The Michigan Supreme Court Speaks

Madugula v Taub and Shareholder Oppression

By Gerard V. Mantese and Douglas L. Toering

In *Madugula v Taub*,[1] the Michigan Supreme Court issued its first decision interpreting MCL 450.1489, which provides a cause of action for shareholder oppression. *Madugula* held that a 1489 cause of action is an equitable claim to be tried before a judge, although the Court stated that it would be entirely appropriate to use a jury in an advisory capacity under MCR 2.509(D). The Court also held that breach of a shareholder agreement may be relevant to establishing shareholder oppression. Along the way, the Court gave potential insight into other aspects of minority shareholder oppression litigation.

The authors have substantial experience in shareholder oppression actions. Mantese represents both plaintiffs and defendants in shareholder litigation, and he briefed and argued the case for the plaintiff in *Madugula*. Toering served on the committee that drafted the amicus brief for the SBM Business Law Section.[2] Given that *Madugula* will have an impact on both transactional and litigation attorneys who represent closely held businesses and their owners, the authors give their thoughts on the case and its implications for future oppression cases.

Did the Court clarify what was needed to prove oppression?

Mantese:

MCL 450.1489 provides remedies for shareholders and corporations harmed by, among other things, "willfully unfair and oppressive" conduct.[3] Although the Court's decision did not issue a definitive list of what constitutes oppression, it provides guidance on the type of conduct that can constitute oppression. The decision instructs us in this regard in four ways.

First, by emphatically holding that an action for shareholder oppression is "equitable" in the context of the jury trial discussion, the Court tied the claim of oppression to the trial judge's sense of fairness and equity. The Court held that the judge has "*wide* latitude" and "*wide* discretion" in this regard, confirming that the judge's equitable power in finding oppression and ordering a remedy is far reaching. This signals to lower courts and practitioners that a shareholder oppression claim is intended to provide redress for a variety of inequitable conduct, including any conduct that is inconsistent with the high standards of fiduciary duty which have always been the standards governing those in control of corporations.[4]

Second, by declining to articulate a bright-line rule for what constitutes oppression, the Court effectively left undisturbed the flexible, case-by-case review that traditionally informs this analysis and which has proven to encompass myriad corporate abuses, thus triggering 1489 liability.

Third, consistent with the wide discretion afforded to the trial court, the decision affirms that a breach of corporate governance documents, including agreements governing shareholder conduct, is appropriately considered as evidence of oppression, depending on the facts of the case. Until this decision was issued, it was unclear whether shareholder rights protected under 1489 could derive from agreements, or whether the protected shareholder rights were limited to those defined by statute. However, the Court laid this issue to rest, squarely in favor of the plaintiff, holding that shareholder rights can arise out of corporate agreements. In fact, one of the issues in *Madugula* was whether the plaintiff would be held to his contractually bargained-for right of arbitration per the shareholder agreement that Taub breached, or whether he could proceed under 1489. The Court allowed the plaintiff to proceed under 1489, sending a strong message that the breach of a substantial shareholder right may trigger 1489 liability.

Fourth, the Court also pointed to rights that a shareholder has under the various statutes in the Michigan Business Corporation Act[5] including, among others, the rights to vote, obtain information, receive dividend distributions, and enter into shareholding agreements. Thus, we can see that oppression may also be proven by showing a substantial interference with any such rights—contractual *or* statutory. As such, the Court's holding is consistent with a substantial body of growing caselaw over the years illustrating that a variety of wrongful actions by those in control may constitute oppressive acts.[6] We have seen cases, for example, where oppression arises out of a shareholder improperly withholding distributions, diverting or usurping assets, obtaining disproportionate compensation, attempting to effectuate an unfair buyout, or committing illegality; and cases where one shareholder has alienated another shareholder from the employees of the company, physically barred a shareholder from the company offices, or shut out a shareholder from input and involvement in the company, in an attempt to force a buyout.

As aptly articulated by the late F. Hodge O'Neal, a leading commentator on business law, "Businessmen, their lawyers and other business advisors, have indeed been prolific and ingenious in devising ways of eliminating undesired business associates."[7] Further, Michigan courts have demonstrated in cases like *Schimke v Liquid Dustlayer, Incorporated*[8] and *Berger v Katz*[9] that they are willing to take a holistic approach to shareholder disputes and craft equitable relief based on the facts of each situation.

Toering:

My perspective is a bit different. First, it is true that a circuit court (sitting in equity) has "wide latitude to fashion relief" in a 1489 case—after oppression has been established.[10] Indeed, as Mantese mentions, the Court's discussion of this discretion occurs in the context of whether the plaintiff has a right to a jury trial, not on what constitutes oppression.

FAST FACTS

A shareholder oppression claim is designed to provide redress for inequitable conduct that is inconsistent with the high standards of fiduciary duty.

Breaching a shareholder agreement may constitute evidence of shareholder oppression, but the violation must be substantial and must interfere with the interests of a shareholder as a shareholder.

What constitutes "substantial" interference will usually be decided through a case-by-case analysis.

Second, the Court focuses on the language of 1489. Section 1489(3) states, in part, "'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." As discussed later, this requires substantial interference with shareholder rights.[11]

Third, the Court states that articles of incorporation, bylaws, and "governing statutes" may be considered to determine a shareholder's interests.[12] Nevertheless, the Court noted that shareholders may "modify these [Business Corporation Act] rights and interests through shareholder agreements."[13] If those interests (as modified) are breached, this "may be evidence of shareholder oppression."[14] Thus, it appears that "new rights" cannot be created for the purpose of 1489, but the shareholders can enlarge existing rights (which are considerable) that they already possess under the articles, bylaws, or the Michigan Business Corporation Act.

Fourth, a breach of fiduciary duty by directors or others in control of the corporation does not automatically give rise to an oppression claim. Rather, it must substantially interfere with shareholder rights. In practice, that is often the case.

What are some of the protected shareholder interests at common law and under the Michigan Business Corporation Act?

Mantese:

Some of the more important shareholder rights include the right to review company records and information; the right to be involved in company direction and decision making; the right to a fair share of company profits and financial benefits; the right to vote at shareholder meetings; the right to access company premises; the right to be dealt with fairly, honestly, and in good faith; and the right to be free from negative employment action that disproportionately interferes with shareholder interests.

One of the most common fact patterns we see triggering oppression liability is a violation of a right to income or distributions.

In this context, we see disproportionate salaries among shareholders, unfair dividend practices, dividend starvation tactics, corporate usurpations and fraudulent related-party dealings, or the firing of one shareholder while the other shareholder maintains his position of employment. Most fundamentally, a shareholder has a right to insist that those in control abide by their fiduciary duties, which means they must treat the shareholder and the company honestly and fairly, with full disclosure, and exercise due care in company matters. Conduct that would violate this fiduciary duty has always been actionable and remains so after *Madugula*.

Toering:

The Michigan Supreme Court has never exhaustively listed the interests or rights of shareholders as shareholders. Nevertheless, under the Michigan Business Corporation Act, a shareholder has "certain statutory rights that allow the shareholder to protect and gain from his or her interest as a shareholder…."[15] These generally include the rights to vote, inspect the books, receive distributions, enter into voting agreements and shareholder agreements, and elect directors.[16]

As mentioned previously, shareholders may agree to alter many of their rights. Shareholder agreements can "modify the method of distributions, establish directors or officers, 'govern[] the exercise or division of voting power by or between shareholders and directors…' change dissolution requirements, and more."[17]

Is every breach of contract case now also an oppression claim?

Mantese:

No; however, it would be difficult to conceive of a situation in which an intentional breach of a corporate governance document that benefitted the controlling shareholder to the detriment of the other shareholder would not constitute evidence of oppression, as it did in *Madugula*. In this analysis, one must examine (1) the nature of the agreement and (2) the effect of the breach. If the nature of the agreement touches on shareholder interests and a breach substantially interferes with a plaintiff's shareholding interest, this will be evidence of an oppressive course of conduct. What constitutes "substantial" interference will usually be decided through a case-by-case analysis.

Toering:

No, and the Court expressly said no in footnote 99. True, breaching a shareholder agreement "may constitute evidence of shareholder oppression"[18] under section 1489(3). But again, the violation must be substantial and must interfere with the interests of a shareholder as a shareholder.

That said, oppression cases often involve conduct that would be actionable apart from breach of a shareholder or other agreement. Breach of fiduciary duty,[19] failure to produce books and records,[20] fraud, and conversion are some examples.

However, willfully unfair and oppressive conduct does not include actions "permitted by an agreement, the articles of incorporation, the bylaws, or a consistently applied written corporate policy or procedure."[21]

Weighing in on this issue, the SBM Business Law Section stated:

> Depending on the degree of interference and the importance of the shareholder interests involved, violation of a single significant shareholder interest could constitute oppression, while violation of multiple lesser shareholder interests might not.
>
> ***
>
> Breach of a single provision [of an agreement] is unlikely to satisfy the test [of shareholder oppression], but it might be evidence of a continuing course of conduct that affects overall shareholder interests.[22]

In *Madugula*, the shareholders agreed to elect each other as directors, provide the shareholders with preemptive rights, and set a 70 percent supermajority provision for certain corporate actions. This "modified the shareholders' statutory rights and interests as shareholders."[23] Evidence that those rights or interests were violated "may be evidence of shareholder oppression."[24] Therefore, the Court remanded to the trial court (sitting in equity) to determine whether and to what degree "any breach of the stockholders' agreement evidences such oppression…."[25]

Should business owners avoid shareholder agreements (or operating agreements, in the case of an LLC) because, after all, violation of those agreements could give rise to an oppression claim? No; shareholder agreements remain important. The owners should know their rights and responsibilities from the outset. Moreover, as mentioned previously, the agreement may defeat an oppression claim by permitting conduct that might otherwise constitute oppression.[26]

Firing a shareholder-employee or reducing employment benefits may also constitute oppression to the degree it interferes with "distributions or other shareholder interests disproportionately as to the affected shareholder."[27] Thus, if a shareholder-employee derives most of his or her compensation from employment (and little from dividends or distributions), termination of employment could constitute oppression. This would most commonly occur in a C corporation.[28]

Does *Madugula* affect the choice-of-forum decision in the shareholder agreement (arbitration vs. business court)? Further, will the ruling change the strategy of litigating cases given that there is no right to a jury on oppression issues?

Mantese:

The ruling in *Madugula* that oppression claims are equitable and are to be tried before the bench (potentially with an advisory jury) will not affect the choice of forum. Cases will still be filed in court. MCL 450.1489 and 450.4515 provide important and potent remedies for shareholders. These causes of action provide an important mechanism by which those in control of close corporations are held in check. Without them, the majority shareholder or top officer would essentially hold a dictatorship, and minority shareholders or members would have no way of achieving fair treatment when they are oppressed.

Toering:

Binding arbitration has long been the default in many shareholder agreements. But the advantages of the Michigan business courts (quick processing times, early judicial involvement, early mediation[29]) plus the disadvantages of arbitration (cost, limited appeal rights) suggest that business courts may be a superior venue for litigating some shareholder disputes.[30]

Although business courts allow for jury trials, there is no such right on the oppression claims. Of course, there may be a right to a jury trial on related claims such as fraud, conversion, breach of fiduciary duty, or breach of contract. ■

Gerard V. Mantese is the founding partner and CEO of Mantese Honigman Rossman and Williamson, PC, in Troy. He focuses his practice on complex business litigation, including shareholder, fiduciary duty, and partnership litigation, contract issues, and real estate. He is the author of several articles and two books and has taught Pretrial Procedure and Trial Practice at Wayne State University Law School and University of Detroit Mercy School of Law.

Before becoming a principal at Toering Law Firm PLLC, Douglas L. Toering practiced as in-house counsel for General Motors Corporation, as a partner at Bowman and Brooke, and as a principal at Grassi & Toering, PLC. His practice emphasizes commercial litigation, shareholder disputes, and insurance litigation. He is the vice chairperson of the SBM Business Law Section, where he chairs the Commercial Litigation Committee and the Small Business Forum.

ENDNOTES

1. *Madugula v Taub*, 496 Mich 685; 853 NW2d 75 (2014).
2. The opinions expressed by Mr. Toering are his own; he does not speak on behalf of the amicus committee or the SBM Business Law Section.
3. MCL 450.1489(1).
4. See Mantese & Williamson, *Fiduciary duty in business litigation*, 93 Mich B J 30 (August 2014), available at <http://www.michbar.org/journal/pdf/pdf4article2418.pdf>. All websites cited in this article were accessed October 15, 2014.
5. MCL 450.1101 *et seq.*
6. See Mantese & Hansma, *Shareholder oppression, fiduciary duty, and partnership litigation in closely held companies*, SRR J 59 (Spring 2014); Mantese, Rossman & Williamson, *Shareholder and corporate oppression actions: Fixing liability against those in control of closely held corporations*, 91 Mich B J 25 (February 2012), available at <http://www.michbar.org/journal/pdf/pdf4article1991.pdf>.
7. O'Neal & Moeling, *Problems of minority shareholders in Michigan close corporations*, 14 Wayne L R 723, 732 (1968).
8. *Schimke v Liquid Dustlayer, Inc*, unpublished opinion per curiam of the Michigan Court of Appeals, issued September 24, 2009 (Docket No. 282421).
9. *Berger v Katz*, unpublished opinion per curiam of the Michigan Court of Appeals, issued July 28, 2011 (Docket Nos. 291663, 293880).
10. *Madugula*, n 1 *supra* at 702. *Madugula* also contains a helpful discussion of the history of 1489. See also Amicus Curiae Brief of the Business Law Section of the SBM to the Michigan Supreme Court in *Madugula v Taub*, pp 1–11, available at <http://www.michbar.org/business/pdfs/AmicusBriefMadugulavTaub.pdf>. The amicus committee included James L. Carey, Justin G. Klimko, Cyril Moscow, and Douglas L. Toering.
11. Although the Court did not focus on it, 1489(1) also allows a claim if "the acts of the directors or those in control of the corporation are illegal [or] fraudulent…." There is no requirement that the illegal or fraudulent acts substantially interfere with the rights of a shareholder as a shareholder.
12. *Madugula*, n 1 *supra* at 718.
13. *Id.* at 689, 719.
14. *Id.* at 719–720.
15. *Id.* at 718.
16. *Id.* at 718–719, citing MCL 450.1345, 450.1441, 450.1461, and 450.1487(2); see also MCL 450.1231, 450.1343, 450.1405, 450.1505(2), and 450.1511.
17. *Id.* at 719, n 97, citing MCL 450.1488(1).
18. *Id.* at 689–690.
19. MCL 450.1541a (director or officer of a corporation); MCL 450.4401 (LLC members in member-managed LLC); MCL 450.4404(1) (LLC manager).
20. MCL 450.1487 (corporation); MCL 450.4213 (LLC); MCL 450.4503 (LLC).
21. MCL 450.1489(3). The Michigan Limited Liability Company Act contains a similar provision to remedy oppression of an LLC member. MCL 450.4515. The *Madugula* Court's analysis of oppression in the case of a corporation would undoubtedly apply to an LLC as well.
22. Amicus Curiae Brief, n 10 *supra* at 14–15.
23. *Madugula*, n 1 *supra* at 719.
24. *Id.* at 719–720.
25. *Id.* at 720.
26. See MCL 450.1489(3).
27. MCL 450.1489(3). The second sentence of section 1489(3) was added in 2006 to address *Franchino v Franchino*, 263 Mich App 172; 687 NW2d 620 (2004).
28. In many small C corporations, most net income is often "bonused out" to the shareholder-employees. This helps reduce income tax at the corporate level, but also leaves little for shareholder dividends.
29. Regarding business courts and alternate dispute resolution, see MCL 600.8031(2)(c) and Administrative Order No. 2013-6(4).
30. See generally Akers, *Michigan's new Business Court Act presents opportunities and challenges*, 33 Mich Bus L J 11 (Summer 2013), available at <http://www.michbar.org/business/BLJ/Summer2013/akers.pdf>. The average time to close a case in the business courts or specialized business dockets in Kent, Macomb, Oakland, and Wayne counties has ranged from 103 to 153 days. Toering, *Michigan's business courts and commercial litigation: Past, present, and future*, 93 Mich B J 27 (August 2014), available at <http://www.michbar.org/journal/pdf/pdf4article2417.pdf>.