 137 S Ct 420 (2016), *United States v Martoma*, (*Martoma I*), 869 F3d 58 (2nd Cir 2017) and *United States v Martoma* (*Martoma II*), 894 F3d 64 (2nd Cir 2018).

15. *Blaszczak*, 947 F3d at 31, *United States v Mahaffy*, 693 F3d 115, 125 (2nd Cir 2012).

16. *Mahaffy*, 693 F3d at 125.

17. *Id.* at 127 (brackets added).

18. *Jun Ying*, 2018 WL 6322308 (Order of United States District Court) (ND Ga Atlanta Div adopting Magistrate's Report and Recommendation, Dec 4, 2018); 2018 WL 7016349 (Magistrate Report and Recommendation Sept 17, 2018).

19. *Jun Ying*, 2018 WL 6322308 at 1, 5.

20. *Id.* at 5.

21. *Newman*, 773 F3d 438 (2nd Cir 2014).

22. *Id.* at 451-452, 455.

23. Pub L 107-204, 116 Stat 745, enacted July 30, 2002.

24. 18 USCA 1348.

25. *Mahaffy*, 693 F3d 113, 125, citing *Motz*, 625 F Supp 2nd 284, 289 (EDNY 2009).

26. 2014 WL 5804191 (ND GA, Atlanta Div) (Magistrate Order and Report and Recommendation).

27. *Id.* at 3.

28. *Id.*, citing *Dirks v SEC*, 463 US 646 (1983).

29. *Slawson*, 2014 WL 5804191, at 3 (brackets added).

30. *Id.*

31. *Id.* at 4 (brackets added).

32. *Slawson* at 5 (brackets added, italics added for emphasis).

33. No. 16-12061 Non-Argument Calendar (11th Cir Feb 2017).

34. *See United States v Melvin*, 143 F Supp 3d 1354 (USDC ND GA Atlanta Division, 2015); Criminal Action No. 3:14-cr-00022-TCB.

35. *Id.* at 1371-72.

36. *Id.* at 1373 (internal quotation marks omitted).

37. *Id.* at 1374.

38. *Id.*

39. *Id.* at 1375.

40. *Id.* at 1376.

41. *Id.* at 1375.

42. *Jun Ying*, 2018 WL 6322308; *Melvin*, 143 F Supp 1354 (2015); *Mahaffy*, 693 F3d 113 (2nd Cir, 2009).

43. District court cases: *United States v Vorley*, 420 F Supp 3d 782 (USDC ND Ill E Div 2019) ("Spoofing"), *United States v Gibson*, 2018 WL 4141036 (USDC D Del) (false certification of financial records); *United States v Dimaria*, 2018 WL 1173094 (USDC SD Fla) (false accounting entries); *United States v Benjamin Wey*, 2017 WL 237651 (USDC SDNY, misleading "pump and dump" scheme involving shell company and money laundering), *United States v Motz*, 652 F Supp 2d 284 (USDC ED, NY 2009) ("cherry picking").

Appellate court cases: *United States v Lundstrom*, 880 Fed. 3d 423 (8th Cir 2018) (scheme to conceal a bank's losses), *United States v Coscia*, 866 F3d 782 (9th Cir 2017) ("spoofing"), *United States v DeMizio*, 741 F3d 373 (2nd Cir 2014) ("honest services" fraud), *United States v Knabb*, 551 Fed Appx 318 (9th Cir 2013) (falsifying books), and *United States v Schwamborn*, 542 Fed Appx 87 (2nd Cir 2013) (misrepresentation—inflated value of securities).

44. *United States v Blaszczak*, 947 F3d 19 (2nd Cir 2019).

45. Section 10(b) of the Exchange Act prohibits use of any "manipulative or deceptive device or contrivance … in connection with the purchase or sale of any registered security." 15 USC 78(j)(b). Its Rule 10b-5 prohibits the use of any means of interstate commerce to among others: (i) "employ any device, scheme to defraud, … (iii) engage in any act, practice or course of business which operates … as a fraud or deception in the purchase or sale of the security." 17 CFR 240.10(b)-5. Additionally, 15 USC 78 ff provides "[a]ny person who *willfully* violates any provision of this chapter [Title 15] or any rule or regulation thereunder … shall upon conviction be … imprisoned … ." [20 years]. (Brackets and italics added.)

46. Section 1348 of Title 18 provides "whoever *knowingly* executes or attempts to execute, a scheme or artifice – (1) to defraud any person in connection with any [registered] security …; or (2) to obtain, by means of false or fraudulent pretenses, representations or promises, any money or property in connection with the purchase or sale of … any security of an issuer with a class of securities registered … shall be fined … or imprisoned not more than 25 years … ." 18 USC 1348 (italics added).

47. *See Blaszczak*, 947 F3d at 29 (brackets and italics added).

48. *Id.*

49. *Id.*, at 34-35.

50. *Id.*, the court citing as support for its explanation of Title 15 requirements, *Newman*, 773 F3d at 447-49. (Brackets added.)

51. *Blaszczak*, 947 F3d at 26 and *see Blaszczak* at 36, "[w]e decline to graft the Dirks personal-benefit test onto the elements of Title 18 securities fraud [i.e., section 1348]." (Brackets added.)

52. *Id.* at 29.

53. Again, for a more recent discussion of what constitutes "personal benefit," see *United States v Martoma*, 894 F3d 64, 68-70, 74, 76, 78 (2nd Cir 2018) (known as *Martoma II*).

54. *United States v Newman*, 773 F3d 438, 447-49 (2nd Cir 2014).

55. *Blaszczak*, 947 F3d at 36 (brackets added).

56. *Id.* at 47-48.

57. *Id.* at 49.

58. *Id.* at 47-48.

59. *Martoma II*, 894 F3d at 73-75 (citations omitted). Especially at 75, "[t]he tipper's *intention to benefit* the tippee proves a breach of fiduciary duty because it demonstrates that the tipper improperly used inside information for personal ends [seemingly the court is implying this mere "intention" is sufficient to constitute a personal benefit] and thus [the disclosures] lacked a legitimate corporate purpose." (Italics and brackets added.)

60. 2018 WL 7016349 (Magistrate's Report and Recommendation Sept 18, 2018); 2018 WL 6322308 (Order of United States District Court) (ND GA, Atlanta Div, adopting Magistrate's R&R, Dec 4, 2018).

61. *Ying*, 2018 WL 6322308, its footnote 13.

62. *Id.* (brackets added). Section 1348 does not contain the word "willful" or "willfully" and instead says "knowingly executed or attempts to execute a scheme or artifice…."

63. *Ying*, 2018 WL 6322308 at 5 (Citation omitted, brackets added.)

64. In *United States v Melvin*, that court stated that even under section 1348, a defendant must have been found to have acted with "fraudulent intent." 143 F Supp 3rd 1354, 1371-72 (ND Ga 2015) citing *United States v Motz*, 652 F Supp 2d 284, 2951 (EDNY 2009) quoting *United States v Mahaffy*, No. 05-CR-613, 2006 WL 2224518 at 12 (EDNY Aug 2, 2006). However, a number of federal criminal statutes use the word "knowingly." 18 USC 1544 "whoever willfully and knowingly …." 18 USC 2251(d)(1) "any person who knowingly makes, prints …." 18 USC 2422(b) "whoever … knowingly persuades, induces, entices …." 21 USC 841(a)(1) "…it shall be unlawful for any person knowingly or intentionally…." 18 USC 1425 "… (a) whoever …; knowingly procures …."

65. 18 USC 1348(1) and (2).

66. 15 USC 78j(b).

67. For discussion of "materiality," *see United States v Moran*, 922 F Supp 867, 892 (SDNY 1996), *O'Hagan*, 139 F3d 641, 648 (8th Cir 1998); *SEC v Texas Gulf Sulfer Co*, 401 F2d 833, 849 (2nd Cir 1968) (en banc).

68. Email comment of Professor Mark Steinberg, Radford Professor of Law, SMU Dedman School of Law, Apr 28, 2020.

Stuart Sinai of Kemp Klein Law Firm in Troy, Michigan, is experienced in taking corporations public, SEC litigation, proxy contests, compliance work under '33 and '34 Acts, municipal bond offerings and representation of clients in SEC and various exchange proceedings, including insider trading charges, NYSE and FINRA rule violations and fraud investigations.

Oppression and Employment – Clearing Up Muddied Waters

By Paul A. McCarthy

Compensation is *the* baseline shareholder value of many, if not most, small businesses. The initial challenge of any small business is to achieve cash flow sufficient to pay its owner anything. The baseline value of many small businesses is employment, and oftentimes nothing more. As a practitioner whose practice is focused on business valuation, this reality is borne out again and again.

As companies grow in value, shareholder compensation can become, and often is, complex. Base compensation is often augmented by bonuses, which are in reality corporate profits, as well as a wide array of insurance, benefits, and other perks, together with—and this is often a big deal—personal and discretionary expenses that are expensed through the business, sometimes in jaw-dropping measure. In the end, the goal of small business is *not* to maximize bottom line net income, but rather, to maximize the *cash flow to its owners* while minimizing income taxes.

Many small businesses are founded by friends or family members. Those close relationships often seed both the concept of the business and partnership as owners. But once-close relationships sometimes sour. Anger and resentment can take root in ways akin to a toxic marriage, whether over the direction of the business, the level of effort exerted, frustrated succession planning/expectations, family issues, or other dynamics. Things can get ugly. When emotions boil over, the majority owner(s), motivated by anger and resentment and not the company's best interest, may terminate the employment of a minority owner. Does Michigan shareholder oppression[1] law adequately protect minority owners whose shareholder benefits come in the form of compensation and related perks? It is this author's view that while unpublished cases have unnecessarily muddied the waters on this issue, the oppression statutes[2] effectively provide the needed legal foothold and that we, the practitioners, need to do a better job identifying and advocating vast shareholder value that is channeled in the form of compensation and related benefits and perks in oppression cases.

Framing the Issue—*Franchino v Franchino*

The Michigan case that framed the issue regarding shareholder employment benefits versus legally established shareholder rights (e.g., the right to vote, the right to inspect records, and the right to dividends) is the 2004 decision in *Franchino v Franchino*.[3] The *Franchino* case is fairly typical of oppression cases in that it involved a battle between family members, specifically a son and 31% shareholder against his father and majority shareholder owning the remaining 69% interest. The relationship between father and son deteriorated and the father ultimately terminated the son's employment while also seeking to merge the company into a new entity to avoid certain obligations to the son under a buy-sell agreement. The son sued for shareholder oppression.

As is often the case, compensation was a key component through which the Franchino shareholders received value for their respective interests in the company, with the son and father each receiving compensation of $500,000 per year in 2001 dollars (adjusted for inflation, roughly $725,000 as of 2020). While being paid such robust compensation, they were only paid a modest $3,100 a year in dividends, thus demonstrating the level of shareholder value channeled in the form of compensation rather than dividends.

The facts in *Franchino*, where corporate profits are paid out to the shareholders in the form of compensation rather than dividends, is typical for many small, privately-owned companies. It is near certain that the compensation paid to the Franchinos far exceeded market-based compensation, i.e., what the company would have to pay in order to attract a comparably-skilled non-owner employee to perform the tasks handled by the shareholder-employee owners. The situation in *Franchino*, where corporate profits are paid out in compensation, is commonplace.

The oppression statute (before being amended in 2006), however, only protected "the interests of a shareholder *as a shareholder*." The Court in *Franchino* wrestled with whether the statute protected shareholder-related benefits channeled through compensation:

> It is generally acknowledged that, in close corporations, shareholders often work for the corporation, and the corporate dividends are often paid in the form of a salary. Likewise shareholders in close corporations are often members of the corporation's management. However, employment and board membership *are not generally listed among rights that automatically accrue to shareholders*. Shareholder's rights are typically considered to include voting at shareholder's meetings, electing directors, adopting bylaws, amending charters, examining the corporate books, and receiving corporate dividends.[4]

Because the oppression statute did not at that time reference employment, both the trial court and the Michigan Court of Appeals—despite expressly recognizing that corporate profits are often paid out in the form of compensation to shareholder-employees—felt constrained to limit oppression claims to the rights that automatically accrue to shareholders as a matter of law (e.g., the right to vote, right to inspect records, and the right to dividends), and not employment.

Bridging the Gap: The 2006 Statutory Amendment to Add Employment

Shortly after the *Franchino* decision (2004), the Legislature addressed this chasm between reality and legally established shareholder rights by amending the oppression statutes in 2006 to specifically include employment. The statute amended the definition of "willfully unfair and oppressive conduct" to include the bolded language below:

> [A] continuing course of conduct or a significant action or series of actions that substantially interferes with the interests of the shareholder. **Willfully unfair and oppressive conduct may include the termination of employment or limitations on employment benefits to the extent that the actions interfere with distributions, or other shareholder interests disproportionately as to the affected shareholder**. The term does not include conduct or actions that are permitted by an agreement, the articles of incorporation, the bylaws, or a consistently applied written corporate policy or procedure.[5]

With the oppression statutes having now been amended to specifically include employment so long as the action taken by those in control is shown to "interfere with distributions [] or other shareholder interests disproportionately as to the affected shareholder," is the confusion over compensation and employment-related issues resolved? Hardly.

Continued Caselaw Confusion

Despite the 2006 amendment to specifically include employment-related matters within the definition of shareholder oppression, unpublished decisions continue to muddy the waters by holding on to, and emphasizing, stand-alone shareholder rights such as the right to vote, inspect books, and the right to receive dividends/distributions, while all but ignoring the reality that substantial shareholder value is commonly channeled through compensation and related benefits.

In the 2018 unpublished decision by the Michigan Court of Appeals in *Pitsch v Pitsch Holding Company, Inc*,[6] the court cited to the 2004 *Franchino* decision as precluding a shareholder from recovering in an oppression action harm inflicted through employment:

> However, as this Court has held, MCL 450.1489 "does not allow shareholders to recover for harm suffered in their capacity as employees or board members." *Franchino v Franchino*, 263 Mich App 172, 178; 687 NW2d 620 (2004) (concluding that termination from employment and removal from the corporation's board of directors did not constitute oppression under MCL 450.1489).[7]

This proposition, however, is untrue in light of the 2006 amendment to the oppression statutes, which specifically permits oppression actions to include employment so long as the action interferes with distributions or other shareholder interests disproportionally to the affected shareholder. The Michigan Court of Appeals in *Pitsch*, however, went even further by seemingly conditioning the viability of pursuing shareholder employment-related matters on whether employment rights were contractually created in a shareholder agreement:

> Plaintiff's termination from employment with the corporation does not

In the end, the goal of small business is *not* to maximize bottom line net income, but rather, to maximize the *cash flow to its owners* while minimizing income taxes.

> necessarily constitute shareholder oppression. See *Franchino*, 263 Mich App at 178. *It might be evidence of oppression if it violates the Shareholder Agreement*, see *Madagula*, 496 Mich at 719, *but it does not*. Paragraph 6.2 of the Shareholder Agreement states that it is "not a contract of employment between [PHC] and any Shareholder," and does "not grant any Shareholder any rights to continue in the employment of the Company, or limit the Company's right to terminate a shareholder's employment." termination of their employment was an action plaintiffs suffered as employees, not shareholders, and it did not violate the Shareholder Agreement. Therefore, it is not evidence of shareholder oppression under MCL 450.1489(3). The same is true of plaintiffs' claim of oppression based on defendant's prohibiting them from attending employee Christmas parties.[8]

The oppression statutes do *not* condition the pursuit of employment-related damages in an oppression action on whether contractual employment rights are created, whether in a separate employment contract or subsumed within a shareholder agreement. Nor does the *Madagula* case provide support for any such connection.[9]

Furthermore, whether a shareholder agreement contemplates the *possibility* that employment of a shareholder can be terminated does not mean that termination is not evidence of oppression. As noted by the Michigan Court of Appeals in the unpublished decision in *Berger v Katz*, when addressing analogous rights to take action under a corporation's bylaws:

> We disagree with defendants' argument that the trial court erred in finding that they engaged in willfully unfair and oppressive conduct because their was authorized by the corporation's bylaws. Although the bylaws gave defendants the general authority to make business decisions such as setting salaries, issuing capital calls, or approving rental payments, that does not mean that defendants were permitted to act in a manner that was willfully unfair and oppressive to the plaintiff, as a minority shareholder. The exception in MCL 450.1498(3) cannot be read as permitting willfully unfair and oppressive conduct under the guise of defendants' general authority to run and manage IPAX.[10]

Does Michigan shareholder oppression law adequately protect minority owners whose shareholder benefits come in the form of compensation and related perks?

The Court of Appeals in *Pitsch* also conflated and confused distributions—which is the payment of profits to the owners of a business—as a right reserved to shareholder-*employees*:

> Plaintiffs' claim that they receive no income from a profitable company in which they have a 40% combined ownership interest is not entirely true. To the extent they are referring to receiving no bonuses *or distributions* of any kind, the record evidence clearly shows that these are perquisites *reserved for employees*, and plaintiffs ceased being employees in 2006. Record testimony established that the company has never paid dividends, *has always tied distributions to employment*, and has never paid shareholders and directors simply for being shareholders and directors.[11]

This quote is, respectfully, both confusing and bizarre. Distributions are profits of a business and payable to the owners of a business in proportion to their ownership. The prospect that the distribution of corporate profits is masqueraded as compensation is the exact circumstance addressed by the 2006 amendment to add employment to the oppression statutes.

Another case that somewhat muddies the waters as it relates to employment is the unpublished Court of Appeals decision in *Castle v Shoham*.[12] There, the trial court rejected all claims of oppression, including 1) termination of plaintiff's employment; 2) the issuance of capital calls; and 3) increase in management fees paid to a related company owned by defendants. The Court of Appeals reversed, finding that defendants' issuance of capital calls and increasing management fees to be oppressive. Having found oppression, it is odd that the Court of Appeals would nonetheless affirm the trial court's rejection of plaintiff's oppression claim as it relates to the termination of his employment. This is particularly true in light of the recent decision in *Franks v Franks*[13] which underscores the importance of proving intent to oppress on the part of those in control.

Despite finding instances of oppression, which thus implicates the defendants' intention to oppress the plaintiff, the Court of Appeals in *Castle v Shoham* nonetheless affirmed the rejection of plaintiff's claim of oppression by way of termination of employment:

> These not only appear to be legitimate and supported reasons for his termination, but Castle has not established that his termination interfered with distributions or other membership interests disproportionately. Castle still retained his 49% membership interest in Filter Depot, his status was acknowledged in the termination letter, and Castle has not established that his termination affected any right of his as a member. *He simply lost his salary and employment as a sales person*. Because sufficient evidence supported that Castle was not subjected to willfully unfair and oppressive conduct under MCL 450.1415, Castle has not met his burden of demonstrating clear error regarding this aspect of his claim.[14]

The loss of income from employment is no "simple" issue that can or should be isolated from the "bushel basket" of shareholder's rights when employment is part of the baseline operations and when oppressive intent is otherwise found on the part of those in control.

Connecting Employment to Shareholder Value

Because the oppression statutes have been amended to specifically include employment, it is up to practitioners to do a better job of establishing that employment-related attributes constitute shareholder value. Or, as stated in the statutes, to demonstrate that decisions terminating or impacting employment "interfere with distributions or other shareholder interests disproportionately as to the affected shareholder."[15]

Establishing the Baseline of Normal Operations

The first question a practitioner should assess is: What was the structure of the company, specifically including employment and compensation, when everything was going well? This sets the baseline for normal operations and best reflects the mutual intentions of all shareholders. Understanding the allocation of responsibilities between and among the shareholder employees is critical. Just as important is understanding what and how each shareholder is paid.

It is against this baseline of normal operations that changes should be evaluated and, in particular, whether changes in employment, job function, responsibility, compensation and perquisites are legitimate and lawful business decisions or are oppressive and unlawful acts taken by those in control to with the intent to limit and harm the value of a shareholder's interest in the company.

Understanding and Quantifying Shareholder Value Through Compensation

Because the value of the company is the cash flow it provides to its owners, it is critical to identify and understand each and every pathway of value to the shareholders. Start with compensation. What is the base compensation? Is it the same for all shareholders? If different, how and why is it different? Are the differences legitimate, meaning differences that would be found in the marketplace for non-owner employees? Shareholder-employees are frequently paid the same compensation even though they perform materially different tasks in a business that would garner different compensation in the marketplace.

What is the bonus structure and how are bonuses derived? What is the connection between profitability and payment of bonus compensation? Are the shareholders awarded bonuses in the same manner or differently? Do differences correlate with ownership or market-based compensation forces? How are the bonuses different from (or similar to) the bonuses paid to non-owner employees?

Understanding and Quantifying Perquisites

In addition to a keen understanding of all forms of direct compensation (base, bonus, and otherwise), a practitioner must gain an understanding of all perquisites paid to or paid for the shareholder through the company. Health insurance is a common benefit paid through a company. Is the health insurance the same as that offered to non-owner employees? And at the same contribution level in terms of premium dollars? Is the company contributing toward an HSA and, if so, in what amount? Are the contributions for shareholder employees higher than those of non-owner employees? Are there any other "bells and whistles" such as executive and concierge health insurance policies being provided to shareholder employees and, if so, at what cost?

Companies often put in place life insurance policies for shareholders. It is important to understand what insurance is provided,

Because the oppression statutes have been amended to specifically include employment, it is up to practitioners to do a better job of establishing that employment-related attributes constitute shareholder value.

what the coverage is, who benefits on death, and the cost. Do the policies have cash value and, if so, who holds the policies? Are the policies picked up on the shareholders' W-2's? Life insurance can be both elaborate and expensive and must be understood by practitioners to delineate the value to shareholder-employees.

Does the company provide its shareholder-employees with vehicles? What kind of vehicles are provided (e.g., luxury vehicles)? Who holds title to the vehicles? Are the vehicles owned or leased? Does the company pay for insurance, gas, and maintenance? It is not uncommon for companies to spend more than $25,000 per year on each vehicle. What amount is picked up on the shareholder's personal return to reflect personal use? What backup documentation was utilized to make the allocation? While it is not uncommon for companies to provide vehicles, it is the rare business that can argue that company-owned vehicles for its shareholder-employees are truly necessary for the business. Company-owned vehicles are most always a discretionary perk of ownership.

In addition to a keen understanding of all forms of direct compensation (base, bonus, and otherwise), a practitioner must gain an understanding of all perquisites paid to or paid for the shareholder through the company.

Understanding and Quantifying Discretionary and Personal Expenses

Do the shareholder-employees have access to and use of a corporate credit card? If so, this is where things can really become interesting. It is critical for a practitioner to gain access to, and to study, corporate credit card purchases to identify discretionary and personal expenses that are run through the business. While items such as meals (deductible at 50%) and travel may be legitimate business expenses, they are often discretionary items incurred by the shareholder-employee and, as such, an avenue through which the shareholder derives benefit from ownership. Here, it is common to find significant purchases for restaurants, air fare, hotels, and rental cars.

It is not uncommon, however, for those with access to corporate credit cards to use them on purely personal purchases while at the same time expensing them through the business. Charges for groceries, household items (e.g., TV/electronics, furniture, landscaping, snow removal, etc.), and clothing are not uncommon. Just as important is for the practitioner to gain access to the company's general ledger to determine the accounting treatment given to transactions to understand which items are expensed through the business and which, if any, are categorized as distributions or aggregated as a shareholder receivable.

Some companies are run as clean as a whistle, where charges expensed through the business are limited to reasonable and necessary business expenses. But other businesses are as dirty as can be, characterized by the expensing of all manner of discretionary and personal items that are enjoyed by the company's shareholders and are, in effect, disguised dividends (that evade income tax). There are potentially huge dollars to be found and confirmed through this effort, nearly all of which are obtained as part of a shareholder's status as employee of the company.

Impact of Shareholder Termination or Curtailment

When those in control of a company terminate a minority shareholder's employment, or take other action to curtail compensation or benefits enjoyed through employment, understanding the above strands of value is imperative to successfully advocating an oppression claim. Another set of questions must be answered, however, concerning the treatment of the company by the shareholder-employees who remain employed by the company.

Take, for example, a company run by three siblings, each owning one-third of the stock. Assume each is paid the same amount in compensation and each receives the same benefit package and roughly the same level of discretionary and personal charges that are expensed through the business. If two of the siblings fire the third sibling, the value of the now terminated shareholder-employee's benefits are of obvious importance. But other questions must be answered as to the remaining shareholder-employees.

With one shareholder excluded from employment, is the compensation paid to the other remaining shareholder-employees in line with the market? Did the remaining shareholders increase their own compensation after the termination? Would the compensation, benefits, and discretionary/personal items paid to the remaining shareholder-employees exceed the level of market-based compensation that would be paid to a non-owner to perform the same job responsibilities? If not, and if the value paid to/for the remaining shareholder-employees exceeds market-based compensation, then this fact is yet another way in which the now discharged shareholder-employee is disadvantaged and harmed by his/her termination. And that harm exists even if the terminated shareholder was justifiably terminated for non-oppressive reasons. The simple fact of the matter is that all shareholders received shareholder value in the form of compensation, benefits, and discretionary/personal charges. Once one shareholder is terminated, and his/her benefits dry up, the remaining shareholders are at risk of an oppression claim unless they curtail their own compensation, benefits, and discretionary/personal charges to be in line with market-based compensation.

Conclusion

The value of a shareholder's interest in a company is a function of the cash flow received by the shareholder. A significant component of that cash flow often is paid through compensation, but not always directly and not always in ways that are picked up on a W-2. Identifying, understanding, and quantifying shareholder benefits through employment is critically necessary. Discerning and quantifying discretionary and personal items that are expensed through the business, but enjoyed by the shareholder-employee, is likewise critical. Understanding these stands of shareholder value end is key to a practitioner's ability to demonstrate that the termination of the shareholder-employee "interfere[s] with distributions or other shareholder interests disproportionately to the affected shareholder." The oppression statutes provide the legal hook, and it is up to us practitioners to demonstrate the vast shareholder value channeled through compensation.

The value of a shareholder's interest in a company is a function of the cash flow received by the shareholder.

NOTES

1. The oppression statutes are effectively the same for corporations, MCL 450.1489, and limited liability companies, MCL 450.4515. For each of reference, this article simply references "shareholder oppression" as a generic alternative.

2. MCL 450.1498; MCL 450.4515.

3. *Franchino v Franchino*, 263 Mich App 172, 687 NW2d 620 (2004).

4. *Franchino v Franchino*, 263 Mich App 172, 184, 687 NW2d 620 (2004) (citations omitted) (emphasis added).

5. MCL 450.1489(3); MCL 450.4515(2).

6. *Pitsch v Pitsch Holding Co, Inc*, Nos 340402, 340494 (Mich Ct App Nov 29, 2018) (unpublished).

7. *Id.* at 7.

8. *Id.* at 8 (emphasis added).

9. While *Madagula v Taub*, 496 Mich 685, 853 NW2d 75 (2014) ruled that violation of a shareholder agreement can be used to establish shareholder oppression, the termination of employment was separately actionable; it was not dependent on the shareholder agreement. The Michigan Supreme Court noted that the Court of Appeals had separately found the termination of employment to give rise to actionable oppression:

> Noting that termination of employment might give rise to oppression under § 489(3), the lead opinion concluded that the termination of Madagula's services was evidence of oppression. It reasoned that Madagula's "termination disproportionately affected Madagula's interest as a shareholder because Madagula's compensation was reduced to zero and he was no longer involved in decisions on material issues such as the development of JPAS.

10. *Berger v Katz*, Nos 291663, 293880 at *5 (Mich Ct App July 28, 2011) (unpublished). The Court of Appeals in Berger specifically found the plaintiff's termination of employment to be actionable as oppression:

> Defendants do not dispute that plaintiff's salary was cut and that plaintiff's rental payments from IPAX to API were stopped. Plaintiff was receiving those payments as a result of his status as a shareholder in this closely-held corporation, as well as the work he performed on the corporation's behalf. Yet, despite defendants' claims that IPAX was financially distressed and losing money, defendants increased their own salaries. The trial court did not clearly err in finding that defendants' conduct was designed to prevent IPAX from showing a profit that could be distributed to plaintiffs as either rent or salary. There was also evidence that defendants refused to allow plaintiff to participate n corporate decisions beginning in 2006. Their conduct therefore affect plaintiff's rights, not only with regard to his employment, but also as a shareholder to participate in decisions affecting the corporation. Thus, defendants' actions affected plaintiff's interest as a shareholder.

11. *Pitsch*, at 8 (emphasis added). In pass-thru corporations, dividends are also referred to as distributions. Distributions are not made as a matter of employment, but pro-rata based on percentage ownership in a company. The prospect of distributions masquerading as compensation, rather than based on ownership, is exactly why the Legislature amended the oppression statutes to made employment-related damages actionable within oppression claims.

12. *Castle v Shoham*, No 337969 (Mich Ct App Aug 7, 2018) (unpublished).

13. *Franks v Franks*, 330 Mich App 69, 944 NW2d 388 (2019) (holding that a plaintiff in an oppression action must prove that defendants subjectively intended their acts to be unfair and oppressive to plaintiff).

14. *Castle v Shoham*, at 4 (emphasis added).

15. MCL 450.1489(3).

Paul A. McCarthy is an attorney at Rhodes McKee in Grand Rapids. He has a background in finance and accounting, and with specialized training in business valuation. He helps clients determine the value of privately held business interests, often in high-stakes, complex and (sometimes) contentious shareholder and family law disputes.

Case Digests

Mohlman v Financial Indus Regulatory Auth, No 20-3257 (6th Cir Oct 14, 2020)

Defendant Financial Industry Regulatory Authority (FINRA) is a self-regulatory organization that regulates practice in the securities industry and enforces disciplinary actions against its members. Plaintiff is a licensed securities professional who was required to be a member of FINRA as a registered securities representative. Plaintiff later became registered with Questar Capital Corporations and started to have conversations concerning WMA Enterprises, Inc. Plaintiff did not receive compensation from WMA and did not attempt to sell investments with WMA. Plaintiff later learned that WMA was a Ponzi scheme and informed all persons who had invested in WMA. FINRA ultimately started an investigation into plaintiff that year.

In 2015, plaintiff signed a Letter of Acceptance, Waiver, and Consent. Pursuant to the Letter, plaintiff consented to a permanent bar from the securities industry, and FINRA agreed to refrain from filing a formal complaint against him. He also waived his procedural rights under FINRA's Code of Procedure and the Exchange Act. Four years later, plaintiff filed a complaint in the Common Pleas Court of Montgomery County, Ohio, alleging that FINRA fraudulently avoided considering mitigating factors in administering the sanction against him and requested over $800,000 in damages. Defendants removed case to the U.S. District Court and filed a motion to dismiss for lack of subject matter jurisdiction and failure to state a claim. The U.S. District Court ultimately granted defendants' motion.

Plaintiff appealed and argued that the Exchange Act does not provide the exclusive remedy for complaints arising from FINRA proceedings, and he still can seek relief under the Ohio Constitution. He also asserted that FINRA is not immune from liability for its present actions, and the Ohio Constitution provided him a private right of action for damages.

The court found that the FINRA Rules, approved by the U.S. Securities and Exchange Commission (SEC) and the Exchange Act provide for three tiers of administrative review before a party may seek judicial review in a U.S. Court of Appeals:

1) An appointed hearing panel decides the dispute;
2) Following a decision of the hearing panel, a party may appeal to the National Adjudicatory Council which may affirm, modify, or reverse any sanction administered by the Hearing Panel;
3) A party aggrieved by a decision of the National Adjudicatory Council may apply for SEC review.

After an SEC review, the aggrieved party can go to the relevant U.S. Court of Appeals.

Here, plaintiff did not exhaust his administrative remedies under the FINRA rules and the Exchange Act. Though he waived his procedural rights when he executed the Letter, he could still have applied for review by the National Adjudicatory Council and the SEC. The U.S. Court of Appeals affirmed the dismissal.

Premiere Prop Servs, Inc v Crater, No 350784, ___ Mich App ___, ___ NW2d ___ (Sept 17, 2020)

Plaintiff hired Crater to manage painting projects. Plaintiff ultimately fired Crater in April 2018 and sued Crater for breach of confidentiality and non-solicitation agreement both during and after employment by using information about plaintiff's customers. He obtained a default judgment against Crater and two companies (Better Brush Painting and Fresh Outlook) that he owns/controls in the amount of over $330,000. He also received a permanent injunction ordering them to comply with the confidentiality and non-solicitation agreement. Plaintiff sought to collect its judgment against defendants.

Plaintiff served a writ of garnishment on True North Painting, Inc., to satisfy a judgment obtained against subcontractor defendants. True North was ordered to withhold payments to defendants and instead to "make all payments withheld under this writ payable to the plaintiff." Plaintiff was seeking a judgment against True North in the amount of three payments made to Crater. Plaintiff alternatively sought an order declaring it could depose True North. Crater ultimately filed a Chapter 7 bankruptcy and True North argued that further proceedings to collect debt owed to Crater were prohibited by the automatic stay. The trial court denied plaintiff's request for entry of judgment on the basis that it would not hold True North personally liable for the amount paid directly to defendants in violation of the writ of garnishment.

The court of appeals reversed the order because True North did not identify any court rule, statute, or caselaw that granted trial courts the discretion to deny plaintiff recovery simply because of inadvertent noncompliance. Further, although Crater filed for bankruptcy, the payments were due to defendants and not subject to the stay. Even if the trial court concludes that further proceedings against True North are not precluded by the stay, the court will decide whether to grant plaintiff's request for a deposition. The matter is reversed and remanded for further proceedings.

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