

Shareholder Oppression and the Direct/Derivative Distinction

By Mark E. Hauck and Andrew J. Kolozsvary

Introduction

Michigan's Business Corporation Act (MBCA) provides specific remedies for misbehavior by those in control of privately owned companies. One such provision, section 489,¹ has been amended twice since its adoption in 1989 as the legislature has sought to fine tune the statute to effectuate its desire to provide protections to minority shareholders. A recent decision in the United States District Court for the Eastern District of Michigan, *Bromley v Bromley*,² raises questions regarding the scope of the remedies section 489 provides and its interplay with other parts of the MBCA. In *Bromley*, the court held that shareholders pursuing what were clearly derivative claims—meaning that the alleged harm had been suffered by the corporation and not the shareholders—could be brought pursuant to section 489, rather than under the sections of the MBCA governing derivative claims. This article will explore that ruling against the backdrop of section 489's history and its application by Michigan courts.

Background

In 1989, the Michigan Legislature enacted comprehensive revisions to the MBCA. Among these changes was the adoption of section 489, the current shareholder oppression statute. Section 489 represented the evolution of a statutory scheme intended to provide remedies to shareholders of closely held corporations who were oppressed by those in control of the corporation. The legislature recognized that the owners of less than a majority of the stock in privately held companies were often at the mercy of those in control. The majority shareholder or shareholders who had the ability to elect the board of directors had the ability to control virtually every aspect of the business, including the payment of salaries and perquisites to themselves and the decision of whether to pay out dividends.³ Some minority shareholders found themselves in a position where the capital they had invested in the company was being held hostage by the majority, with no prospect of receiving a return on their investment, while the con-

trolling shareholders treated the company as their personal piggy bank.⁴

In 1973, the Michigan legislature adopted former section 825 of the MBCA, codifying the equitable remedy of involuntary dissolution that some courts had exercised in extreme cases of shareholder oppression, but also specifically empowering the courts to fashion less harsh remedies to address oppression. Section 825 provided as follows:

(1) 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 wilfully unfair and oppressive to the corporation or to such shareholder.

(2) In an action filed by a shareholder to dissolve the corporation on a ground enumerated in subsection (1), the circuit court upon establishment of such ground may make such order or grant such relief, other than dissolution, as it deems appropriate, including, without limitation, an order providing for any of the following:

(a) Cancellation or alteration of a provision contained in the articles of incorporation, or an amendment thereof, or in the bylaws of the corporation.

(b) Cancellation, alteration or injunction against a resolution or other act of the corporation.

(c) Direction or prohibition of an act of the corporation or of shareholders, directors, officers or other persons party to the action.

(d) Purchase at their fair value the shares of a shareholder, either by the corporation or by the officers, directors or other shareholders responsible for the wrongful acts.⁵

Section 825 was made a part of the MBCA that dealt with dissolution, rather than gen-

eral shareholder issues. As a result, courts applying the statute focused on the involuntary dissolution remedy and seem to have largely ignored the express language in the statute authorizing less severe remedies. A good example of this is *Barnett v International Tennis Corp.*⁶ In *Barnett* the court essentially ignored the appellant's request that the majority be required to purchase the oppressed shareholders' stock for "fair value" and instead focused entirely on whether the company should be involuntarily dissolved. Finding that dissolution was a "drastic remedy," the court held that no remedy was appropriate. It was over ten years before the legislature addressed this situation by amending the statute and including a panoply of remedies for shareholder oppression.⁷

When it enacted section 489, the legislature moved the oppression statute from the MBCA's chapter on dissolution to the chapter on shareholders and added specific and detailed damage remedies. In addition, corporations whose shares are listed on national securities exchanges or regularly quoted in the over-the-counter market were excluded, making it clear that these remedies were reserved for shareholders in closely held businesses. Such shareholders are especially vulnerable to freeze-outs and other heavy-handed actions of controlling owners due to a lack of a market through which to sell and escape. In other words, section 489 was intended to substantially increase the protections afforded to minority shareholders. But did section 489 make an even more substantial—if thus far virtually unrecognized—change to Michigan's corporate law? Did the Michigan legislature intend to abolish the distinction between direct and derivative actions in the context of close corporations? Did it mean to allow shareholders to bring a direct action for harm to the corporation, without resorting to the derivative procedures set forth in the MBCA? A recent decision of the U.S. District Court for the Eastern District of Michigan suggests that it might have done just that.⁸

Direct vs. Derivative

Michigan law recognizes a distinction between direct and derivative shareholder actions. "In general, a suit to enforce corporate rights or to redress or prevent injury to the corporation must be brought in the right of the corporation and not that of a stockholder, officer or employee."⁹ The distinction between direct and derivative actions is

based on principles of standing and the fundamental concept that corporations are entities distinct from their owners. Whether an action is direct or derivative depends upon the nature of the injury: "[W]here the injury to the individual results only from injury to the corporation, the injury is merely *derivative* and the individual does not have a right of action." (Emphasis added).¹⁰ In other words, if the injury to the shareholder is dependent on an injury to the corporation, the action belongs to the corporation and must be brought either by the corporation itself or derivatively by shareholders on behalf of the corporation.¹¹ A direct claim is one in which the shareholder suffers a direct loss or damages.

The MBCA defines a "derivative proceeding" as "a civil suit in the right of a domestic corporation or a foreign corporation that is authorized to or does transact business in this state."¹² Derivative proceedings are subject to a host of requirements and procedures, including a written demand requirement,¹³ a 90-day automatic stay that runs from the date a derivative demand is made,¹⁴ provisions for the appointment of disinterested persons to investigate the demand,¹⁵ the ability to stay actions pending an investigation,¹⁶ and provisions for dismissal based on the recommendations of disinterested persons or directors.¹⁷

Thus, although the distinction is often amorphous and difficult to apply between direct and derivative shareholder actions, it can have real significance. The mischaracterization of a derivative claim as direct may result in dismissal for lack of standing. If a derivative claim is determined by disinterested persons or directors to lack merit, it will be summarily dismissed.

The Bromley Decision

In *Bromley v Bromley*, shareholders of National Semi-Trailer Corp. ("National"), a closely held corporation, asserted minority oppression claims against National's officers and directors, alleging misconduct associated with company expenses, self-dealing, and mismanagement. The defendants moved for dismissal of the oppression claim, arguing that the plaintiffs lacked standing because the plaintiffs alleged damage only to National as a corporation, and, therefore, the claims must be brought derivatively on National's behalf. The court disagreed, rejecting the defendants' reliance on the derivative action

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rule as “irrelevant” for two reasons: it failed to address the plain language of section 489, and it failed to account for the Michigan Court of Appeals’ decision in *Estes v Idea Engineering & Fabrications, Inc.*¹⁸ As a result, the court concluded that “claims of mismanagement of the corporation resulting in harm ... to the corporation” can be brought as direct actions by the shareholder under section 489.

Taking the latter factor first: in *Estes*, the Court of Appeals stated that “it is clear that this statutory cause of action [in section 489] for ‘oppression’ in favor of minority shareholders who are abused by ‘controlling’ persons, is a direct cause of action, not derivative....”¹⁹ The court in *Bromley* perhaps went too far when it referred to this language as “*Estes*’ central holding.” The central issue in *Estes* was the statute of limitations applicable to claims brought under section 489. As a threshold matter, the court had to decide whether section 489 created a separate cause of action or, alternatively, was simply a standing, venue, and jurisdiction statute. Previously, in *Baks v Mouron*, a panel of the court of appeals, over a dissent by Judge Hoekstra, had concluded that section 489 did not create a cause of action, but rather “identifie[d] persons with standing to initiate a derivative action” and set forth the proper venue and jurisdiction for such actions.²⁰ Based on this reasoning, the *Baks* court applied the statute of limitations in section 541a—which sets forth the standards of conduct applicable to officers and directors of corporations (and the breach of which usually gives rise to derivative claims for harm to the corporation).

In *Estes*, a special panel was convened to resolve the conflict that had developed on this issue. The *Estes* panel concluded that section 489 did in fact create a separate cause of action, and that the catch-all, six-year statute of limitations applied. In so holding, the court rejected the *Baks* majority’s holding that section 489 merely identified who could bring derivative claims and approved the reasoning of Judge Hoekstra’s dissent:

[W]e reiterate that the dissent in *Baks* and the history of §§ 489 and 541a demonstrate clearly that § 489 and § 541a have different standards, different parties, different purposes, and different relief provisions. Section 541a applies to all Michigan corporations; § 489 is available only to shareholders of Michigan corporations whose shares are not listed

on national securities exchange and are not regularly traded in a market maintained by one or more members of a national or affiliated securities association. Section 489 provides a cause of action for illegal or willfully unfair and oppressive conduct. This is a different standard of relief than the reasonable person standard set forth in § 541a. Further, as pointed out in the *Baks* dissent, the plaintiff in the § 489 case is a shareholder suing directly whereas a plaintiff in a § 541a action is a corporation suing for breach of a duty to the corporation or a shareholder suing derivatively on behalf of the corporation. Also, the remedy for a breach of a § 541a cause of action is mandatory whereas the remedy for oppressive conduct under § 489 is discretionary. Additionally, the remedy under § 541a is for the benefit of the corporation and the harm done to it whereas certain of the remedies contained in § 489 are specifically for the benefit of the shareholder, and may not necessarily benefit and could impose obligations on the corporation.²¹

The *Estes* decision is unassailable as far as it goes. There is now no doubt that a minority oppression action under section 489, as generally understood, is “direct” and not “derivative” in the sense that the shareholder sues for direct injuries that are not derivative of injuries to the corporation. However, it does not follow—and the court in *Estes* did not decide—that a shareholder can also bring as a direct action what otherwise would have to be brought derivatively, i.e., where the damage is suffered by the corporation.

The statutory language presents a more difficult interpretive task. The “plain language” of section 489 provides: “A shareholder may bring an action...to establish 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 the shareholder.” (Emphasis added.)²² *Bromley* took the understandable view that the “or” in the statute must mean something, and concluded that it meant that a shareholder could bring a direct action for “claims of mismanagement of the corporation resulting in harm ... to the corporation.”²³ This reading may go too far, as, generally speaking, claims for mismanagement that injure a corporation

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are claims for breach of fiduciary duty (recall section 541a) that must be brought as derivative actions. Thus the *Bromley* opinion could be read to mean that, by virtue of section 489, Michigan has exempted shareholders in close corporations from the rule that actions for injury to the corporation must be brought derivatively and from that part of the MBCA dealing with derivative claims.

Some jurisdictions have adopted such an approach, creating a closely held corporation exception to the general rule that actions seeking redress for injuries to the corporation must be brought derivatively.²⁴ Indeed, the American Law Institute advocates that all states abolish the distinction and adopt the following approach:

In the case of a closely held corporation, the court in its discretion may treat an action raising derivative claims as a direct action, exempt from those restrictions and defenses applicable only to derivative actions, and order an individual recovery, if it finds that to do so will not (i) unfairly expose the corporation or the defendants to a multiplicity of actions, (ii) materially prejudice the interests of creditors of the corporation, or (iii) interfere with the fair distribution of the recovery among all interested persons.²⁵

The rationale for the ALI's approach in particular, and the closely held corporation exception to the derivative action rule generally, is based on a cluster of principles. First, in the ALI's view, "the concept of a corporate injury that is distinct from any injury to the shareholders approaches the fictional in the case of a firm with only a handful of shareholders."²⁶ Similarly, courts have evinced concerns that because recovery in a derivative claim is made by the corporation, it inures to the benefit of all shareholders—including those engaged in the wrongdoing.²⁷ Courts have also reasoned that close corporations function, and should be treated, more like a partnership than a corporate entity.²⁸

But this is not the majority rule, and some courts have expressly rejected it because it inappropriately disregards the corporate form.²⁹ The Supreme Court of Virginia has noted that even in the context of closely held corporations, "[t]he overwhelming majority rule is that an action for injuries to a corporation cannot be maintained by a shareholder on an individual basis and must be brought

derivatively."³⁰ In rejecting the ALI's proposal to create a general exception for closely held corporations, the Seventh Circuit reasoned as follows:

The premise of [the exception for closely held corporations] may be questioned. Corporations are not partnerships. Whether to incorporate entails a choice of many formalities. Commercial rules should be predictable; this objective is best served by treating corporations as what they are, allowing the investors and other participants to vary the rules by contract if they think deviations are warranted. It is understandable that not all states have joined the parade.³¹

As yet, Michigan has not joined the parade, and it is doubtful that section 489 should be read as an admission ticket. There is no Michigan case adopting a close corporation exception to the general rule regarding derivative actions. Further, the purpose and legislative history of section 489 do not support the conclusion that it was intended to create such an exception.

Section 489 is Michigan's contribution to the wave of jurisdictions expanding the remedies available for oppressed shareholders in closely held corporations.³² The legislative history of section 489 provides the context for its adoption. Section 489 "include[d] in the remedies currently available to a shareholder who brings an action alleging unfair and aggressive actions by the corporation the dissolution and liquidation of the corporation's assets and business and the award of damages. None of the remedies would apply to shareholders whose shares are traded on the market."³³ "The section, which is drawn in large part from section 825 of the present MBCA, is significantly modified to assure that a wide variety of remedies are available in the event of oppression of minority shareholders. The section is made applicable only to smaller or closely held corporations to assure that it will operate in conformity with its original purpose, the protection of minority holders of untraded stock."³⁴ The reporters' comment to section 489 indicates that, although the remedies for shareholder oppression were expanded, "[t]he standard of oppression, however, has not been changed."³⁵

In the context of this article, it is important to note that at the same time, in the very same bill, the legislature made substantial revisions to the MBCA's provisions concerning

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derivative suits, making mandatory a written demand on the board of directors to take action, providing mechanisms for determining whether an action is in the corporation's best interests, and allowing the court to stay or dismiss the derivative proceeding. There is no indication that the legislature intended a statutory section specifically targeted at expanding the remedies for—but not the definition of—oppression to also except closely held corporations from the derivative procedures created in the same bill.

Then What Is the “Or” For?

It is one thing to conclude that section 489 does not embody a blanket closely held corporation exception to the rules applicable to derivative proceedings. But that leaves open the question of how to interpret the statutory language providing that a shareholder can sue for acts oppressive to the corporation. One option, rejected by *Bromely*, is to read it out of the statute. The entire focus of the statute, as indicated by the legislative history, is on oppression of the shareholder, not to address wrongs against the corporation. Furthermore, in 2001, the legislature amended section 489 to add subsection 3, which defines oppression as follows:

As used in this section, “willfully unfair and oppressive conduct” means 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. 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.³⁶

Notably, the legislature provided a definition of “willfully unfair and oppressive conduct” generally—not of “willfully unfair and oppressive conduct to shareholders.” In other words, even though the statute refers to acts that are “willfully unfair and oppressive to the corporation or to the shareholder,” it defines “willfully unfair and oppressive” conduct only with reference to shareholders.

In *Franchino v Franchino*, a 2004 court of appeals decision, which led to the most recent amendment of section 489, the court discussed the sorts of harms a shareholder usually can suffer as a shareholder: “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.”³⁷ Furthermore, *Franchino* held that “MCL 450.1489 only gives rise to a cause of action in cases where a minority shareholder suffered oppression in his capacity as a shareholder.” Limiting an action under section 489 to these sorts of issues comports both with the general understanding of “shareholder oppression” and with the direct/derivative distinction.³⁸

However, ignoring the words used by the legislature is rarely a viable option. So what could the “or” mean? One option is to conclude that section 489 merely recognizes that one type of derivative action that a shareholder may bring is for oppressive conduct to the corporation itself as a result of the actions of the controlling group. This approach would leave in tact the applicability of the derivative procedures contained in the MBCA. This interpretation is also consistent with the original purpose of section 489, which was to codify the circuit court’s jurisdiction to provide equitable remedies in the event of oppression, whether the oppressed party is a shareholder or the corporation itself. In this way, section 489 can be read to provide that a shareholder can bring a direct action for oppression that harms the shareholder as shareholder *and* a derivative action for oppression that harms the corporation. In either case, the remedies specified in the statute are available. Thus, neither the derivative proceedings nor part of the statutory language are rendered nullities.

Alternatively, section 489 could be read to mean that the legislature intended to create a narrow close corporation exception to the derivative rule. Under this approach, unlike in other jurisdictions, and unlike the potentially expansive reading of *Bromley*, a shareholder cannot bring a direct action for *all* wrongdoing by the controlling persons that injures the corporation, but *can* bring a direct action for injuries arising out of acts that are *oppressive* to the corporation. These would be claims based on oppression that injures the corporation as opposed to perhaps less egregious conduct that would still create a cause of ac-

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tion in the corporation that would have to be brought derivatively. Thus, under this reading of 489, a shareholder could bring directly (i.e., without following the derivative procedures) a claim for oppression that harms the corporation—even if the shareholder has not itself suffered direct harm.

In the final analysis, it may be that inclusion of what appear to be derivative claims within the language of section 489 is nothing more than an historical anomaly. The predecessor statute, section 825, was adopted to provide Michigan's circuit courts with clear authority to fashion equitable remedies in the event of oppressive conduct by those in control of the corporation. At the time that section 825 was adopted, the MBCA did not contain the detailed derivative claim procedures that were added with the 1989 amendment. Therefore, it made sense at that time for the legislature to include oppression against the corporation among the wrongs that could be remedied through the statute. With the adoption of the derivative rules in 1989, such protection became somewhat redundant. However, there is nothing in the legislative history to suggest that the legislature intended to excuse shareholders who bring claims to address harms caused to the corporation from the specific derivative procedures required by the MBCA.

The legislature should address this ambiguity, either by removing the "corporation or" language from the statute, clarifying that derivative claims brought pursuant to section 489 are still subject to the derivative rules, or defining the scope of any exception to the derivative rules for oppression claims, if such an exception was intended in adopting section 489. In the meantime, shareholders pursuing derivative claims like the plaintiffs in *Bromley* should plead causes of action under both section 489 and under the derivative rules.

NOTES

1. MCL 450.1489.
2. *Bromley v. Bromley*, 2006 US Dist LEXIS 37022 (ED Mich June 7, 2006).
3. Virgil C. Smith, Jr., Section-by-Section Summary Analysis of Substitute for Senate Bill No. 181, p. 10, April 1989.
4. See e.g., *Miner v Belle Isle Ice Co*, 93 Mich 97, 53 NW 28 (1892).
5. Former section 825 of the MBCA, MCL 450.1825.

6. 80 Mich App 396, 263 NW2d 908 (1978).
7. For a thorough overview of Michigan case law concerning shareholder oppression and the courts' application of Section 825, see Moscow and Ankers, *Oppression of Minority Shareholders*, 77 Mich BJ 1088 (October 1998).
8. *Bromley v Bromley*, US Dist LEXIS 37022 (ED Mich June 7, 2006).
9. *Michigan Nat'l Bank v Mudgett*, 178 Mich App 677, 679, 444 NW2d 534 (1989).
10. *Id.* at 680.
11. Daniel S. Kleinberger, *Direct Versus Derivative and the Law of Limited Liability Companies*, 58 Baylor L Rev 63, 88 (2006).
12. MCL 450.1491a(1).
13. MCL 450.1493a.
14. *Id.*
15. MCL 450.1495.
16. MCL 450.1494.
17. MCL 450.1495.
18. *Estes v. Idea Engr'g & Fabrications, Inc.*, 250 Mich App 270, 649 NW2d 84 (2002).
19. *Estes*, *supra* at 278.
20. *Baks v Mouron*, 227 Mich App 472, 479, 576 NW2d 413 (1998).
21. *Estes*, 250 Mich App at 284-85.
22. MCL 450.1489(1).
23. Of course, it may often be the case that the same set of facts could give rise to both derivative claims for breach of fiduciary duties or mismanagement and a direct action for shareholder oppression under section 489. But that does not necessarily mean that a shareholder can use section 489 to bring claims that belong to the corporation. In other words, the fact that certain conduct harms both the corporation and the shareholder does not mean that a shareholder can bring an individual action for the corporate harms; if it did, the direct/derivative distinction would vanish.
24. *Durham v Durham*, 151 NH 757, 871 A2d 41 (2005); *Barth v Barth*, 659 NE2d 559 (Ind 1995); *Crosby v Beam*, 548 NE2d 217 (Ohio 1989).
25. 2 A.L.I., *Principles of Corporate Governance: Analysis and Recommendations* § 7.01(d), p. 17 (1992).
26. *Id.* § 7.01 cmt. (e) (1992).
27. *Norman v Nash Johnson & Sons' Farms, Inc*, 140 NC App 390, 537 SE2d 248 (2000).
28. See *Meiselman v Meiselman*, 309 NC 279, 289, 307 SE2d 551, 557 (1983) (noting that close corporations are often characterized as little more than "incorporated partnerships," such characterization "rest[ing] primarily on the fact that the 'relationship between the participants [in a close corporation], like that among partners, is one which requires close cooperation and a high degree of good faith and mutual respect..."); *Barth*, *supra*.
29. *Simmons v Miller*, 261 Va 561, 544 SE2d 666 (2001); *Landstrom v Shaver*, 1997 SD 25, 561 NW2d 1 (1997); *Bagdon v Bridgestone/Firestone, Inc*, 916 F2d 379, 384 (7th Cir Ill 1990).
30. *Simmons*, *supra*.
31. *Bagdon*, *supra* at 384.
32. See John H. Matheson and R. Kevin Maler, *A Simple Statutory Solution to Minority Oppression in the Closely Held Business*, 91 Minn L Rev 657, 666 (2007).
33. Senate Fiscal Agency Analysis for Senate Bill 181, April 25, 1989.
34. Virgil C. Smith, Jr., Section-by-Section Summary Analysis of Substitute for Senate Bill No. 181, April 1989.
35. See Moscow and Ankers, *supra* at 1089.
36. MCL 450.1489(3) (emphasis added).

37. *Franchino v Franchino*, 263 Mich App 172, 184, 687 NW2d 620 (2004).

38. The *Franchino* opinion was criticized as having ignored the practical realities of the minority shareholder's position in the closely held company; specifically, the fact that in many situations the shareholder's employment status with the company was integral to his or her rights as a shareholder. See Hauck and King, *Franchino v Franchino: A serious blow to minority shareholder oppression lawsuits in Michigan*, 25 Mich Bus LJ 16 (Summer 2005).



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