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Business Law

- Litigating a business fraud case? Don't overlook the red flag defense
- Trial experts beware! Court's duties under newly amended FRE 702
- Succession planning and the approaching massive transfer of wealth
- Privacies of life in commercial e-discovery: Modern opinions on employers' duties to preserve evidence on employees' personal cellphones

Succession planning and the approaching massive transfer of wealth

BY GERARD V. MANTESE AND IAN WILLIAMSON

Said the Eye one day, "I see beyond these valleys a mountain veiled with blue mist. Is it not beautiful?"

The Ear listened, and after listening intently a while, said, "But where is any mountain? I do not hear it."

Then the Hand spoke and said, "I am trying in vain to feel it or touch it, and I can find no mountain."

And the Nose said, "There is no mountain, I cannot smell it."

Then the Eye turned the other way, and they all began to talk together about the Eye's strange delusion. And they said, "Something must be the matter with the Eye."

— *Kahlil Gibran, "The Eye"*[1]

Like the Eye in Gibran's story, successful businesspeople and business attorneys are visionary and see things that others do not. Astute vision is important in succession planning and with the U.S. about to witness the greatest transfer of wealth in its history, succession planning is one of the hottest issues for today's business lawyer.

The Wall Street Journal recently reported that "more than $84 trillion in wealth has been, or is set to be, transferred by estates big and small between 2021 and 2045[.] That wave of inheritance has brought a rise in lawsuits and other conflicts over family assets."[2] These transferred assets will include ownership interests in companies, which will inevitably lead to intergenerational disputes among business owners. Conflicts over entity control, fortunes, fame, and long-simmering emotions are often bruising, as was brilliantly depicted in HBO's riveting series "Succession." To avoid calamity, business lawyers need the

foresight of Gibran's Eye, seeing far into the distance and planning for the continued success of our clients.

Here, we discuss some key issues to consider when drafting operating agreements, shareholder agreements, and buy-sell agreements. We also address several salient cases relating to succession, control, and fights over business interests. Finally, we identify some important tax and estate planning considerations.

KEY CONTRACT CLAUSES

The Magnificent Seven stocks[3] have outsized standing and influence in the stock market. Similarly, while all contract clauses are important and even a comma placement can mean millions of dollars,[4] the following seven provisions are critical in succession planning and control disputes.

Management: Who is the Top Executive, and Can She Be Removed?

Among other things, top officers may make employment decisions, set salaries, and have significant influence over profit distributions. Governing documents should be clear as to when and how these executives may be dismissed. The authors litigated one case in which one officer/owner assaulted the company's president and argued that despite his no contest plea, he could not be discharged under the shareholder agreement. While the contractual duty of good faith and the law of oppression provided potential remedies, it's best to have an agreement that delineates when, how, and why top executives may be discharged.

Employment: Do Owners Have the Right to be Employed?

Michigan's oppression statutes provide that termination of an owner's employment can be oppressive if it disproportionately interferes with that owner's rights in comparison to other owners.[5] Despite this statutory protection, which can have varying applicability, it is best to specify in an operating agreement or shareholder agreement when and under what circumstances owners have a right to employment and the mechanism for determining compensation.

Distributions: What are Owners' Rights to Profit Distributions?

Owners' rights to dividends and other distributions have been litigated as long ago as the famous *Dodge v. Ford Motor Co.* case.[6] Business owners generally intend to make money and business lawyers should clearly define when monies will be distributed. Unscrupulous co-owners often use squeeze-out techniques such as dividend starvation or, perhaps even more painful, refusing to issue tax distributions to owners in pass-through entities such as limited liability corporations or S corporations. *Franks v. Franks*, a leading oppression case in Michigan, involved a refusal to declare dividends, leading the court to find shareholder oppression and order $2.1 million in dividends and interest to the plaintiffs after an 11-day trial.[7]

Liquidity: Do Owners Have Put Rights?

When owners have no easy ability to sell their ownership interests to third parties and no redemption rights, those locked-in equity interests may be mere paper wealth. One of the most important elements that a business attorney can address in a contract is when, if ever, equity owners have a right to liquidity.[8] When parties fail to outline this important issue, the control group may financially exploit the minority owners knowing that they have no recourse to exit the company outside of abusive, low-ball stock redemptions. In addition, contract clauses on put rights should carefully explain what value will be paid for subject shares.

Valuation: What is the Value of an Owner's Interests?

Shareholder agreements, operating agreements, and buy-sell agreements may provide for buyouts of owners if they die, retire, or leave the business, but how to value ownership interests is not always discussed. Appropriate and mutually agreed-upon valuation formulae can mean the difference between a fair transaction and an abusive one that sets the stage for oppressive conduct and likely litigation. In *Franks v. Franks*, the trial court found shareholder oppression where the control group made a redemption proposal at a fraction of the value calculated by professionals, which they followed with a denial of dividends for two years.[9] To minimize the risk of litigation, redemptions should be based on professional valuations using predetermined and memorialized formulae.

Dilution: Can Owners be Diluted?

Business owners should always recognize if and how their ownership interest can be diluted. Frequently, the control group can require additional capital infusions or pursue outside investors' capital; owners who don't contribute may be diluted by these transactions. These capital events frequently incur at inflection points where the business' current financial situation or growth potential is uncertain, leading to outsized impacts (positive or negative) on valuation, which drives the amount of dilution.

In *Frank v. Linkner*,[10] the Michigan Supreme Court held that oppression may occur at the moment a plan for future dilution is implemented, even if the actual dilution occurs years later. This is exemplified in the 2010 film "The Social Network" in which the protagonist procured the chief financial officer's signature (who was promised 30% ownership of Facebook) on seemingly standard corporate documents that then allowed the protagonist to dilute the CFO's stake to below 1%. Bottom line: business attorneys should ensure their clients understand when and how owners may be diluted.

Competition: May Owners Engage in Competing Businesses?

While noncompetition agreements have become less favored and the Federal Trade Commission proposed a rule banning them for employees, Michigan law still provides certain protections against competition by business owners. The corporate opportunity doctrine dictates that in certain circumstances, shareholders must first provide corporate opportunities to the company before pursuing them.[11] Moreover, owners may contractually establish clear rules about engaging in competing or parallel businesses with, for ex-

ample, restrictive covenants. Failing to establish such guideposts from the outset can ultimately result in resentment between owners and protracted and expensive legal battles. This can be more complicated when interests pass to new owners who may already hold competing businesses.

EXEMPLARY CASE LAW

Recent cases highlight the confusion and power struggles that can arise from a lack of robust succession planning.

Ray v. Raj Bedi Revocable Tr

Faced with a deficient buy-sell agreement, the 50/50 shareholders in *Ray v. Raj Bedi Revocable Trust*[12] took their buyout litigation on tour through state court in Michigan to state and federal court in Indiana. When Bedi died, Ray exercised his purchase option under the parties' buy-sell agreement, which required arbitration by certified public accountants to determine fair market value in the event of a valuation dispute. This inevitably materialized because the agreement failed to include a valuation standard and procedure. Bedi sued in Michigan, Ray sued in Indiana, and Bedi removed to federal court. *Both* sides sought dismissal of the federal action on competing terms; Ray wanted remand back to Indiana, while Bedi wanted dismissal in favor of the original Michigan action. The federal court agreed with Bedi and sent the parties back to Michigan state court — all of which could have been avoided if the parties had a clearly defined valuation procedure.

Seokoh, Inc v. Lard-PT, LLC

Some buy-sell agreements contain a mechanism known as a shotgun clause; when deadlock occurs, one party can name a price and then, like the resolution of Abraham and Lot's conflict, the other party has the option to either purchase the first party's interests or sell its own interests at that price. As shown in *Seokoh, Inc v. Lard-PT, LLC,*[13] the failure to include key terms in the buy-sell can doom these otherwise desirable separation mechanisms.

The parties in *Seokoh* spent nearly a year negotiating the terms of Lard's election to purchase Seokoh's shares. Seokoh declared Lard to be in breach of his purchase obligation which, per the buy-sell, gave Seokoh the option to purchase Lard's interest at a 30% discount of the shotgun price. Seokoh sued for specific performance in New York and deadlock-based dissolution in Delaware. Lard moved to dismiss, arguing that the parties had a shotgun agreement for resolving deadlock. The vice chancellor disagreed — the shotgun clause had completely failed in its mission of preventing deadlock because it was missing key terms such as a pricing method and a timeline for closing.

Coster v. UIP Companies, Inc[14]

When Wout Coster, a 50% owner of UIP, developed leukemia, he began negotiations with 50% owner Steven Schwat and two executives for a buyout of his shares. After a year of failed negotiations, Wout died and his shares passed to his widow, Marion. The parties deadlocked over electing directors and Marion sued to appoint a custodian to resolve the deadlock. Schwat then sold a one-third ownership interest to one of the executives, which resolved the deadlock and mooted the custodian action.

The stock sale diluted Marion's ownership, and she sued to cancel it. The Delaware Supreme Court held[15] that the sale met the state's strict entire fairness standard and was not undertaken for inequitable purposes — it was a justified response to the existential crisis of the custodian action and implemented the succession plan Wout Coster favored in the first place. Ultimately, nearly a decade of fraught negotiations and litigation passed between Wout's diagnosis and the final decision with Marion no closer to receiving the financial security Wout had desired for her — all of which could have been avoided with a clear buy-sell agreement.

Franks v. Franks[16]

Successor generation control groups often resent sharing profits with owners who choose not to work at the company and are content to receive distributions while pursuing other careers. Here, the control group, all employed at the company, sought to divest the non-employed 50% owners through a combination of low buyout offers and no dividends. On appeal, the Michigan Court of Appeals held[17] that, among other things, pleading a prima facie case for shareholder oppression inherently negated the business judgment rule.

Allen & Allen Properties, LLC v. Smith[18]

Without effective succession planning, an owner's death or disability can result in uncertainty as to the company's ownership structure and may even threaten the company's continued existence. Two brothers, Howard and Curtis Smith, co-founded Allen & Allen Properties in 2004 — Howard owned 90% and Curtis owned the remaining 10%. After Howard passed away in 2020, defendant Jason Smith asserted that in 2014, Howard executed a handwritten amendment to the operating agreement that gave Jason an ownership interest. Curtis disputed the amendment's validity and sought a declaration that he was the sole owner. Jason moved to dismiss, invoking an arbitration provision in the operating agreement. Curtis countered that Jason was not a member and had no ability to enforce the provision. The trial court ruled that an arbitrator should determine whether Jason was a member. The Michigan Court of Appeals reversed,[19] emphasizing that under Michigan law, the court — not an arbitrator — decides the threshold question of an arbitration clause's enforceability, which was dependent on Jason's undetermined membership status.

Castle v. Shoham[20]

Edward Castle and Bill Down formed The Filter Depot, LLC to sell air filtration products. Castle owned 49% and Down owned 51% via Midwest Air Filter, Inc. (MAF). Castle and Down made a handshake deal that Filter Depot would pay MAF monthly for administrative services but did not adequately document how to calculate that fee.

The arrangement went smoothly until Down died in 2013 and his daughter and son-in-law (the defendants) purchased his ownership interest in Filter Depot. After hostilities arose, Castle sued, asserting various claims including member oppression under MCL 450.4515. According to Castle, the defendants' wrongful conduct included terminating his employment, issuing an improper capital call, and increasing MAF's monthly fee. The Michigan Court of Appeals reversed[21] the dismissal of all claims, holding that the capital call could constitute oppression despite the absence of identifiable damages because financial injury is not required to demonstrate harm.[22] Further, Castle's unrebutted expert testimony undermined the defendants' assertion that there was a reasonable basis for the increased monthly fee.[23]

TAX ISSUES[24]

Significant transactions almost always have tax ramifications, so succession planning requires the guidance of great tax attorneys. These ramifications can differ based on whether the transaction is a redemption or a buyout. Similarly, tax treatment differs for cash-versus-accrual partnerships/LLCs; "hot assets" is a phrase that may take on newfound significance for the seller of a cash-basis LLC. Purchase prices involving promissory notes greater than $5 million can result in elevated tax liabilities from imputed interest. It's also important to remember that a put- or call-driven market created via the terms of a buy-sell agreement and the purchase amounts/payment terms set forth in it can have relevance to the value of a decedent's taxable estate, determination of fair market value for a lifetime gift, and, for divorcing parties, determining the division of their marital estate.

Owners will often buy life insurance on a key or controlling owner to facilitate a family's continued ownership of a company; then, when the owner passes, the proceeds are used to redeem that owner's shares. *Connelly v. United States Dep't of Treasury, Internal Revenue Service*[25] addresses how to treat the funds that flow into the corporation. There, the remaining shareholders argue that the insurance proceeds do not increase the company's value because the moment the funds are received, they must be used to redeem shares; the IRS argues that the proceeds increase the corporation's assets. This case was argued in the U. S. Supreme Court in March, and a decision was released on June 6, 2024, where the Court ruled in favor of the IRS and held that the insurance proceeds do in fact increase the company's value.[26]

ESTATE PLANNING

Estate planning attorneys should also weigh in on the transition of ownership interests with the following objectives:

1. avoiding costs and delays associated with probate, possibly by transferring ownership interests to revocable living trusts;
2. minimizing the federal estate tax, possibly by making gifts of ownership interests to irrevocable trusts, keeping in mind that shares in an S corporation must be held in either an intentionally defective grantor trust or by a qualified subchapter S trust;
3. ensuring that ownership interests are given and/or sold to beneficiaries best suited to operate the business; and
4. protecting beneficiaries from creditors.

Business owners must also incorporate successor management into their estate planning while addressing family issues that often accompany leadership and ownership decisions and assuring sufficient liquidity to avoid a forced sale of the business. Owners should develop detailed contingency plans in case they die or become unable to continue working sooner than anticipated and consider alternative corporate structures or stock-transfer techniques that might help the business achieve its succession goals. And where the most valuable asset in a business owner's estate is the business itself, the owner's trust should contain language waiving the successor trustee's duty to diversify trust assets under the prudent investor rule.[27]

CONCLUSION

Succession planning efforts and fights over succession will require substantial legal services — both transactional and litigation — as baby boomers transition into retirement. The key documents for corporations and LLCs must be given special attention to facilitate smooth succession of the company. Tax and estate planning experts should also be intimately involved in the process.

The authors acknowledge the substantial contributions of their talented associates, Brian Markham and Matthew Rose; renowned estate planning attorneys Julius Giarmarco and Paul Wakefield; and the excellent insights of certified public accountant Thomas Frazee.

Gerard Mantese has a national practice in shareholder and LLC member disputes, partnership disputes, and complex business litigation. He is the CEO at Mantese Honigman with offices in Michigan, Manhattan, Miami, and Missouri. He is co-chair of the LLC and Partnerships Committee of the State Bar of Michigan Business Law Section, and is on the SBM Board of Commissioners. A past recipient of the Roberts P. Hudson Award, Mantese also devotes a substantial portion of his practice to pro bono and public interest cases.

Ian Williamson is a partner at Mantese Honigman and a key member of the firm's business litigation practice group. He handles all manner of business disputes, representing both plaintiffs and defendants, and has successfully resolved numerous disputes among owners of closely held business entities. Williamson is vice-chair of the State Bar of Michigan Business Law Section and has published and presented extensively on business law issues.

ENDNOTES

1. Kahlil Gibran, *The Eye* <https://www.poetryfoundation.org/poems/58720/the-eye-56d23d5a8a6c9> (All websites accessed June 11, 2024).
2. Ashlea Ebeling, *Hash Out the Inheritance Now, or Fight your Family Later*, The Wall Street Journal (April 6, 2024) <https://www.wsj.com/personal-finance/hash-out-the-inheritance-now-or-fight-your-family-later-5fd836b9>.
3. The Magnificent Seven stocks are Nvidia, Meta Platforms, Apple, Amazon, Tesla, Alphabet, and Microsoft. See Rocco Pendola, *et al*, *What are the Magnificent 7 stocks?*, <https://www.cnn.com/cnn-underscored/money/magnificent-7-stocks> (updated June 10, 2024).
4. See, eg, *O'Connor v Oakhurst Dairy*, 851 F3d 69 (CA 1, 2017).

5. See MCL 450.1489 and MCL 450.4515.
6. *Dodge v Ford Motor Co*, 204 Mich 459, 467; 170 NW 668 (1919).
7. Mantese and Williamson represented the successful plaintiffs in *Franks v Franks*, 330 Mich App 69; 944 NW2d 388 (2019).
8. Mantese recently handled a case where virtually all other owners were given put rights — the right to require the company to redeem their shares at a specified value — except the plaintiffs. The plaintiffs sued claiming that this uneven treatment was shareholder oppression and the plaintiffs recently defeated a motion to dismiss.
9. *Franks, supra* n 6.
10. *Frank v Linkner*, 500 Mich 133; 894 NW2d 574 (2017). Mantese argued this case in the Michigan Supreme Court.
11. See *Prod Finishing Corp v Shields*, 158 Mich App 479, 485–86; 405 NW2d 171 (1987).
12. *Ray v Raj Bedi Revocable Trust*, 611 F Supp 3d 567 (ND Ind, 2020).
13. *Seokoh, Inc v Lard-PT, LLC*, Opinion of the Delaware Court of Chancery, issued March 30, 2021 (Case No CV 2020-0613-JRS).
14. *Coster v UIP Companies, Inc*, 300 A3d 656 (Del, 2023).
15. *Id.*
16. *Franks, supra* n 6.
17. *Id.*
18. *Allen & Allen Props, LLC v Smith*, unpublished per curiam opinion of the Court of Appeals, issued July 28, 2022 (Docket No. 358047),
19. *Id.*
20. *Castle v Shoham*, unpublished per curiam opinion of the Court of Appeals, issued August 7, 2018 (Docket No. 337969).
21. *Id.*
22. See *Frank, supra* n 9, argued by Mantese.
23. MCL 450.4515(2).
24. The discussion of tax issues and estate planning issues is not intended to provide tax or estate planning advice and one's tax and estate advisors must be consulted.
25. *Connelly v United States Dep't of Treasury, IRS*, 70 F4th 412, 415 (8th Cir), *cert granted sub nom Connelly v United States*, 144 S Ct 536 (2023).
26. Connelly v. United States, 602 U.S. ____ (2024).
27. MCL 700.1501, *et seq.*

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