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Guest Article

■ Shareholder Oppression, Fiduciary Duty, and Partnership Litigation in Closely Held Companies



Shareholder oppression claims are important tools available to minority shareholders who believe they are the victims of abuse and overreaching at the hands of those in control of the corporation. With few exceptions, minority shareholders are not in control of the affairs of the company and are often unable to prevent the majority from taking unfair or oppressive actions toward them. Because there is no liquid or easily accessible market for shares in closely held companies, minority shareholders cannot easily escape oppressive behavior by selling their shares.¹ Often, the only recourse for an oppressed minority shareholder is judicial relief in a shareholder oppression or breach of fiduciary duty suit.²

Given that oppression claims are a species of each state's particular statutory and case law, there is no single standard across the country for determining when "oppression" has occurred. In some states, statutory prohibitions against oppression do not actually define oppressive conduct.³ In other states, statutes do set forth particular definitions of oppression. Michigan's shareholder oppression statute, for example, defines "willfully unfair and oppressive conduct" as "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."⁴ This statutory definition leaves room for interpretation, however, and courts have often analyzed it by reference to traditional fiduciary duties.⁵

Because there is no uniform legislative direction for defining oppression across jurisdictional boundaries, different courts have developed several definitions. For example, some courts have defined oppression as "burdensome, harsh and wrongful conduct ... or a visible departure from the standards of fair dealing and violation of fair play" on which a shareholder is entitled to rely.⁶ Other courts have simply equated oppression with the violation of the fiduciary duties of good faith and loyalty owed by shareholders of close corporations.⁷ Another common approach is the "reasonable expectations test." Courts using this test have defined oppression as the "frustration of the reasonable expectations of the corporation's shareholders."⁸

Regardless of the test applied, courts typically recognize that "oppression" is an expansive term that is used to cover a multitude of situations dealing with improper conduct, which can be—but is not necessarily—illegal or fraudulent.⁹

¹ *Muellenberg v. Bikon Corp.*, 669 A.2d 1382, 1386 (N.J. 1996).

² *Estes v. Idea Engineering & Fabricating, Inc.*, 649 N.W.2d 84, 90-91 (Mich. Ct. App. 2002).

³ See, e.g., Wis. Stat. § 180.1430.

⁴ Mich. Comp. Laws § 450.1489(3).

⁵ See *Bromley v. Bromley*, 2006 WL 2861875 at *5 (E.D. Mich. Sept. 28, 2006) ("[I]t is reasonable to conclude that the type of conduct amounting to a breach of fiduciary duties in close corporations is the type of conduct prohibited by § 450.1489").

⁶ *Buar v. Buar Farms, Inc.*, 832 N.W.2d 663 (Iowa 2013) (internal citation and quote marks omitted).

⁷ *Id.*

⁸ *Id.*

⁹ See, e.g., *Balvik v. Sylvester*, 411 N.W.2d 383, 386 (N.D. 1987).

A review of case law reveals certain common conduct that courts are likely to find oppressive, regardless of the test applied.

These include:

- Failing to pay dividends when the corporation has the financial wherewithal to do so¹⁰
- Causing the corporation to pay the majority shareholders compensation which is excessive and unfair to the minority and/or the corporation¹¹
- Paying the majority shareholders compensation amounting to a de facto dividend to the exclusion of the minority shareholder¹²
- Denying shareholders participation in management of the corporation or a voice in decision-making processes¹³
- Attempting to implement an unfair stock redemption plan that favors the majority shareholders¹⁴
- Failing to provide the minority shareholder documents necessary to properly evaluate his interests when selling his shares¹⁵
- Not allowing minority shareholders to participate in capital calls or otherwise protect themselves from dilution of their equity¹⁶
- Using corporate funds to pay the personal expenses of other shareholders or related parties (such as family)¹⁷
- Failing to provide financial statements or other information shareholders have a right to receive¹⁸
- Engaging in acts designed to freeze the minority shareholder out of the corporation rather than give him his fair share of his investment¹⁹
- Denying a shareholder any return on the shareholder's equity while refusing to buy-out the shareholder's shares for Fair Value²⁰

An exhaustive list of potentially oppressive acts cannot be prepared given the flexible definition of “oppression” and the case-by-case basis in which the concept is applied. Moreover, oppressive acts rarely occur in isolation. Instead, each oppressive act is often part of a series of actions perpetrated by the majority against the minority.²¹

Shareholder Agreements are Particularly Relevant to Oppression Claims ■ ■ ■

Often, shareholder oppression claims involve the failure of the majority to abide by the parties' agreements. This is because the parties' governing agreements are highly relevant to the shareholders' interests and expectations. In *Madugula v. Taub*, 2012 WL 5290285 (Mich. Ct. App. Oct. 25, 2012), for example, the trial court found oppression based upon, among other things, violations of a supermajority voting provision of a stockholders' agreement. On appeal, the defendant argued that this was tantamount to finding that breaches of stockholders' agreements necessarily constitute shareholder oppression rather than a simple breach of contract.²² The Michigan Court of Appeals disagreed and held that the supermajority provision was “highly relevant in determining if [the plaintiff's] interests as a shareholder were substantially interfered with because [the] provision details what [the plaintiff's] interests and rights are.”²³ As of the submission of this article, the *Madugula* case is on appeal to the Michigan Supreme Court and was argued by Gerard Mantese, one of the authors of this article.

The court in *Ballard v. Roberson*, 733 S.E.2d 107 (S.C. 2012), found oppression where the defendants authorized the issuance of 900,000 new shares in violation of the parties' stock purchase agreement and the articles of incorporation. In finding oppression, the court emphasized that this stock issuance was in direct conflict with both the articles and the stock purchase agreement.²⁴ However, like the *Madugula* court, the *Ballard* court did not base its decision solely on the breaches of agreements, noting that the breaches were part of a larger plan to freeze the minority shareholders out of the business.²⁵ Violations of those agreements were evidence of oppression and the existence of oppressive schemes, but did not necessarily constitute oppression on their own.

Minority shareholders should note that, while breach of an agreement may be evidence of oppression, shareholder oppression claims will not necessarily save minority shareholders from the agreements they made at arm's length.²⁶

¹⁰ *Schimke v. Liquid Dustlayer, Inc.*, 2009 WL 3049723 at *5 (Mich. Ct. App. Sept. 24, 2009); *Colgate v. Disthene Group*, 85 Va. Cir. 286, 2013 WL 691105 at *8-9 (Va. Cir. Ct. 2012).

¹¹ *Colgate*, *supra* at *15.

¹² *Argo Data Resource Corp. v. Shagrithaya*, 380 S.W.3d 249, 268 (Tx. Ct. App. 2012).

¹³ *Booth v. Waltz*, 2012 WL 6846552 at *22 (Conn. Supr. Ct. Dec. 14, 2012); *Berger v. Katz*, 2011 WL 3209217 at *15 (Mich. Ct. App. July 28, 2011); *In re Dissolution of Clever Innovations, Inc.*, 94 A.D.3d 1174, 1176 (N.Y. App. Div. 2012); *Kaible v. Gropack*, 2013 WL 2660995 at *4 (N.J. App. Div. June 14, 2013).

¹⁴ *Schimke*, *supra* at *3; *Colgate*, *supra* at *10.

¹⁵ *Bull v. BGK Holdings, LLC*, 859 F. Supp. 2d 1238, 1242 (D. N.M. 2012).

¹⁶ *Fox v. Idea Sphere, Inc.*, 2013 WL 1191743 at *14-15 (S.D.N.Y. March 21, 2013).

¹⁷ *Cardiac Perfusion Services, Inc. v. Hughes*, 380 S.W.3d 198, 201 (Tx. Ct. App. 2012).

¹⁸ *Baker v. Baker*, 2011 WL 3505500 at *5 (Neb. Ct. App. Aug. 9, 2011).

¹⁹ *Pointer v. Castellani*, 918 N.E.2d 805, 816 (Mass. 2009); *Bluewater Logistics, LLC v. Williford*, 55 So.3d 148, 161 (Miss. 2011).

²⁰ *Baur v. Baur Farms, Inc.*, 832 N.W.2d 663, 671 (Iowa 2013).

²¹ *Kiriakides v. Atlas Food Systems & Services, Inc.*, 541 S.E.2d 257, 267 (S.C. 2001).

²² *Madugula v. Taub*, 2012 WL 5290285 at *3 (Mich. Ct. App. Oct. 25, 2012).

²³ *Id.*

²⁴ *Ballard v. Roberson*, 733 S.E.2d 107, 111-12 (S.C. 2012).

²⁵ *Id.* See also *Adler v. Tauberg*, 881 A.2d 1267, 1270-1271 (Pa Super Ct, 2005) (affirming finding of oppression where the defendants had transferred shares of stock “in violation of the parties' agreement(s)”; *Simms v. Exeter Architectural Products, Inc.*, 868 F Supp 668, 673 (MD Pa, 1994) (“Plaintiff's allegations of wrongful termination... and Defendants' intentional disregarding of the Shareholder Buy-Sell Agreement certainly raise the issue of oppression[.]”).

²⁶ See e.g. *Kortum v. Johnson*, 755 N.W.2d 432, 445 (N.D. 2008).

Termination of Shareholder Employment as an Act of Oppression ■ ■ ■

Shareholder employment is another issue that frequently arises in the context of shareholder oppression litigation. A classic method of freezing out minority shareholders is to remove them from their positions within the company. Termination of employment is a potent freeze-out technique because, in the close corporation context, shareholders often do not receive dividends. Instead, the return on their investment often comes through their salary as an employee. Firing a minority shareholder can effectively defeat the minority shareholder's purpose in becoming a shareholder.²⁷

A number of courts have found that continued employment constitutes a shareholder interest, as long as the expectation of employment is reasonable under the circumstances.²⁸ But termination of employment likely does not defeat a shareholder's reasonable expectations where the shareholder is not receiving financial compensation for the employment and has no agreement requiring employment.²⁹

Statutory language may impact whether an oppression claim can be based on a termination of employment. For example, prior to the 2006 amendments to Michigan's oppression statute, the Michigan Court of Appeals held that the termination of employment was not oppression. At the time, Michigan's statute defined oppression simply as "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."³⁰ The Michigan Court of Appeals held that employment with a company is not an "interest of the shareholder as a shareholder," and the statute only protected a shareholder's interests "as a shareholder."³¹ In response, Michigan's legislature amended the oppression statute in 2006 to clarify that oppression may include the "termination of employment or limitations on employment benefits to the extent that the actions interfere with distributions or other shareholder interests disproportionately as to the affected shareholder."³²

Common Remedies in Shareholder Oppression Cases ■ ■ ■

Though jurisdictions vary on the remedies available to oppressed shareholders, the most common remedies in oppression cases are damages, redemption (or purchase) of the minority shareholder's shares, or dissolution of the company.

In some states, oppression claims arise under, and are based on, dissolution statutes.³³ Hence, the use of the dissolution remedy. But even where oppression claims are asserted under dissolution statutes, some courts have ordered the redemption of a minority shareholder's interests instead of corporate dissolution.³⁴ Other courts have held that they are bound by their dissolution statutes and are not permitted to fashion other remedies.³⁵

Other states have broader oppression statutes providing courts with numerous remedies, including dissolution, repurchase of the shareholder's stock, appointment of a receiver, injunction, or money damages.³⁶ In *Madugula*, for example, the court awarded both money damages and redemption of the plaintiff's shares at Fair Value.³⁷ Redemption of the minority shareholder's shares is probably the most common remedy for shareholder oppression. Thus, parties will typically need proof—usually in the form of expert testimony—on the issue of Fair Value, i.e., the value of the stock based on its pro rata share of the value of the corporation as a going concern.³⁸

Experts – Especially Valuation Experts – Are Vitaly Important in Oppression Cases ■ ■ ■

The effective use of experts can be critical to litigating a shareholder oppression case, particularly when it comes to valuing the shares of the minority shareholder. Judges and juries are not experts in business valuation, and a plaintiff without sufficient evidence at trial of the value of the minority shareholder's shares risks a directed verdict in favor of the defendants.

In *Ginnard v. Advanced Design and Prototype Tech., Inc.*, 2012 WL 4465191 (Mich. Ct. App. Sept. 27, 2012), the presiding trial judge was so unsatisfied with the expert testimony submitted by the parties regarding the value of the plaintiff's shares that he appointed his own independent expert.³⁹ When the court-appointed expert was unable to value the shares because certain documents he requested did not exist, both parties agreed that they did not wish to spend more money on further evaluation by the court-appointed expert. The expert therefore provided an estimated valuation of the plaintiff's shares in the range of \$600,000 to \$1,000,000. The trial court found this too speculative and awarded no damages.⁴⁰ The court of appeals remanded for a determination of the level of certainty required for an award of

²⁷ *Knights' Piping, Inc. v. Knight*, 123 So.3d 451, 458 (Miss. Ct. App. 2013).

²⁸ See, e.g. *Ritchie v. Rupe*, 339 S.W.3d 275, 291 (Tex. Ct. App. 2011).

²⁹ *Mueller v. Cedar Shore Resort, Inc.*, 643 N.W.2d 56, 65-66 (S.D. 2002).

³⁰ Mich. Comp. Laws § 450.1489(3).

³¹ *Franchino v. Franchino*, 687 N.W.2d 620, 628-30 (Mich. Ct. App. 2004).

³² Mich. Comp. Law. § 450.1489(3). See, e.g., *Berger v. Katz*, 2011 WL 3209217, at *5 (Mich App, July 28, 2011) ("[Statute] now allows a minority shareholder to claim willfully unfair and oppressive conduct as a result of reductions in salary or other employment benefits[.]").

³³ See, e.g. *Ritchie v. Rupe*, 339 S.W.3d 275, 291 (Tex. Ct. App. 2011).

³⁴ See, e.g., *Hayes v. Omsted & Associates, Inc.* 21 P.3d 178, 181 (Or. Ct. App. 2001) ("When appropriate, a court may order an involuntary purchase of a minority shareholder's interest in lieu of corporate dissolution as a remedy for the oppressive conduct."); *Spears v. Com Link, Inc.*, 837 N.W.2d 680 (Iowa Ct. App. 2013) ("Iowa courts have been willing to provide equitable relief for minority shareholder oppression outside the statutory claim for judicial dissolution[.]").

³⁵ *Colgate*, *supra* at *5.

³⁶ See, e.g., Mich. Comp. Law. 450.1489(1); N.J.S.A. 14A:12-7(1).

³⁷ *Madugula*, *supra* at *1.

³⁸ *Hayes*, *supra*.

³⁹ *Ginnard v. Advanced Design and Prototype Tech., Inc.*, 2012 WL 4465191 at *1 (Mich. Ct. App. Sept. 27, 2012).

⁴⁰ *Id.*

damages in a closely held corporation, and the propriety of other remedies besides a buy-out.⁴¹

Expert testimony in shareholder oppression cases may be useful outside of the stock valuation context. In *Colgate v. Disthene Group*, 85 Va. Cir. 286, 2013 WL 691105 (Va. Cir. Ct. 2012), the court heard expert testimony on a variety of subjects relevant to both liability and damages. For example, expert testimony was presented on the subject of whether the defendants' compensation was excessive when compared to the compensation paid to comparable officers in other companies.⁴² The parties also presented forensic accountants to testify on the value of corporate assets used by the defendants for personal reasons without compensation.⁴³ These same accountants testified regarding whether a reduction of dividends was financially necessary.⁴⁴ The court even heard testimony from a professor presented as an expert in "corporate governance matters."⁴⁵

Traditional Defenses to Corporate Decisions may not be Available ■ ■ ■

Oppression claims have a unique relationship with traditional defenses of corporate decisions such as the business judgment rule. As a general rule, the business judgment doctrine will protect the majority where an oppression claim is based on alleged mismanagement, but such protection may not be available where there is a freeze-out of the minority. For example, the decision to distribute dividends is typically deemed a discretionary act by the board of directors protected under the business judgment rule.⁴⁶ And courts typically recognize that challenged conduct may not constitute willful oppression when the majority reasonably relies on the advice of corporate attorneys or other outside advisors.⁴⁷ But that majority must be composed of independent and disinterested individuals for the business judgment rule to apply.⁴⁸

For this reason, the business judgment rule is often inapplicable in the shareholder oppression context because the majority is not disinterested. Shareholder oppression claims are typically in the nature of a breach of fiduciary duty, including the duty of loyalty and good faith by an interested majority. Courts in New Jersey, for example, have held that New Jersey's oppression statute demonstrates a legislative determination that principles of corporate law such as the business judgment rule have failed to curb oppressive conduct by majority shareholders.⁴⁹ Likewise,

the Texas Court of Appeals has held that a corporation's interest in managing its affairs does not include the right to substantially defeat the reasonable expectations of a minority shareholder.⁵⁰ In *Viener v. Jacobs*, 834 A.2d 546 (Pa. Super. 2003), the court held that the business judgment rule would not insulate the defendants from liability where the case was related to an alleged freeze-out of participation in corporate governance, rather than the power of the corporation manage its property and conduct its business.⁵¹

Parties Should be on the Look Out for Implied Partnerships ■ ■ ■

Finally, a few words should be said about the possibility of an implied partnership between shareholders in a corporation. In *Byker v. Mannes*, 641 N.W.2d 210 (Mich. 2002), for example, the plaintiff alleged that he had an over-arching, unwritten "general partnership" with the defendant, while the defendant claimed he only invested in specific business ventures and never agreed to a general partnership. The Michigan Supreme Court held that subjective intent to create a partnership is irrelevant where the conduct of the parties shows intent to carry on as co-owners of a business for profit.⁵² In keeping with *Byker*, implied partnership claims can be a powerful weapon for plaintiffs in some contexts and an unpleasant surprise for unwary defendants.

Courts typically recognize that a partnership may be implied from the circumstances of the parties' dealings.⁵³ Where parties "place their money, assets, labor or skill in commerce with the understanding that profits will be shared between them[,] the result is a partnership whether or not the parties understood that it would be so."⁵⁴

Most courts will not find a partnership based only on a party's mere assertion that a partnership existed, when there is no evidence of a meeting of the minds on an agreement to jointly operate a business.⁵⁵ Factors relevant to the finding of a partnership include 1) sharing of profits, 2) sharing of losses, 3) ownership of partnership assets, 4) joint management and control, 5) joint liability to creditors, 6) intention of the parties, 7) compensation, 8) contribution of capital, and 9) loans to the organization.⁵⁶ Agreements to share profits or losses are particularly relevant in proving a partnership.⁵⁷

⁴¹ *Id.* at *3.

⁴² *Colgate*, *supra* at *15.

⁴³ *Id.* at *18-21.

⁴⁴ *Id.* at *9.

⁴⁵ *Id.* at *13.

⁴⁶ *Renbaum v. Custom Holding, Inc.*, 871 A.2d 554, 569 n.22 (Md. Ct. App. 2005).

⁴⁷ *Schaefer v. Ulinski*, 644 N.W.2d 293 (Wis. 2002).

⁴⁸ *Carsanaro v. Bloodhound Technologies, Inc.*, 65 A.3d 618, 637 (Del. Ch. 2013).

⁴⁹ *Grato v. Grato*, 639 A.2d 390, 396 (1994).

⁵⁰ *Ritchie*, *supra* at 296

⁵¹ *Viener v. Jacobs*, 834 A.2d 546, 557 (Pa. Super. 2003).

⁵² *Byker v. Mannes*, 641 N.W.2d 210, 218 (Mich. 2002).

⁵³ *Baggett v. Baggett*, 2013 WL 4606383 at *8 (Tenn. Ct. App. Aug. 26, 2013).

⁵⁴ *Finch v. Raymer*, 2013 WL 1896323 at *9 (Tenn. Ct. App. May 6, 2013).

⁵⁵ *Carlson v. Ismail*, 2012 IL App (3d) 110566-U (Ill. Ct. App. Sept. 13, 2012).

⁵⁶ *Ashlock v. Slone*, 2012 WL 3055775 at *7 (S.D.N.Y. July 26, 2012).

⁵⁷ *Id.*; *DiPasquale*, *supra*.

The partnership issue is significant because the fiduciary duties of partners are especially broad, “connoting not mere honesty but the punctilio of honor most sensitive.”⁵⁸ Where a plaintiff shareholder can establish an over-arching partnership, the defendant may be subject to greater liability than would be allowed under ordinary corporate law principles.

Conclusion ■ ■ ■

While statutes and case law governing shareholder oppression differs to some extent from state to state, there are certain trends in the law of shareholder oppression that tend to surface regardless of where the issue is litigated. Despite the different tests for defining oppression, efforts to withhold distributions from the minority, deprive them of a return on their investment, dilute their shareholding interest, or otherwise freeze them out of the company, are generally considered oppressive. Further, unless statutory language provides otherwise, termination of a minority shareholder’s employment from a closely held corporation is likely to constitute oppression, especially in cases where the shareholder is not receiving other financial benefits of being a shareholder. These actions typically are not protected by the business judgment rule because, rather than being good faith decisions of independent directors, they are intentional acts of disloyalty designed to benefit the majority at the expense of the minority. When a shareholder oppression dispute arises, parties will be well advised to seek appropriate experts early, both on the substantive issues and issues of stock valuation and forensic accounting.

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⁵⁸ *Urbain v. Beierling*, 835 N.W.2d 455, 460 (2013). See *Meinhard v. Salmon*, 245 NY 458, 464 (1928).