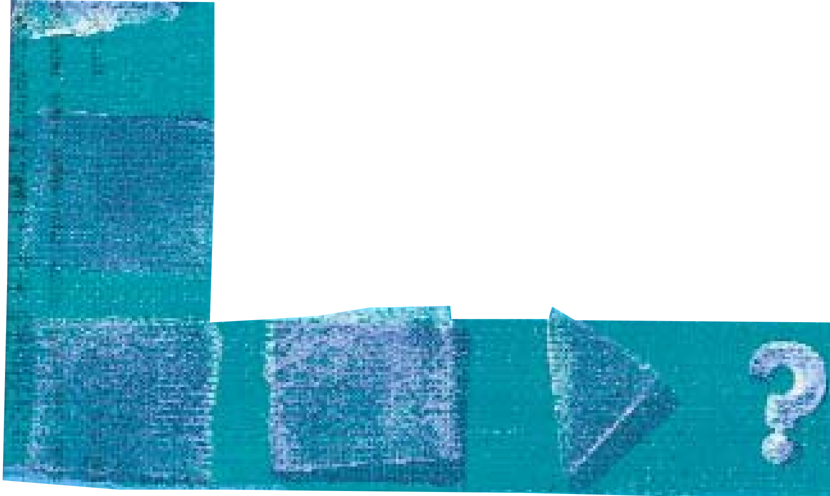


By Gerard V. Mantese and Ian M. Williamson

Minority

Introduction

Closely held corporations are often formed in an air of optimism, camaraderie, and entrepreneurial spirit. The shareholders may be close friends or family members, entering into a new business venture with an "all for one, one for all" enthusiasm. Shareholders frequently expect that, in addition to serving as an investment, the new venture will provide them with employment and other financial benefits. Shareholders often presuppose the continuation of this early camaraderie without taking into account the possibility of serious disagreements, deadlock, or worse.

Unfortunately, as business attorneys know all too well, the honeymoon phase of a new venture can quickly end when divergent opinions arise regarding the operation of the entity. For example, one shareholder may want the company to expand into new markets, while another prefers to focus narrowly on a specific product or service in an established geographical area. One of the shareholders may insist on hiring a favorite nephew, who dropped out of college and has no ascertainable skills aside from generating creative excuses for his lack of performance. Even worse, one shareholder may surreptitiously usurp corporate opportunities, while another may convert corporate assets.

Since minority shareholders of closely held corporations often fail to provide themselves with contractual protection at the inception of the enterprise, they may be at risk if they confront unfair or abusive conduct later on. Disagreements arise, tempers flare, and the one who has the most shares often wins, while the loser may face ouster from the premises, termination of employment, removal from board positions, discontinuation of dividends, and denial of access to corporate information—in other words, the classic corporate squeeze-out. This article discusses Michigan's minority oppression statute, recent case law, and how difficulties commonly faced by minority shareholders can be avoided by drafting appropriate agreements and corporate documents.

MCLA 450.1489: Legislative Protection for the Oppressed Minority Shareholder

Michigan law addresses minority shareholder oppression in MCL 450.1489 (Section 489), which provides in part as follows:[1]

> *Sec. 489. (1) A shareholder may bring an action in the circuit court of the county in which the principal place of business or registered office of the corporation is located 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. If the shareholder establishes grounds for relief, the circuit court may make an order or grant relief as it considers appropriate, including, without limitation, an order providing for any of the following:*
>
> *(a) The dissolution and liquidation of the assets and business of the corporation.*
>
> *(b) The cancellation or alteration of a provision contained in the articles of incorporation, an amendment of the articles of incorporation, or the bylaws of the corporation.*
>
> *(c) The cancellation, alteration, or injunction against a resolution or other act of the corporation.*
>
> *(d) The direction or prohibition of an act of the corporation or of shareholders, directors, officers, or other persons party to the action.*
>
> *(e) The purchase at fair value of the shares of a shareholder, either by the corporation or by the officers, directors, or other shareholders responsible for the wrongful acts.*
>
> *(f) An award of damages to the corporation or a shareholder. An action seeking an award of damages must be commenced within 3 years after the cause of action under this section has accrued, or within 2 years after the shareholder discovers or reasonably should have discovered the cause of action under this section, whichever occurs first.*

Under this statute, potential defendants are not only directors, but also "those in control of the corporation"—generally, but not

Shareholder Oppression

From *Estes* to *Franchino*

necessarily, the majority shareholders.[2] Subsection (2) of the statute limits its application to closely held corporations.[3]

In 2001, the legislature amended Section 489 by adding subsection 3, to define "willfully unfair and oppressive conduct," and, as the legislative history provides, to "make it clear that more than an ordinary breach of duty would be required to create a claim under Section 489."[4] Subsection 3 provides:

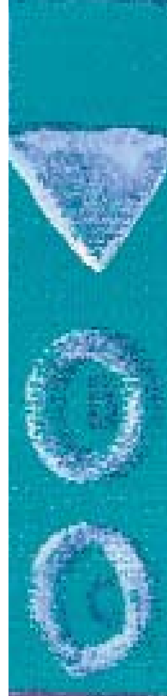
> *(3) As used in this section, "willfully unfair and oppressive conduct" means a continuing course of conduct or a significant action or series of actions that substantially interferes with the interests of the shareholder as a shareholder. The term does not include conduct or actions that are permitted by an agreement, the articles of incorporation, the bylaws, or a consistently applied written corporate policy or procedure.*

Despite this 2001 amendment, case law shows that the level of unfair conduct necessary to trigger the remedies of Section 489 has not yet been defined with precision by the courts. In fact, few appellate decisions have discussed these issues in detail. Michigan's most recent published decision involving a claim of minority shareholder oppression, the 2004 case of *Franchino v Franchino,*[5] departs from the relatively broad manner in which many other states define oppressive conduct. Therefore, counsel for prospective minority shareholder-employees should ensure that their clients' rights are adequately defined and protected through carefully worded agreements and corporate documents in the event that the conduct complained of is not actionable under the statute.

Standing[6] Resolved: Minority Shareholders Have a Direct Claim Under Section 489

The Michigan Court of Appeals did not definitively hold that Section 489 created a direct, non-derivative cause of action for oppressed minority shareholders until 2002, in *Estes v Idea Engineering & Fabricating, Inc.*[7] *Estes* overruled the 1998 decision of *Baks v Moroun,*[8] where the court held that Section 489 served only to "affect by whom, in what tribunal, according to what standard of fiduciary duty, and within what time frame such common-law actions should be pursued, if at all."[9] In *Estes,* the court declared, "we hold that Section 489 creates a separate and independent statutory cause of action and that the six-year period of limitation contained in the residual statute applies."[10]

A minority shareholder thus has a cause of action under the statute to contest illegal, fraudulent, or "willfully unfair and oppressive conduct." As defined in Section 489(3), conduct that is "willfully unfair and oppressive" must "substantially interfere[] with" a shareholder's interests "as a shareholder." Under the statute, conduct that comports with a written agreement cannot qualify as oppressive, even if it seriously disadvantages a minority shareholder. However, this provision does not create a total shield to an abusive scrivener. For example, while a bylaw may in certain circumstances be thought of as a written agreement,[11] under Section 489(1)(b), a court has the power to order "the cancellation or alteration of a provision contained in the articles of incorporation, an amendment of the articles



Fast Facts:

Disagreements arise, tempers flare, and then the minority shareholder is ousted and deprived of dividends and information—the classic corporate squeeze-out is underway.

When directors or those in control of a corporation engage in conduct that is illegal, fraudulent, or willfully unfair and oppressive to a shareholder's interest as a shareholder, the courts have broad powers under Section 489 to provide a remedy, including dissolution and liquidation, injunctive relief, a forced buy-out, and damages.

Because the remedies under Section 489 do not appear to be granted with regularity, counsel for minority shareholders should be involved at the inception of the enterprise, and should define their clients' rights clearly, in written agreements and corporate documents.

of incorporation, or the bylaws of the corporation." Thus, a court has the ability to actually rewrite certain corporate documents agreed to by the shareholders, in order to remedy conduct that is otherwise illegal, fraudulent, or willfully unfair and oppressive.

Unpublished Cases Since *Estes:* What Constitutes Actionable Conduct?

Since *Estes* created a direct cause of action under 489, the Michigan Court of Appeals has made few determinations of whether specific conduct meets the "illegal, fraudulent or willfully unfair and oppressive" standard. In *Nagia v Chota,*[12] an unpublished case decided in 2002, the plaintiff minority shareholders asserted a claim under Section 489, asserting, among other things, that the defendants had failed to distribute an appropriate amount of dividends. Yet, the evidence showed that the defendants had actually distributed more dividends than were required under the parties' preincorporation agreement. Accordingly, the court held that the plaintiffs failed to meet their evidentiary burden of establishing a factual dispute sufficient to prevent summary disposition with regard to the Section 489 claim.

Shortly thereafter, in *Langrill v Diversified Fabricators, Inc,*[13] also decided in 2002, the plaintiff based a minority oppression claim on, inter alia, a stock transfer between the individual defendants and excessive compensation received by those defendants. Since the plaintiff had consented in writing to the stock transfer and the compensation agreements, the court held that he could not bring a claim for minority oppression based on those actions, citing to Section 489(3), which prohibits claims based on conduct permitted by agreement. The plaintiff failed to present evidence that he had been forced to sign the agreements or that he had been forced out of the company, and the evidence suggested that he had refused to sign other proposed agreements with no repercussions. The court thus rejected the plaintiff's claim that the challenged actions met the "illegal, fraudulent, or willfully unfair and oppressive" standard.

The plaintiff in *Reinhart v Cendrowski Selecky, PC,*[14] decided December 30, 2003, brought a claim for minority shareholder oppression based on the defendants' alleged failure to pay certain

fees to the plaintiff. Specifically, the plaintiff alleged that the defendants had terminated his employment for the sole purpose of triggering the stock purchase agreement immediately before the corporation's receipt of substantial fees and profits, to which the plaintiff would otherwise have been partially entitled. In a bench trial, the trial court directed a verdict for the defendant on the ground that the plaintiff failed to prove that the defendants' actions were not permitted under the terms of the agreements between the parties, and that the plaintiff therefore failed to demonstrate that the conduct was oppressive. The Court of Appeals affirmed and noted that the plaintiff's claims would now be prohibited by Section 489(3), which excludes claims based on conduct permitted by an agreement.

This line of unpublished cases since *Estes*[15] demonstrates, as discussed above, that counsel for minority shareholders should insist on carefully drafted agreements and corporate documents such as employment agreements, buy-sell agreements, bylaws, articles of incorporation, and agreements specifying those actions that require super-majority shareholder votes, so that their clients' expectations and interests are protected. Minority shareholders cannot lightly assume that they will be entitled to invoke the remedies of Section 489 if they are unhappy with the direction that those in control of the corporation are taking, or with the treatment they are experiencing by those in control.

Franchino v Franchino

The only published Michigan case since *Estes* that explores the boundaries of "willfully unfair and oppressive conduct" is *Franchino v Franchino,*[16] decided by the Michigan Court of Appeals in 2004. In *Franchino,* the plaintiff was a 31 percent shareholder in a close corporation and had signed an employment agreement that provided he could be terminated only by the unanimous agreement of the board of directors. While he was employed by the corporation, the plaintiff drew a salary of approximately $500,000 per year and received annual dividends of $3,100. The board consisted solely of plaintiff and defendant, the latter who owned the remaining 69 percent of the corporation. The plaintiff and defendant were also parties to two buy-sell agreements, which the defendant eventually decided were not in his interest.

When the plaintiff refused to set aside the buy-sell agreements upon the defendant's demand, the defendant incorporated a new entity and began preparations to merge the corporation into it. Around the same time, he purported to fire the plaintiff from his position with the corporation, albeit without the unanimous consent of directors required under the employment agreement. Shortly thereafter, the defendant held a meeting of the board of directors at which he removed the plaintiff from the board, amended the corporation's bylaws to allow for a board consisting of as little as one director, and then held a board meeting at which he again terminated the plaintiff's employment, curing the procedural deficiency in the previous firing.

In his subsequent lawsuit against the defendant and the corporation, the plaintiff alleged that he had been subjected to "willfully unfair and oppressive" conduct under Section 489. The trial court disagreed, holding that, while the plaintiff may have had a reasonable expectation of continued employment and directorship, the defendant's actions had not affected the plaintiff's interests "as a shareholder." The Court of Appeals affirmed, holding that, "To construe the statute in a way that allows plaintiff to sue for oppression of his interests as an employee and director would ignore the Legislature's decision to insert the phrase 'as a shareholder' and render the phrase nugatory, which is contrary to a fundamental rule of statutory construction."[17] The *Franchino* court focused on the statutory language, defining "willfully unfair and oppressive conduct" as that which "substantially interferes with the interests of the shareholder *as a shareholder.*" (Emphasis added.)

The *Franchino* court held that shareholders do not have an inherent right to be employed by, or to serve on the board of directors of, their corporation, and actions affecting employee or director status thereby did not interfere with the shareholder interests of the plaintiff. The court distinguished Michigan's statute on oppression from statutes in other states that, by their express language, grant minority shareholders relief from oppressive actions against them not only in their capacities as shareholders, but also in their capacities as directors, officers, and/or employees. Since the Michigan statute expressly limits its scope to actions that are oppressive to minority shareholders "as a shareholder," the court held that conduct oppressive to a minority shareholder in other capacities was not covered by Section 489.

Another important aspect of *Franchino* is the Court of Appeals' discussion of the "reasonable expectations" test, which is frequently employed in other jurisdictions to identify oppressive conduct. This test is based on the notion that conduct by a controlling shareholder that frustrates the objectively reasonable expectations of a minority shareholder may constitute willfully unfair and oppressive conduct. Although several Michigan cases had previously mentioned the reasonable expectations test, *Franchino* rejected it.[18]

Conclusion

While embarking on a new corporate venture is exciting, and all parties may initially be on good terms, appropriate agreements should be discussed and finalized to clarify the rights and obligations of each shareholder. If each shareholder expects to be employed by the new entity, this should be documented in agreements, as MCL 450.1489 by its terms protects a party's interests only as a shareholder, not as an employee. Further, the shareholders should discuss whether they wish to provide the automatic right to be bought out in certain circumstances. Even absent an agreement, however, the courts have broad powers under Section 489 to remedy the misconduct of the directors or those in control of the corporation. If a minority shareholder can establish that directors or those in control of the corporation have engaged in conduct that is illegal, fraudulent, or willfully unfair and oppressive to the corporation or to the shareholder, Section 489 provides the court with a significant and wide-ranging panoply of statutory remedies, including dissolution and liquidation, injunctive relief, an order that the directors or

those in control purchase the shares of the plaintiff at fair value, and/or an award of damages. However, because it may be uncertain in any particular case whether a court will grant the statutory remedies of Section 489, counsel for minority shareholders should define their clients' rights clearly at the inception of the enterprise. ◆

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Footnotes

1. See Cyril Moscow, Norman C. Ankers, *Oppression of Minority Shareholders,* 77 Mich BJ 1088 (1998) for an excellent and in-depth analysis of statutory and case law dealing with shareholder oppression through *Baks v Moroun,* 227 Mich App 472 (1998).
2. See generally *Kearney v Jandernoa,* 957 F Supp 116 (WD Mich 1997) (minority shareholders with actual control over corporation's affairs have fiduciary duties as controlling shareholders).
3. Cf MCL 450.4515 (governing minority oppression in the limited liability company context).
4. SB 206 (S-1): First Analysis at 7 (Mich 2001).
5. 263 Mich App 172, 687 NW2d 620 (2004) (rejecting the "reasonable expectations" test).
6. See Daniel D. Quick, Nakisha N. Chaney, *The Murky Pit of Minority Shareholder Standing: A Moot Point?,* 19 Mich LW 31 (2004) for an insightful analysis of shareholder standing issues.
7. 250 Mich App 270, 649 NW2d 84 (2002) (overruling *Baks v Moroun*).
8. 227 Mich App 472, 576 NW2d 413 (1998).
9. Id. at 485.
10. 250 Mich App at 285–86.
11. See *Calvary Temple Church, Inc v Paino,* 827 NE2d 125 (Ind App 2005) (bylaws constitute a binding contract); see also *Feyz v Mercy Memorial Hospital,* 264 Mich App 699, 692 NW2d 416 (2005) (by-laws may create contract rights).
12. No 229311 (Mich App June 14, 2002).
13. No 225001 (Mich App June 25, 2002).
14. No 239540 (Mich App Dec. 30, 2003).
15. See also *McCarthy v Miller,* No 231829 (Mich App, February 21, 2003) (holding that only a current shareholder may bring an action under Section 489).
16. 263 Mich App 172, 687 NW2d 620 (2004).
17. 263 Mich App at 185–86.
18. Id.