Defending Michigan Shareholder and Member Oppression Claims In Closely Held Companies

By H. Joel Newman

The law:

The Michigan Business Corporation Act and Limited Liability Company Act permit a shareholder in a closely held corporation or an LLC member to sue if the acts of directors or others exercising control are *"illegal, fraudulent, or willfully unfair and oppressive to the company and/or to the shareholder/member."* The statutes describe *"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."*

MBCA MCL 450.1489
LLC Act MCL 450.4515

This broad statutory language could include almost any allegedly "unfair" activity, including changes in employment or benefits that disproportionately affect the shareholder; improper use of company funds, interference with voting rights, unfair self-dealing; usurping corporate opportunities; excessive compensation, inadequate dividends or distributions, improper capital calls or other maneuvers to dilute minority interest (or squeeze them out), inadequate disclosures and withholding information from minority owners.

Oppression is poorly defined under Michigan law.

MichiganÂ courts often look to Delaware corporate law for guidance. However, Delaware does not have an oppression statute. In addition to the above statutory language, there are only four reported cases decided under the statute and, as of this date, approximately thirty three "unpublished" cases, which consider different scenarios under the Acts. The courts are only bound to follow the precedent of the four reported cases, and those cases only address a fraction of the issues that can arise, leaving plenty of room for argument. For example, there is no Michigan law which adequately defines, "inadequate dividends", "excessive compensation", or "fairness".

Courts have far-reaching powers to fashion remedies for oppression. For example, and without limitation, courts can dissolve a company, appoint a receiver to take it over, order a buyout at what the court considers a fair price, which may or may not include minority discounts, undo or prohibit unfair acts, order or cancel special dividends or distributions and award damages and attorney's fees. Accordingly, oppression lawsuits can threaten the very existence of a successful company. Oppression actions can be very expensive to litigate. They can disrupt the company's operations and, during their pendency, they can cause a lot of uncertainty.

What triggers oppression suits?

Closely held businesses are often formed by relatives or friends who trust one another and therefore operate informally without strict adherence to the governing documents â€“ or fail to create these documents altogether.

Even where informal governance is successful, the situation can quickly change. A substantial proportion of the cases are triggered by changes in ownership and control resulting from death and inheritance, divorce, changing coalitions among the owners or the sale of an ownership interest to an outside investor.

Additionally, external economic factors sometimes trigger minority owner disputes. Poor company performance can

result in reduced dividends/distributions and could motivate an owner to sell. Minority ownership interests can be difficult to sell and are often discounted for lack of marketability and lack of control. Minority owners can avoid traditional lack of control and marketability discounts by bringing a successful oppression action. Many suits without merit are brought specifically to extort a buyout at a higher price from the defendants or to avoid discounts to the sale price.

Legitimate grievances, such as improper allocation of company assets, improper dilution of a minority ownership interest, unfair related party transactions, usurpation of corporate opportunities, unfair termination of employment or interference with other benefits and interference with voting or inspection rights are all potential grounds for oppression lawsuits.

The Risk of an Oppression Lawsuit can be Greatly Reduced

The best lawsuit is no lawsuit. Many oppression actions could be avoided with proper documentation.

Actions specifically authorized by the articles of incorporation, bylaws, and/or operating agreement, as well as consistently applied written policies or agreements, are, for the most part, exempted under the Acts. These documents are the first line of defense for both companies and shareholders. Business that do not have adequate written policies, operating agreements or bylaws, are strongly encouraged to carefully create these documents and tailor them to each situation. **"Form" documents should be avoided.** It is also important that the documents be enforced. Directors and managers have a fiduciary duty to remain informed and to oppose wrongful conduct. Failing to oppose wrongful acts as a director/manager could expose one to potential liability.
Among other things, company documents should address:

- Shareholder/member voting rights, powers, limitations
- Director/Manager authority and limitations
- Removal of directors/managers
- Classes of ownership
- Capital calls
- Procedures and restrictions for valuing, buying and selling ownership interests

Additionally, outside employment, related party transactions, and even involvement in competitive businesses are common and frequently legitimate/beneficial to closely held companies. Often, one or more of the company's owners might be the company's landlord. Different owners or combinations of owners might own competing real estate projects. Related companies may be vendors of goods or services to the company. All of these examples can be insulated from liability by inclusion in the bylaws, operating agreement or policies.

Related Party Transactions are fertile ground for aggressive plaintiffs' attorneys

Michigan law provides a safe harbor for related party transactions under the following circumstances:

(a) The transaction was fair to the corporation at the time entered into.

(b) The material facts of the transaction and the director's or officer's interest were disclosed or known to the board, a committee of the board, or the independent director or directors, and the board, committee, or independent director or directors authorized, approved, or ratified the transaction.

(c) The material facts of the transaction and the director's or officer's interest were disclosed or known to the shareholders entitled to vote and they authorized, approved, or ratified the transaction.

(2) For purposes of subsection (1)(b), a transaction is authorized, approved, or ratified if it received the affirmative vote of the majority of the directors on the board or the committee who had no interest in the transaction, though less

than a quorum, or all independent directors who had no interest in the transaction. The presence of, or a vote cast by, a director with an interest in the transaction does not affect the validity of the action taken under subsection (1)(b).

(3) For purposes of subsection (1)(c), a transaction is authorized, approved, or ratified if it received the majority of votes cast by the holders of shares who did not have an interest in the transaction. A majority of the shares held by shareholders who did not have an interest in the transaction constitutes a quorum for the purpose of taking action under subsection (1)(c).

Proof of fairness is the only safe harbor for related transactions which are not disclosed or known. Aggressive Plaintiffs' attorneys sometimes bundle numerous minor allegations of "wrongdoing" and retain hired gun "experts" to testify about unfairness of related party transactions. The proofs as to whether or not these transactions are fair to the company can be complex and subjective.

Specific authorization for these activities in the bylaws, operating agreement or policies promulgated at the Board level satisfy the above and can insulate individuals and the company from lawsuits regarding these activities without having to prove fairness, which can be difficult. Accordingly, disclosures above and beyond those required by law are advisable.

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