

Fiduciary Duty in Business Litigation

By Gerard V. Mantese and Ian M. Williamson



“[T]o say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?”

—Justice Frankfurter, *SEC v Chenery Corp.*,
318 US 80, 85–86; 63 S Ct 454; 87 L Ed 626 (1943)

Fiduciary duties arise in many contexts, both under statute and common law. This article examines Michigan statutory law and caselaw on fiduciary duty in the context of close corporations and limited liability companies (LLCs). We address who is a fiduciary and to whom, the conduct required of fiduciaries, and standing to bring claims against fiduciaries.

Overview of fiduciary duty

The Michigan Supreme Court has defined a fiduciary relationship as “a relationship in which one person is under a duty to act for the benefit of the other on matters within the scope of the relationship.”¹ Fiduciary relationships arise (1) where one reposes trust in the faithful integrity of another, who gains influence over that person; (2) where one assumes control and responsibility over another; (3) where one has a duty to act for or advise another on matters within the scope of the relationship; and (4) when the specific relationship has traditionally been recognized as involving fiduciary duties, such as between lawyer and client.²

Fiduciary relationships may be created informally or even unintentionally, without any specific intent of the parties.³ When one party places trust and reliance in the other’s judgment, an abuse of that relationship may result in viable legal claims.⁴ However, the placement of trust must be reasonable.⁵

Closely held businesses involve various fiduciary duties

For directors, officers, or managers of closely held businesses, the scope of fiduciary duty focuses on the duties of loyalty and care along with duties of good faith and disclosure. These duties protect against a fiduciary’s service to himself at the expense of the company or the shareholders. In Michigan, these duties are based in common law, but have been largely codified in Michigan’s Business Corporation Act⁶ and Limited Liability Company Act.⁷

The duty of loyalty requires the fiduciary to place the interests of his principal ahead of his own and prohibits the fiduciary “from acting in any antagonistic position whether for [his] own personal benefit or for the benefit of other competitive corporations.”⁸ This duty “is typically implicated when directors engage in self-dealing, or when they take personal benefits not shared with all the shareholders.”⁹

The duty of care requires attentiveness to the affairs of the company, requiring the fiduciary to make decisions as would a reasonably prudent person in a similar situation. The “general rule by which to measure the degree of care and diligence required”

by fiduciaries in control of a business enterprise is that they “must answer for ordinary neglect; and ‘ordinary neglect’ is understood to be the omission of that care which every man of common prudence takes of his own concerns.”¹⁰

The fiduciary duty of good faith, frequently cited in Michigan and other jurisprudence, is typically addressed within the context of alleged breaches of the duties of loyalty and care. In the context of the duty of care, a showing of “bad faith” may preclude a fiduciary’s reliance on the business judgment rule to escape liability.¹¹ In connection with the duty of loyalty, authorizing a transaction for some purpose other than the best interests of the corporation may constitute bad faith.¹²

The fiduciary duty of disclosure is rooted in agency principles and may be viewed as appurtenant to the duty of loyalty. This duty requires the fiduciary to disclose to the corporation and shareholders all information the fiduciary knows is relevant to the affairs of the corporation, and which the fiduciary knows the shareholders would desire to have.¹³ This duty often comes into play where the fiduciary has withheld material information as part of a scheme to advance his own interests.

Statutory duties of directors, officers, and managers

MCL 450.1541a codifies the duty of care for corporate officers and directors and includes the duty of loyalty—addressed indirectly in the concept of “good faith” set forth in (1)(a) of the statute. The duty of loyalty is also addressed in MCL 450.1545a, which establishes a safe harbor for interested party transactions involving directors or officers where (1) the transaction was fair to the corporation when entered into; or (2) the material facts were disclosed to the board, a board committee, or the independent directors, and the same approved or ratified the transaction; or (3) the material facts were disclosed to the shareholders and they approved or ratified the transaction.¹⁴

FAST FACTS

The Michigan Business Corporation Act and Limited Liability Company Act codify fiduciary duties of care, loyalty, and good faith for directors, officers, and managers of closely held business entities.

“Those in control” of closely held business entities are likely fiduciaries even if they are not formally named as directors, officers, or managers.

Shareholders or members may be able to pursue claims based on breaches of fiduciary duties even in nonderivative actions.

In Michigan, LLCs may be managed by their members or by managers, subject to specific operating agreement provisions.¹⁵ A *manager* is a person “designated to manage the limited liability company pursuant to a provision in the articles of organization stating that the business is to be managed by or under the authority of managers.”¹⁶ Managers have statutory duties of care essentially identical to those of corporate officers and directors, as well as a codified duty of loyalty, set forth in MCL 450.4404.

Managers of LLCs also have a statutory safe harbor parallel to that of MCL 450.1545a for interested party transactions that are fair or were disclosed and approved.¹⁷ Further, managers are statutorily deemed agents of the LLC for the purpose of its business and therefore owe the LLC as principal all fiduciary duties applicable to agents.¹⁸

Members of member-managed LLCs are subject to the same duties that attach to managers under MCL 450.4404.¹⁹ Further, in member-managed LLCs, *all* members are deemed agents of the LLC for the purpose of its business unless the operating agreement provides otherwise.

Common law fiduciary duties of directors and officers

Corporate officers and directors in Michigan owe common law duties of loyalty and good faith both to the corporation they serve and to its shareholders.²⁰ The common law duty of good faith includes a duty of disclosure requiring officers and directors “to communicate to [their] principal facts relating to the business which ought in good faith be made known to the latter.”²¹

While corporate directors and officers owe fiduciary duties directly to shareholders, Michigan courts generally prohibit shareholders from bringing direct claims for breach of those duties because such breaches typically cause injury to the corporation as a whole. Under Michigan caselaw governing the direct/derivative distinction, suits to redress injury to a corporation must be brought derivatively in the name of the corporation, but exceptions to this general rule exist when (1) the individual plaintiff is owed a duty independent of the corporation²² or (2) the individual plaintiff has sustained an injury separate and distinct from the corporation’s shareholders generally.²³

Direct shareholder suits under oppression statutes

The statutory duties discussed above flow from directors, officers, or managers to the entity they serve and are therefore enforceable directly by the entity and derivatively by shareholders or members.²⁴ However, Michigan law allows shareholders of close corporations to bring direct claims against directors or those in control of a corporation for conduct that is “illegal, fraudulent, or willfully unfair and oppressive to the corporation or the shareholder.”²⁵ Since the statute uses the word “or” between the terms “the corporation” and “the shareholder,” a shareholder may bring a direct action against the directors to address any actionable conduct under § 489 that harms the corporation, including a breach of statutory duty.

In the LLC context, members may bring an action “to establish that acts of the managers or members in control...are illegal or fraudulent or constitute willfully unfair and oppressive conduct toward the limited liability company or the member.”²⁶ If a member sues under MCL 450.4515, that member should, therefore, have standing to sue for any actionable conduct under the statute that harms the company or the member, including a breach of statutory duty.²⁷

Some commentators, arguing that legislative intent on this issue is not sufficiently clear, have misguidedly called for a narrowed interpretation of § 489 which would preclude shareholders from bringing direct actions to address “illegal” or “fraudulent” conduct toward the corporation.²⁸ But this call disregards the meaning of the word “or” as used in MCL 450.1489 and is therefore at odds with its plain language, which provides expanded remedies for a variety of directorial misconduct whether it harms the corporation or the shareholder.

As the Michigan Supreme Court recently recognized in *Madugula v Taub*, direct shareholder actions permissible under § 489 are “often derivative in nature because the remedies sought affect the corporation.”²⁹ In close corporations, it makes sense to permit shareholders to bring traditionally derivative claims like those for breach of fiduciary duties directly, even where such breaches damage the corporation. Noncontrolling shareholders often lack a ready means of selling or redeeming their shares, and are more likely to bear the brunt of any damage to the corporation resulting from illegal or fraudulent acts by directors or those in control.³⁰

Duties of controlling shareholders and members

Nondirector/officer shareholders with actual control over a corporation’s actions are common law fiduciaries. In *Estes v Idea Engineering & Fabrications, Incorporated*,³¹ the Court of Appeals held that those in control of a closely held corporation have “a higher standard of fiduciary responsibility, a standard more akin to partnership law.”³² In *Miner v Bell Isle Ice Company*,³³ the Michigan Supreme Court held that when majority combinations of shareholders exert control, “they become, for all practical purposes, the

corporation itself, and assume the trust relation occupied by the corporation towards its stockholders.”³⁴ Some Michigan courts have defined this as a duty to manage the corporation “as to produce to each stockholder the best possible return on his investment.”³⁵

Nonmanager members in a manager-managed LLC are not automatically subject to statutory duties of care, and Michigan courts have been reluctant to find fiduciary duties among equally positioned LLC members.³⁶ However, Michigan appellate courts tend to look to corporation law. Further, members “in control of” an LLC, whether through majority ownership or otherwise, are subject to a statutory duty not to commit illegal or fraudulent or willfully unfair and oppressive actions toward the company or its members.³⁷

The business judgment rule

The “business judgment rule” provides some protection against claims of fiduciary breaches. The rule protects directors and officers from liability for making honest and reasonable judgments on company operations that turn out, in hindsight, to be unwise.³⁸

The business judgment rule creates “a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”³⁹ The rule implicates the fiduciary duty of loyalty in that it protects *only* business decisions reached by disinterested officers and directors.⁴⁰ To enjoy the protection of the rule, officers and directors must also act with due care and inform themselves “of all material information reasonably available to them” before making a decision.⁴¹ The rule also requires that officers and directors act “in good faith and in the honest belief that the action taken was in the best interests of the company.”⁴²

To rebut the presumptions of the business judgment rule, a plaintiff must show that those presumptions are factually inapplicable. If the directors or officers had an interest in the transaction at issue, the rule may not apply.⁴³ Also, a showing of bad faith will typically preclude application of the rule’s protections.⁴⁴

No Michigan appellate court has specifically addressed whether the rule’s protections apply to managers or members of an LLC, though trial courts do apply it in the LLC context.⁴⁵ Given the similarities in statutory duties of corporate officers and directors and LLC managers, parties should presume that the same protections apply.⁴⁶

Conclusion

A fiduciary must be loyal and diligent to the interests of his charges—and aware of who those varying charges may be. While those in control of a business entity have some protection under the business judgment rule, they should be aware that shareholders or members may raise allegations of fiduciary breach even in nonderivative actions and for harm to a shareholder or member as well as harm to a corporation or LLC. If a fiduciary duty exists, the facts in question must be closely analyzed to determine if the fiduciary acted in self-interest, imprudently, or in bad faith. ■

Michigan law allows shareholders of close corporations to bring direct claims against directors or those in control of a corporation for conduct that is “illegal, fraudulent, or willfully unfair and oppressive to the corporation or the shareholder.”



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ENDNOTES

1. *In re Karmey Estate*, 468 Mich 68, 74, n 2; 658 NW2d 796 (2003), citing Black's Law Dictionary (7th ed).
2. *Id.*; cf. *Banker & Brisebais Co v John C. Maddox, CPA*, unpublished opinion per curiam of the Court of Appeals, issued April 29, 2014 (Docket No. 310993) ("accountant-client relationship is not a traditionally recognized fiduciary relationship").
3. See *Meretta v Peach*, 195 Mich App 695, 697; 491 NW2d 278 (1992) (an agency relationship exists where the principal suggests the agent may act on his account); *Bykker v Mannes*, 465 Mich 637, 653; 641 NW2d 210 (2002) (a partnership exists where individuals carry on business for profit regardless of intentions).
4. See *Vicencio v Ramirez*, 211 Mich App 501, 508; 536 NW2d 280 (1995).
5. *Prentis Family Foundation, Inc v Barbara Ann Karmanos Cancer Inst*, 266 Mich App 39, 44; 698 NW2d 900 (2005) (citations omitted).
6. MCL 450.1101 *et seq.*
7. MCL 450.4101 *et seq.* Partnerships and joint ventures are outside the scope of this article.
8. *Wagner Electric Corp v Hydraulic Brake Co*, 269 Mich 560, 566; 257 NW2d 884 (1934).
9. Gold, *The new concept of loyalty in corporate law*, 43 UC Davis L R 457, 459 (2009).
10. *Martin v Hardy*, 251 Mich 413, 416; 232 NW 197 (1930). This standard of care is modified by the business judgment rule.
11. See *Dodge v Ford Motor Co*, 204 Mich 459, 500; 170 NW 668 (1919) (finding that the discretion of directors is not interfered with by courts in absence of bad faith, willful neglect, or abuse).
12. See Bishop, *Directorial abdication and the taxonomic role of good faith in Delaware corporate law*, 2007 Mich St L R 905, 932 (Winter 2007) (discussing Delaware law; Michigan courts have not closely analyzed the specific parameters of what constitutes "bad faith" in the business entity context).
13. *Pinnacle Express, Inc v Trout*, unpublished opinion of the Michigan 6th Circuit Court, issued June 26, 2002 (Docket No. 01-441-CZ).
14. See MCL 450.1545a(1)(a), (b), and (c). Notably, under MCL 450.1545a(4), "satisfying the requirements of subsection (1) does not preclude other claims relating to a transaction in which a director or officer is determined to have an interest."
15. See MCL 450.4401.
16. MCL 450.4102(2)(o).
17. MCL 450.4409(1). Member votes are also taken into account in determining whether this safe harbor is applicable, unless the articles or an operating agreement provide otherwise. MCL 450.4502(5).
18. MCL 450.4406; see also Miller, *Limited Liability Companies: A Common Core Model of Fiduciary Duties* (2014 ed).
19. See MCL 450.4401(a) and (b).
20. *Pittiglio v Michigan Nat'l Corp*, 906 F Supp 1145, 1154 (ED Mich, 1995).
21. *Production Finishing Corp v Shields*, 158 Mich App 479, 486; 405 NW2d 171 (1987).
22. *Michigan Nat'l Bank v Mudgett*, 178 Mich App 677, 679; 444 NW2d 534 (1989).
23. *Christner v Anderson, Nietzke & Co, PC*, 433 Mich 1, 9; 444 NW2d 779 (1989).
24. See *Estes v Idea Engineering & Fabrications, Inc*, 250 Mich App 270, 285; 649 NW2d 84 (2002).
25. MCL 450.1489(1) (emphasis added).
26. MCL 450.4515(1) (emphasis added).
27. See *Ewie Co, Inc v Mahar Tool Supply, Inc*, unpublished opinion per curiam of the Court of Appeals, issued October 8, 2008 (Docket No. 276646) at *5, *rev'd in part* on other grounds, *Ewie Co, Inc v Mahar Tool Supply, Inc*, 483 Mich 905; 762 NW2d 160 (2009) (member had standing to sue directly after the managing member moved the contract from the LLC into a new company).
28. Hauck & Kolosvary, *Shareholder oppression and the direct/derivative distinction*, 27 MI Bus LJ 18, 22 (Summer 2007); Quick & Pawlowski, *The Tyranny of the Minority*, 15 ABA Commercial and Business Litigation Newsletter 7 (Winter 2014).
29. *Madugula v Taub*, ___ Mich ___, ___ NW2d ___ (2014).
30. This is consistent with MCL 450.1103 (requiring that Michigan's Business Corporation Act be liberally construed to "give special recognition to the legitimate needs of close corporations"). See *Bromley v Bromley*, unpublished opinion of the U.S. District Court for the Eastern District of Michigan, issued June 7, 2006 (Docket No. 05-71798) at *4. ("Defendants further ignore both *Estes*' and the statute's clear language that an action may be brought for minority oppression resulting in harm either to the shareholder or to the corporation. Plaintiff's Complaint alleges numerous claims of mismanagement of the corporation resulting in harm both to the corporation and to the interests of the shareholders and therefore satisfies the basic standing requirement of § 489.") (Emphasis added.)
31. *Estes*, n 24 *supra*.
32. *Id.* at 281.
33. *Miner v Bell Isle Ice Co*, 93 Mich 97; 53 NW 218 (1892).
34. *Id.* at 114.
35. *Veeser v Robinson Hotel Co*, 275 Mich 133, 138; 266 NW 54 (1936). "The overarching objective of the corporate entity is its own common good, which is generally to make profits." Bayne, *A philosophy of corporate control*, 112 U Pa L R 22, 42 (1963).
36. See *Alliance Associates, LLC v Alliance Shippers, Inc*, unpublished opinion per curiam of the Court of Appeals, issued June 1, 2006 (Docket No. 265101) (finding there is no fiduciary duty between equal members of the LLC).
37. MCL 450.4515(1).
38. The business judgment rule does not protect failures to act unless such inaction arises from a conscious decision not to act. Varallo, Dreisbach & Rohrbacher, *Fundamentals of Corporate Governance: A Guide for Directors and Corporate Counsel* (2d ed), p 60.
39. *Aronson v Lewis*, 473 A2d 805, 812 (Del 1984); see also *In re Butterfield Estate*, 418 Mich 241, 255; 418 NW2d 453 (1983) ("In the absence of bad faith or fraud, a court should not substitute its judgment for that of corporate directors....").
40. *Aronson*, n 39 *supra* at 812.
41. *Id.*
42. *Id.*
43. *Id.* But see MCL 450.1545a (providing safe harbors for interested transactions in some circumstances).
44. See *Dodge*, n 11 *supra* at 500.
45. See *Savas v Yaker*, unpublished opinion per curiam of the Court of Appeals, issued April 20, 2010 (Docket No. 288991) (noting trial court's application of business judgment rule in LLC dispute).
46. Courts regularly apply a version of the business judgment rule to LLC management decisions in the employment context. See, e.g., *Crawford v TRW Automotive US LLC*, unpublished opinion of the U.S. District Court for the Eastern District of Michigan, issued December, 28, 2007 (Docket No. 06-14276) at *3.