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Derivative or Direct Claim? Michigan Supreme Court Simplifies Analytical Framework

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On Tuesday, April 5, 2022, the Michigan Supreme Court issued its unanimous decision in the case of *Murphy v Inman*, greatly clarifying and simplifying the analysis of whether claims brought in a corporate setting may be made directly or only as derivative claims. The Court held that a shareholder who claimed corporate directors had breached their fiduciary duty in approving a cash-out merger may bring that claim as a direct shareholder action.

In *Murphy v Inman*, a former shareholder of Covisint Corporation sued the corporation's former directors, claiming they had breached their fiduciary duties to shareholders by failing to maximize shareholder value in the 2017 cash-out merger by which Covisint was acquired by OpenText Corporation. The defendant directors had obtained dismissal in the trial court by arguing that plaintiff's claims were derivative and could only be brought by complying with the derivative claim procedures in Michigan's Business Corporation Act ("BCA"). The Michigan Court of Appeals affirmed that dismissal.

The Supreme Court reversed. It held that the claim could be brought as a direct claim. Borrowing from Delaware law, the Supreme Court adopted a two-factor test for evaluating whether a claim is direct or derivative. It also found that directors owe common law fiduciary duties to shareholders that were not abrogated by the BCA.

The holding did not decide the merits of the claim, that is, whether the directors breached any duty.^[1] It addressed the procedural issue of how the claim may be asserted. Nevertheless, this is an important holding because the question of whether a claim is direct or derivative often determines whether the claim can be maintained at all, and whether the corporation may control the claim.

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Prior Michigan case law had observed a “general rule” that assumed that claims belong to the corporation (and thus could only be asserted by a shareholder derivatively) unless they satisfy one of two exceptions: the shareholder suffered separate and distinct harm from other shareholders, or there has been a violation of a duty owed directly to the shareholder.

Rejecting this framework, the Supreme Court adopted an analytical framework borrowed from the Delaware Supreme Court case of *Tooley v Donaldson, Lufkin & Jenrette, Inc*, 845 A2d 1031, 1033 (Del, 2004). The new framework consists of two simple inquiries: “(1) who suffered the alleged harm [the corporation or the suing stockholders, individually]; and (2) who would benefit of any recovery or other remedy [the corporation or the stockholders, individually]?”[2] If the corporation is the answer to both questions, the action is derivative. If the shareholder suffers the harm independent from the corporation and receives the remedy rather than the corporation, the action is direct. The Court explained that this framework, unlike the former “general rule,” focuses on “the nature of the wrong alleged by the complaining shareholder,”[3] which is the fundamental distinction between direct and derivative shareholder actions.

The Court also concluded that directors of a corporation owe fiduciary duties to shareholders of the corporation. The defendants in *Murphy v Inman* argued that Section 541a of the Michigan Business Corporation Act abrogated any recognized common law fiduciary duties owed by directors to shareholders. Section 541a provides the standards of duty owed by corporate directors to the corporation but does not expressly reference shareholders. However, as explained by the Court, Michigan has consistently recognized that directors owe fiduciary duties to shareholders, both before and after the adoption of the Michigan Business Corporation Act and Section 541a. The language of the Act evidenced no legislative intent to abrogate the common law that existed prior to the time the BCA was adopted. Further, the Michigan legislature has never implied abrogation or created a direct cause of action for shareholders; therefore, no changes made in Section 541a can be read as eliminating a previous statutory right or as abrogating the common law fiduciary duties owed to shareholders.

In concluding that corporate directors owe fiduciary duties to their shareholders, the Court went on to analyze the scope of these duties in cash-out merger transactions. The Court again adopted a principle from a Delaware Supreme Court case, *Revlon, Inc v MacAndrews & Forbes Holdings, Inc*, 506 A2d 173 (Del, 1986), stating that when it becomes inevitable that a company will be sold, directors’ duties change to “getting the best price for the stockholders at a sale of the company.”[4] This principle had previously been applied by Federal courts construing Michigan law, but had not been explicitly adopted by the Michigan Supreme Court. The Court explained that in a cash-out merger “directors of the target corporation must disclose all material facts to shareholders regarding the merger and must exercise their fiduciary duties with one goal in mind: maximizing shareholder value by securing the highest value share price reasonably available.”[5]

In reaching this holding, the Supreme Court reiterated the “shareholder primacy” rule of Michigan corporate law, enunciated more than a century ago in *Dodge v Ford Motor Company*,[6] that Michigan business corporations are to be operated for the profit of its stockholders. The Court stated that

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“...under this state’s common law, directors owe fiduciary duties first and foremost to the shareholders of the corporation; their roles within, and obligations to, the corporation cannot be properly understood without first recognizing this fundamental tenet of corporate law in Michigan.”[7]

The *Murphy* decision dealt with issues in the context of the BCA, and thus is directly applicable only to claims involving corporations. Analytically, however, there is no reason that the rule it announces for evaluating direct vs. derivative claims would not also apply to lawsuits involving other types of business entities, such as limited liability companies.

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[1] The Supreme Court remanded the case to the trial court for proceedings consistent with its opinion.

[2] *Murphy v Inman*, __ Mich __; __ NW2d __ (2022) (Docket 161454); slip op at 28–29.

[3] *Id.* at 25.

[4] *Id.* at 13, citing *Revlon*, *supra* at 182.

[5] *Id.* at 14–15

[6] 204 Mich 459, 507; 170 NW 668 (1919).

[7] *Murphy*, slip op at 11.