Shareholder Agreements, Operating Agreements, and Partnership Agreements

A Survey of Recent Caselaw

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Corporate bodies have several critical legal elements. The skeleton of the corporate body is the statutory structure provided by the legislature. This is fleshed out by business agreements, including shareholder agreements, operating agreements, partnership agreements, and others. Caselaw is the heart and blood of the corporate body, bringing life and vitality. The clothes on the corporate body are the trademarks, trade names, and dressing apparent to the public. The internal organs are the owners, employees, and assets of the business. This article discusses various corporate agreements, how they have been interpreted by Michigan courts over the past few years, and how they add meat to the bones of the corporate body.

Shareholder agreements and bylaws

Shareholder agreements, including bylaws, are contracts and are interpreted accordingly. A corporation's bylaws or other governing documents "may provide for the regulation and management of [the corporation's] affairs *as long as the provision is not inconsistent with law or the*

articles authorizing the entity."[1] (Emphasis added and internal citation omitted.) In addition, the Michigan Supreme Court has held that violations of a shareholder agreement may constitute evidence of shareholder oppression pursuant to MCL 450.1489(3).[2]

In *Wentworth v Wentworth*, the Court of Appeals considered a corporation's bylaws to determine whether two minority shareholders were directors of the company. The plaintiff minority shareholders alleged that they were made directors by the defendant during an in-person meeting at a restaurant.[3] The bylaws set forth a specific procedure by which directors would be elected; the bylaws also required the company's officers to maintain updated records regarding directors.[4] The Court found that the alleged appointment was never memorialized in writing and that the company's records did not reflect that plaintiffs were directors.[5] Additionally, the plaintiffs signed, as shareholders, annual meeting minutes for 10 years that listed the defendant as the sole director.[6] Based on these facts and the plain language of the bylaws, the Court held that there was no genuine dispute of material fact that the plaintiffs were not elected directors.[7]

Articles of incorporation: breaches of fiduciary duties and exculpation

In *In re Caraco Pharmaceutical Laboratories Shareholder Litigation*, minority shareholders alleged that the defendants engaged in a scheme to devalue the company's stock in the months preceding a going-private transaction to force the transaction to take place and lower the value paid to the minority shareholders.[8] The defendants alleged that the plaintiffs' claims of breach of fiduciary duty were not actionable because the company's articles of incorporation contained an exculpatory clause that protected directors from personal liability to the fullest extent allowed by MCL 450.1209. The Court disagreed, holding that the statute does not allow an exculpatory provision to eliminate or limit a director's liability from *intentionally inflicting harm on the corporation or the shareholders*.[9]

The Court further disagreed with the defendants' argument that the plaintiffs' only remedy was through the Michigan appraisal statute.[10] The Court held that, in fact, the plaintiffs' claims addressed more than just price; they included complaints about the defendants' breaches of fiduciary duties in causing the company to be devalued. Lastly, the Court declined to apply the business judgment rule to exonerate the defendants, finding that the rule does not protect decisions that are fraudulent or not made in good faith, both of which the plaintiffs' complaint alleged.[11]

At a Glance

When forming a business, one of the threshold issues is choice of entity: corporation, LLC, or partnership. An important component of these entities is the governing document(s). These governing documents, along with statutory law and caselaw, determine the rights and obligations of business owners.

Operating agreements: ramifications of failure to comply

Operating agreements can provide important protections to LLC members, including provisions related to distributions, membership, and management as well as road maps for admitting new members, removing members, or dissolving the entity. Generally, however, to obtain the protections of the operating agreement, the parties must closely adhere to the agreement's provisions.

For example, in *Jode Investments, LLC v Burning Tree Properties, LLC*,[12] the Court considered whether three members of an LLC remained members despite filing personal bankruptcies, which, pursuant to the operating agreement, was grounds for involuntary withdrawal. The Court explained:

> [W]hile it is undeniable that the occurrence of bankruptcy is one of the conditions precedent for involuntary withdrawal from the company, it is also undisputed that there is no evidence that the company followed the terms and conditions set forth [in the operating agreement], which addresses how the company goes about purchasing—i.e., removing—the member's interest.[13]

Because the company failed to strictly follow the requirements of the operating agreement, the three members each remained 25 percent members of the company "irrespective of their status as a purported 'withdrawn member.'"[14]

Equitable estoppel may override express terms

In *Patel v Bhakta*, the plaintiffs brought various claims as purported members of the LLC.[15] The defendants alleged that the plaintiffs were not members because there was never a vote to admit them pursuant to the LLC Act and the company's operating agreement did not provide for admission in any other way.[16] The plaintiffs argued that "a formal vote was unnecessary because there was consent between 'two long-time

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friends and partners.'"[17] The Court disagreed, holding that because both existing members of the LLC had not formally agreed to admit them, the plaintiffs were not members.[18]

Still, the Court considered whether the defendants were *equitably estopped* from denying the plaintiffs' membership because the defendants treated them and held them out as members.[19] In fact, the plaintiffs were held out as members in tax filings and in negotiations with a franchisor and a lender, were active participants in internal company discussions, and periodically received management reports and financial information. Accordingly, the Court held that the plaintiffs had indeed made a sufficient showing based on equitable estoppel to preclude summary judgment on the issue of membership.[20]

What is a partnership and when does one exist?

Although general partnerships are not typically the entity of choice, when forming a business, a partnership can arise by operation of law. MCL 449.6(1) states that a "partnership is an association of 2 or more persons…to carry on as co-owners a business for profit." In *Byker v Mannes*,[21] the Michigan Supreme Court interpreted the partnership statute as providing that "if the parties associate themselves to 'carry on' as co-owners a business for profit, they will be deemed to have formed a partnership relationship regardless of their subjective intent to form such a legal relationship."[22] The Court held that a partnership can exist even if the parties are not aware of their status as partners.[23] "In ascertaining the existence of a partnership, the proper focus is on whether the parties intended to, and in fact did, 'carry on as co-owners a business for profit' and not whether the parties subjectively intended to form a partnership."[24]

In *Herman v Pickell*, the Court affirmed the trial court's determination that a partnership existed based on a factual finding that the plaintiff had paid the defendant $50,000 in exchange for a partnership interest.[25] Although no actual partnership agreement was signed, the trial court determined that a partnership existed based on one letter from the defendant to the plaintiff. The letter stated that: (1) the plaintiff was a 10 percent silent partner in the business; (2) the plaintiff was not responsible for any business decisions, but his expertise would be sought after in an advisory capacity; (3) the plaintiff was entitled to 10 percent of the monthly net earnings; and (4) if the business was sold or dissolved, the plaintiff would be entitled to 10 percent of the business assets. Based on these facts, the Court found that a partnership existed and that the plaintiff was entitled to the value of his 10 percent ownership interest.[26] As stated by the Court, "[T]he parties' subjective intent to create a 'partnership' is not the determining factor."[27]

Statute of limitations

In 2017, the Michigan Supreme Court held that a member's claim for oppression accrued when the LLC amended its operating agreement to subordinate the members' shares, rather than when the LLC sold substantially all of its assets and the members received nothing for their shares from that sale.[28] "Once 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…[T]his is true regardless of the time when monetary damages result."[29]

In *Holland v Kraatz*, the plaintiff and her mother invested $25,000 in a company in 2004 as recommended by the defendant investment advisor.[30] They received distributions for several years until the company was liquidated in 2012, when they did not receive any distribution.[31] The plaintiff sued in 2014, alleging that the defendant advisor failed to recommend a suitable investment, failed to inform the plaintiff of the risks, and fraudulently made misrepresentations about the investment.[32]

Faced with a statute of limitations defense, the plaintiff argued that the harm occurred in 2014 when the plaintiff did not receive any distribution from the liquidation.[33] Applying *Linkner*, the Court held that the harm actually occurred in 2004: "Actionable harm as a result of defendant's purported improper acts and omissions occurred when Laurena purchased units in LEAF I, and the claims accrued at that time."[34] The Court cited *Linkner*'s ruling that "this is true regardless of the time when monetary damages result….Thus, even if plaintiff did not incur a calculable financial injury until 2012,

her causes of action still accrued upon Laurena's purchase of an unsuitable investment procured by intentional or fraudulent misrepresentations and material omissions." Accordingly, plaintiff's claims were barred.[35]

Use of extrinsic evidence to interpret terms of an agreement

Business formation agreements are, at their core, contracts. As contracts, they are subject to the same rules of interpretation, including use of extrinsic evidence. In *Kenney v Boss*, the Court held that the trial court did not err when it allowed extrinsic evidence to interpret the company's obligations under its operating agreement, even though the agreement contained an integration clause.[36] In *Boss*, the company's operating agreement provided that sewer/water assessments were to be paid by each member "proportionally" and "proportionately." The company paid the sewer and water assessments the first year but then stopped making such payments. The plaintiffs claimed that the company breached the operating agreement when Boss said that the company would no longer pay the assessments until the property owners transferred free and clear title to their properties. The Court held that an understanding of the company's obligations under the operating agreement as to assessments—specifically as to the terms "proportionately" and "proportionally"—was material to the plaintiffs' claim. However, neither term was defined in the operating agreement and both were susceptible to more than one interpretation. Extrinsic evidence was therefore permissible to aid the jury.[37]

Arbitration provisions: who is bound?

In *Altobelli v Harmann*, the Michigan Supreme Court addressed whether an arbitration provision in an operating agreement signed by the plaintiff and his former law firm applied to principals of the law firm who had not signed the agreement.[38] The defendants alleged that the arbitration clause applied to them as principals and managers of the firm, even though they had not individually signed the operating agreement. The arbitration provision stated that it applied to disputes "between the Firm...and any current or former Principal."[39]

The Court explained that "although no Michigan court has explicitly applied agency principles when interpreting an arbitration clause, it is well established that 'corporations can act only though officers and agents.'"[40] (Internal citation omitted.) Therefore, "the acts of officers and agents of a corporation, within the scope of their employment, are the acts of the corporation."[41] Applying these agency standards, the Court found

that the firm's operating agreement explicitly provided the defendants with complete power and responsibility for managing the affairs of the firm. "As officers, managers, and directors entrusted with carrying out the Firm's business, defendants are agents of the Firm."[42] Because it is "axiomatic that the Firm cannot act on its own...and because these particular defendants are clearly endowed with agency authority to administer the Firm's affairs," the Court held that the individual defendants were included within the meaning of "the Firm" in the arbitration clause.[43]

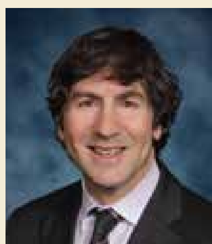
Economic loss doctrine

Generally, under Michigan law, a plaintiff may not maintain an action in tort for nonperformance of a contract. The economic loss doctrine "is animated by the idea that tort remedies should not bail out parties who could have anticipated losses caused by failed performance and negotiated an appropriate response."[44]

However, not all tort claims are barred by the existence of a contract. Instead, courts must inquire whether the legal duty allegedly violated by the defendant "arises separately and distinctly from a defendant's contractual obligations."[45] For example, in *Atlas Technologies*, the court held that Michigan's economic loss doctrine did not apply to bar the plaintiff-LLC's tort claims against its former officers.[46] The court found that the plaintiff's tort claims, particularly its fraud claims, were not barred by the economic loss doctrine because "the plaintiff could not have anticipated losses caused by the tortious conduct alleged in the second amended complaint. The legal duties that the defendants allegedly violated arise separately and distinctly from the defendants' contractual obligations."[47]

Conclusion

A company's governing documents are an important place to look to determine the rights and obligations of business owners. After that, a review of statutory law and caselaw should be undertaken to determine what other rights and remedies are available to the owners. Of course, principles of fiduciary duty, waiver, and estoppel along with the shareholder and member oppression statutes and other statutory protections remain potent principles to remedy financial abuses. ■



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ENDNOTES

1. *Wentworth v Wentworth*, unpublished per curiam opinion of the Court of Appeals, issued October 17, 2017 (Docket No. 333030), p 4.
2. *Madugula v Taub*, 496 Mich 685; 853 NW2d 75 (2014).
3. *Wentworth*, ___ Mich App ___ at 2.
4. *Id.* at 4.
5. *Id.* at 6.
6. *Id.*
7. *Id.* at 7.
8. *In re Caraco Pharmaceutical Laboratories Shareholder Litigation*, unpublished per curiam opinion of the Court of Appeals, issued June 13, 2017 (Docket No. 329933).
9. *Id.* at 10.
10. *Id.* at 11.
11. *Id.* at 14. See also *Marco Int'l, LLC v Como-Coffee, LLC*, unpublished opinion of the United States District Court for the Eastern District of Michigan, issued April 16, 2018 (Case No. 17-cv-10502) (discussing plaintiff's claim of fraud and recognizing as an exception to the limited liability provided by MCL 450.4501(4) to members and managers, "the familiar principle that agents and officers of a corporation are liable for the torts that they personally commit." (Citations omitted.)).
12. *Jode Investments, LLC v Burning Tree Props, LLC*, unpublished per curiam opinion of the Court of Appeals, issued February 27, 2018 (Docket Nos. 335299, 336726).
13. *Id.* at 9.
14. *Id.*
15. *Patel v Bhakta*, unpublished opinion of the United States District Court for the Eastern District of Michigan, issued October 8, 2014 (Case No. 13-cv-14099).
16. *Id.* at 6.
17. *Id.*
18. *Id.* at 7.
19. *Id.*
20. *Id.* at 8–9.
21. *Byker v Mannes*, 465 Mich 637; 641 NW2d 210 (2002).
22. *Id.* at 646.
23. *Id.* at 648–649.
24. *Id.* at 653.
25. *Herman v Pickell*, unpublished per curiam opinion of the Court of Appeals, issued April 12, 2016 (Docket No. 325920).
26. *Id.* at 5–6
27. *Id.* at 5. See also *Custom Pack Solutions v Great Lakes Healthcare Purchasing*, unpublished per curiam opinion of the Court of Appeals, issued February 22, 2018 (Docket No. 334815).
28. *Frank v Linkner*, 500 Mich 133; 894 NW2d 574 (2017).
29. *Id.*, 500 Mich at ___; 895 NW2d at 586.
30. *Holland v Kraatz*, unpublished per curiam opinion of the Court of Appeals, issued March 13, 2018 (Docket No. 336808).
31. *Id.* at 2.
32. *Id.*
33. *Id.* at 4.
34. *Id.* at 5.
35. *Id.*
36. *Kenney v Boss*, unpublished per curiam opinion of the Court of Appeals, issued July 18, 2017 (Docket No. 331905).
37. *Id.* at 4–5. See also *Boesky v Siegel*, unpublished opinion of the United States District Court for the Eastern District of Michigan, issued March 29, 2018 (Case No. 17-cv-12119) (integration clause in operating agreement applied to prior or contemporaneous agreements, not subsequent agreements, and therefore parol evidence rule did not apply).
38. *Altobelli v Harmann*, 499 Mich 284; 884 NW2d 537 (2016).
39. *Id.* at 296–297.
40. *Id.*
41. *Id.*
42. *Id.* at 301–302.
43. *Id.* at 302.
44. *Atlas Technologies v Levine*, 268 F Supp 3d 950, 963 (ED Mich, 2017).
45. *Loweke v Ann Arbor Ceiling & Partition Co*, 489 Mich 157, 166; 809 NW2d 553 (2011).
46. *Atlas Technologies*, 268 F Supp 3d at 964.
47. *Id.* See also *Marco Int'l, LLC v Como-Coffee, LLC* ("Here, Plaintiff is complaining about the Defendants' failure to make the payments agreed to under the contract. The obligation to make the payments that Steen allegedly falsely promised would be made arises solely out of the Agreement. Plaintiff did not plead facts that plausibly allege that Steen breached some duty independent of the duty to perform under the Agreement.").