

**FOUR IMPORTANT QUESTIONS TO ASK WHEN EVALUATING SHAREHOLDER  
DISPUTES**

**BY STEPHEN D. WADSWORTH**

Representing clients in shareholder litigation is a great way to make a living. The work is both challenging and rewarding. Your clients tend to be hard-working men and women who earned equity in a company through sweat and ingenuity. They have often been cheated by people they once considered friends or family. The human drama is high. The potential recovery sometimes represents most of your client's net worth and livelihood. The injuries aren't physical, but they are very real.

This article is not designed to be a treatise that answers every question that may come up in practice, nor is it designed to be an academic work that moves the law forward. Instead, I hope this article will point lawyers in the right direction of answers to the most common questions that come up in the opening stages of shareholder litigation. These questions should be always be answered before drafting a complaint:

1. Which state's law governs the claims?
2. Which claims do I bring?
3. Are the claims direct or derivative?
4. Is presuit demand on the board of directors futile?

**I. Which State's Law Governs the Claims?**

The first question that must be resolved in shareholder litigation is "which state's law governs the claims?" As a general rule, Alabama follows the Internal Affairs Doctrine, which means that "the law of the state of incorporation governs the internal corporate relationship."<sup>1</sup>

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<sup>1</sup> *Scrushy v. Tucker*, 70 So. 3d 289, 298 (Ala. 2011).

Put differently, if the company is organized under Alabama law, Alabama law applies to claims against a company's officers or directors, or otherwise relating to the company's management. Delaware law governs claims arising out of Delaware corporations. The law of the forum still governs procedural issues, but the law of the state of incorporation will provide the substantive law.

Alabama's application of the Internal Affairs Doctrine does not appear to be absolute. Alabama adopted as authoritative the *Restatement (Second) of Conflict of Laws*.<sup>2</sup> The *Restatement* allows for the application of the substantive law of the forum state if it "has a more significant relationship . . . to the parties and the transaction . . ."<sup>3</sup> This means that even if a company is incorporated in another state, if it does business almost exclusively in Alabama, the shareholders are in Alabama, and the facts giving rise to the case occurred in Alabama, Alabama law may be applied.

The choice of law issue must be answered first. It affects everything from the remedies available to your client to the hoops you must jump through when filing your complaint. While it's unlikely that a Court would dismiss your claims with prejudice for applying the wrong state's law, it could cause needless delay.

## **II. Which Claims Do I Bring?**

There are many different claims which can be brought in commercial litigation claims. Describing them all is well beyond the scope of this article. Below, I describe five of the most common claims arising in shareholder litigation.

### **A. Breach of Fiduciary Duties**

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<sup>2</sup> *Massey v. Disc Mfg., Inc.*, 601 So. 2d 449, 454–55 (Ala. 1992).

<sup>3</sup> *Restatement (Second) of Conflict of Laws* § 309.

Alabama statutory law sets forth the fiduciary duties owed to the company and minority shareholders. In all business entities, the default rule is that corporate fiduciaries owe duties of good faith, care, and loyalty to the company.<sup>4</sup> Persons in authority over LLCs and LLPs owe these same duties to the members or partners.<sup>5</sup> Officers and directors in Alabama corporations do not owe fiduciary duties to shareholders, but may be held liable for unfair treatment of minority shareholders through claims for oppression.<sup>6</sup>

The duty of care is generally defined as “the care an ordinarily prudent person in a like position would exercise under similar circumstances.”<sup>7</sup> To prove a breach of the fiduciary duty of care, a plaintiff must show conduct which is “grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.”<sup>8</sup>

“The duty of loyalty is the duty to act honestly for the corporation's best interest and to avoid acts of self-dealing. An officer-director of a corporation owes a duty of managing the corporate affairs honestly and impartially and he may not achieve personal advantage, profit, or gain from his position.”<sup>9</sup> Generally, the duty of loyalty means that a corporate fiduciary may not enrich himself at the company's expense by entering into a conflicting interest transaction with the company or taking a corporate opportunity from the company.<sup>10</sup>

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<sup>4</sup> Ala. Code §§ 10A-2-8.30 (Corporations); 10A-5A-4.08 (LLCs); and 10A-9A-4.08 (LLPs).

<sup>5</sup> Ala. Code §§ 10A-5A-4.08 (LLCs); and 10A-9A-4.08 (LLPs).

<sup>6</sup> *Davis v. Dorsey*, 495 F. Supp. 2d 1162, 1170 (M.D. Ala. 2007).

<sup>7</sup> Ala. Code §§ 10A-2-8.30

<sup>8</sup> Ala. Code §§ 10A-5A-4.08 (LLCs); and 10A-9A-4.08 (LLPs)

<sup>9</sup> *Davis v. Dorsey*, 495 F. Supp. 2d 1162, 1170 (M.D. Ala. 2007) (internal quotations and alterations omitted) (quoting *Jefferson County Truck Growers Ass'n v. Tanner*, 341 So.2d 485, 487 (Ala.1977) and Richard A. Thigpen, *Alabama Corporation Law*, § 10:2).

<sup>10</sup> *Davis*, 495 F. Supp. 2d at 1170-71; Ala. Code §§ 10A-5A-4.08 (LLCs); and 10A-9A-4.08 (LLPs).

In LLCs and LLPs, members may contract around the duties of loyalty and care owed to the company and the other members.<sup>11</sup> The general contractual duty of good faith and fair dealing may not be waived by the parties.<sup>12</sup>

Because the LLC and LLP acts are so new, it is unclear how courts will interpret the duty of good faith in situations where the LLC agreement expressly waives the duties of care and loyalty. Delaware cases interpreting similar exculpatory provisions indicate a willingness to interpret the duty of good faith broadly in order to achieve equity.<sup>13</sup> Put differently, bad actors may find that their nonwaivable duty of good faith includes many elements of the duty of care and loyalty.

### **B. Waste**

The concept of corporate waste is related to a claim for breach of the fiduciary duties of care or loyalty. A director or officer commits corporate waste by making unnecessary or wasteful expenditures or by paying himself or family members disproportionate salaries or bonuses, or any other inappropriate spending.<sup>14</sup> A claim for corporate waste seeks recovery of this inappropriate spending from the wrongdoer.

### **C. Shareholder Oppression**

Shareholder oppression, or squeeze-out is a claim based on a pattern of treating minority shareholders unfairly. Examples of actionable, oppressive unfairness have been described in several Alabama cases:

The squeezers may refuse to declare dividends; they may drain off the corporation's earnings by exorbitant salaries and bonuses to the majority shareholder-officers and

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<sup>11</sup> Ala. Code §§ 10A-5A-1.08(b)(2) (LLCs); and 10A-9A-1.08(b)(2) (LLPs).

<sup>12</sup> Ala. Code §§ 10A-5A-1.08(c)(5) (LLCs); and 10A-9A-1.08(c)(8) (LLPs).

<sup>13</sup> See, e.g., *Solar Cells, Inc. v. True N. Partners, LLC*, No. CIV. A. 19477, 2002 WL 749163, at \*4 (Del. Ch. Apr. 25, 2002) (holding that in light of evidence of bad faith “it is not an unassailable defense to say that what was done was in technical compliance with the law”).

<sup>14</sup> *Galbreath v. Scott*, 433 So. 2d 454, 456-57 (Ala. 1983).

perhaps to their relatives, by high rental agreements for property the corporation leases from majority shareholders, or by unreasonable payments under contracts between the corporation and majority shareholders; they may deprive minority shareholders of corporate offices and of employment by the company; they may cause the corporation to sell its assets at an inadequate price to the majority shareholders or to companies in which the majority are interested; they may organize a new company in which the minority will have no interest, transfer the corporation's assets or business to it, and perhaps then dissolve the old corporation; or they may bring about the merger or consolidation of the corporation under a plan unfair to the minority. As indicated, the techniques listed here merely illustrate the techniques which resourceful squeezers may utilize.<sup>15</sup>

In order to plead an oppression claim, identify one or more examples of unfairness or bad faith of the type mentioned above. This cause of action is especially useful in claims against corporations because, as mentioned above, directors and officers owe no direct duties to corporate shareholders.<sup>16</sup> Oppression or squeeze-out claims allow for minority shareholders to recover damages directly for unfair treatment at the hands of majority shareholders.

It was recently suggested that shareholder oppression claims should not exist or be brought against Alabama LLPs and LLCs.<sup>17</sup> The Alabama Supreme Court has not directly answered whether the claim may be brought against LLCs.<sup>18</sup> The Northern District of Alabama allowed a claim for oppression to survive a motion to dismiss, but, the existence of the claim seems to have been stipulated to by the parties.<sup>19</sup>

Even if Alabama courts later determine that there is no claim for oppression in LLCs and LLPs, minority investors may still bring claims for breaches of the nondischargeable duty of good faith and fair dealing discussed above. It is probable that evidence which supports a claim

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<sup>15</sup> *Robbins v. Sanders*, 890 So. 2d 998, 1015 (Ala. 2004).

<sup>16</sup> *Davis v. Dorsey*, 495 F. Supp. 2d 1162, 1170 (M.D. Ala. 2007).

<sup>17</sup> Douglas B. Hargett & G. Bartley Loftin, III, *Minority Oppression in Limited Liability Companies: The Birth of A New Claim or A Hole in the Law?*, 77 Ala. Law. 36 (2016).

<sup>18</sup> *DGB, LLC v. Hinds*, 55 So. 3d 218, 232–33 (Ala. 2010) (affirming dismissal of oppression claim on the basis on inadequate briefing).

<sup>19</sup> *In re Dixie Pellets, LLC*, No. 09-05411, 2010 WL 2367326, at \*4 (Bankr. N.D. Ala. June 9, 2010).

for oppression in the corporate context would also support a claim for breach of the duty of good faith and fair dealing in an LLC.

#### **D. Devaluation of Stock**

Often in corporate squeeze-out cases, the majority shareholder makes a low-ball offer for the minority's stock. This puts the minority shareholder in a bad position because often, he has no viable market for his shares other than his partner. As a result, the minority shareholder feels like he has no choice other than to unload his shares at any price. Alabama has provided statutory protection to these shareholders.

Alabama Code § 10A-2-8.32 forbids corporate fiduciaries from doing or saying anything “with the intent to depreciate the market value of the stock . . . of the corporation, and with the further intent . . . to buy any stock . . . at less than the real value thereof.”<sup>20</sup> “The measure of damages is the difference between the real and the depreciated value of the stock at the time the defendant perpetrates the wrongfully depreciating act.”<sup>21</sup> A corporate fiduciary may not make a low-ball offer even if the minority shareholder knows the actual value of his stock and does not rely on the misrepresentation.<sup>22</sup> A claim under this statute is a powerful, and underused tool for plaintiffs in shareholder litigation.

#### **E. Breach of the Shareholder Agreement**

In Alabama and elsewhere, LLCs and LLPs are creatures of contract. The operating agreements of these entities “serve as contracts that set forth the rights, duties, and relationships of the parties to the agreement.”<sup>23</sup> Often in shareholder litigation, the majority shareholder's

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<sup>20</sup> Ala. Code § 10A-2-8.32.

<sup>21</sup> *Fulton v. Callahan*, 621 So. 2d 1235, 1246 (Ala. 1993).

<sup>22</sup> *Fulton*, 621 So. 2d at 1247.

<sup>23</sup> *Harbison v. Strickland*, 900 So. 2d 385, 391 (Ala. 2004).

unfair actions not only fail to meet equitable concepts of fairness, but also breach the express, written terms of the operating agreement.

The elements for a claim for breach of the shareholder agreement are the same as any other breach of contract claim. Before filing the complaint, review the operating agreement to determine if the majority is living up to its duties.

### **III. Are the Claims Direct or Derivative?**

After determining the choice-of-law issues and determining which claims should be included in the complaint, the next question you have to answer in any shareholder case is “are the claims derivative or direct?” This question can be answered by two other questions:

- 1) Who has been injured, the shareholder or the company?; and
- 2) Should the shareholder or the company receive the benefit of the recovery?<sup>24</sup>

#### **A. Who Has Been Injured, the Shareholder of the Company?**

If the harm at issue falls on one shareholder rather than the company, the claim is direct. If all shareholders were injured equally, the claim is derivative. Sometimes, a single action gives rise to both direct and derivative claims. Under Alabama law, both derivative and direct claims may be pursued in a single action.

A derivative claim is a claim a shareholder brings on behalf of the company to redress an injury suffered by the company.<sup>25</sup> The Alabama Supreme Court restated the law defining derivative and direct claims in 2011.<sup>26</sup> If the shareholder’s harm is incidental to his status as a shareholder, the claim is derivative.<sup>27</sup> In other words, if the shareholder has been harmed only because the company was damaged by the majority shareholder, the claim is a derivative claim.

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<sup>24</sup> *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031, 1033(Del. 2004).

<sup>25</sup> *James v. James*, 768 So. 2d 356, 358 (Ala. 2000).

<sup>26</sup> See generally, *Altrust Fin. Servs., Inc., v. Adams*, 76 So. 3d 228 (Ala. 2011).

<sup>27</sup> *Id.* at 241.

Claims which have traditionally been deemed derivative include claims for corporate waste,<sup>28</sup> failure to declare dividends,<sup>29</sup> mismanagement,<sup>30</sup> and other claims which harm the company directly and the shareholder indirectly.

If the harm was not suffered by the company, but was instead “a direct fraud” on the shareholder that “do[es] not affect other shareholders” the shareholder may bring the action in his own name, on his own behalf.<sup>31</sup> The shareholder must have an enforceable right based reasonable expectations—such as the right to continued employment in a small business or the right to certain fees or commissions—to bring a direct claim.

### **B. Should the Shareholder or the Company Receive the Benefit of the Recovery?**

The second part of this analysis is more complicated and is best explained through an example. Suppose a majority shareholder used his control of the company to steal several million dollars in corporate funds rather than declare dividends to all shareholders or reinvest the funds in a way that benefits the company. In theory, the minority shareholder’s waste claim to recover these funds are derivative because the company has been harmed. Your client’s only harm is as a result of his ownership in the company. If the court were to find for your client on a derivative claim and order restitution from the majority shareholder to the company, it would only return money to the hands of the wrongdoer, who might steal it all over again. Even if the majority shareholder doesn’t steal the money a second time, he is unlikely to declare a dividend in your client’s favor.

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<sup>28</sup> *Galbreath v. Scott*, 433 So. 2d 454, 457 (Ala. 1983).

<sup>29</sup> *Boykin v. First Ala. Bank of B’ham*, 384 So. 2d 10, 12 (Ala. 1980).

<sup>30</sup> *Gilliland v. USCO Power Equip. Corp.*, 631 So. 2d 938, 940 (Ala. 1994) (quoting Andrew P. Campbell, *Litigating Minority Shareholder Rights and the New Tort of Oppression*, 53 Ala. Law. 108, 114 (1992)).

<sup>31</sup> *Altrust Fin. Servs., Inc., v. Adams*, 76 So. 3d 228, 242 (Ala. 2011) (quoting *Green v. Bradley Const., Inc.*, 431 So. 2d 1226, 1229 (Ala. 1983)).

This is an issue that has come up time and again in commercial litigation and the law around the country has adapted to meet the realities of the problem. After all, shareholder derivative cases devolved from equity, and “equity will not suffer a wrong without a remedy.”<sup>32</sup>

This problem demonstrates the purpose of the second question mentioned at the top of this section, “who should receive the benefit of any recovery?” Sometimes equity is best served by allowing a shareholder to recover his pro rata share of the damage to the company directly, even when the damage is nominally derivative. Courts generally allow direct recoveries for derivative damages in three circumstances:

- (a) Where the derivative action is against insiders who have misappropriated corporate assets; here an individual pro rata recovery prevents the funds from reverting to the control of the wrongdoers;
- (b) Where there are both “innocent” and “guilty” shareholders; hence a pro rata recovery may be limited to the “innocent” ones; [or]
- (c) Where the corporation is no longer a going concern; here individual awards facilitate distribution of funds.<sup>33</sup>

Alabama case law on this issue is less developed, but it appears to be consistent with this national rule. In *James v. James*, a minority shareholder sued a majority shareholder for waste in a closely-held company.<sup>34</sup> A jury awarded the minority shareholder his pro rata portion of the amount the majority shareholder had taken from the company.<sup>35</sup> The judgment was awarded

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<sup>32</sup> *Shepard v. Mt. Vernon Lumber Co.*, 68 So. 880, 883 (Ala. 1915).

<sup>33</sup> *Marquis Theatre Corp. v. Condado Mini Cinema*, 846 F.2d 86, 92 n.5 (1st Cir. 1988); *In re El Paso Pipeline Partners, L.P. Derivative Litig.*, 132 A.3d 67, 123–26 (Del. Ch. 2015) (citing in footnotes 72–73 cases from around the country applying this rule) *overruled on other grounds by El Paso Pipeline GP Co., L.L.C. v. Brinckerhoff*, 152 A.3d 1248, 1256 (Del. 2016); *see also Perlman v. Feldmann*, 219 F.2d 173, 178 (2d Cir. 1955) (holding that minority shareholders who successfully sued majority shareholder for recovery of wasted funds “are entitled to a recovery in their own right, instead of in right of the corporation”); *Lud v. Howard*, 411 N.W.2d 792, 795 (Mich Ct. App. 1987) (holding that “courts may tailor the relief granted to fit the particular case, and in some instances, direct relief to the stockholders may be allowed”); *Lochhead v. Alacano*, 662 F. Supp. 230, 233 (D. Utah 1987) (holding that “[t]here is ample authority for permitting a pro rata recovery to the injured shareholders”); *see also O’Neal and Thompson, Oppression of Minority Shareholders* § 7:9.

<sup>34</sup> 768 So. 2d 356, 357 (Ala. 2000).

<sup>35</sup> *Id.* at 358.

after the company had been wrapped up.<sup>36</sup> The Alabama Supreme Court held that these damages were derivative, not direct, because the injured party was the company, not the shareholder.<sup>37</sup>

Despite finding that the damages were derivative, the Alabama Supreme Court upheld the direct award to the minority shareholder, holding that in “an equity proceeding, such as the present one, the judgment can be molded so as to adjust the equities of all parties and to meet the obvious necessities of each situation.”<sup>38</sup> This flexibility shows that Alabama courts are likely to recognize the three exceptions permitting direct recovery by minority shareholders referenced above.

Courts may have less flexibility under the new LLC act. That act specifies that the recovery should be for the benefit of the company only and that shareholders must repay to the company any amount they receive in a judgment for derivative claims.<sup>39</sup> This law is yet to be tested or interpreted by the Alabama Supreme Court. There is nothing in the law that would prevent a court from using a two-step dance to order recovery for the company followed by a compelled dividend in favor of the minority shareholders.<sup>40</sup>

#### **IV. Is Presuit Demand on the Board of Directors Futile?**

The final question that must be determined before filing suit is “must I make a presuit demand before filing the complaint?” Alabama Rule of Civil Procedure 23.1 requires a plaintiff to “allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for the plaintiff’s failure to obtain the action or for not

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<sup>36</sup> *Id.* at 359.

<sup>37</sup> *Id.* at 359.

<sup>38</sup> *Id.* at 359.

<sup>39</sup> Ala. Code § 10A-5A-9.08.

<sup>40</sup> Indeed, until the Alabama Supreme Court has the opportunity to interpret the LLC Act, its impact cannot be fully known.

making the effort.”<sup>41</sup> Similarly, the new LLC Act requires that a member either make a presuit demand or show that demand would be futile.<sup>42</sup> What this means is that the shareholder or an attorney representing the shareholder must communicate his complaint to the majority shareholder, other members, or the board of directors before filing suit unless doing so would be futile. Under both Rule 23.1 and the new LLC Act, the demand must be alleged with particularity, the LLC Act going so far as to require the details of the date of the demand, the relief sought, and the company’s response.<sup>43</sup>

On first glance, Rule 23.1 would seem to be a procedural rule. The Alabama Supreme Court has held this rule (and its counterparts under other states’ laws) to be substantive. Thus, the Internal Affairs Doctrine applies and the presuit demand requirements will be determined under the law of the state of incorporation.<sup>44</sup>

Alabama law allows for a significant amount of flexibility in the form a pre-suit demand must take. In *James v. James*, a minority shareholder wrote a letter to the majority shareholder outlining his demands.<sup>45</sup> Older law indicates that the demand need not even be in writing but may be made in face-to-face communication.<sup>46</sup> Other states’ law may require more formal demands.

Once the demand is made, the corporation may have the opportunity to investigate the claims to determine if they are meritorious or should be pursued.<sup>47</sup> If the directors determine

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<sup>41</sup> Ala. R. Civ. P. 23.1.

<sup>42</sup> Ala. Code § 10A-5A-9.04.

<sup>43</sup> Ala. Code § 10A-5A-9.05; Ala. R. Civ. P. 23.1.

<sup>44</sup> *Scrushy v. Tucker*, 70 So. 3d 289, 299–303 (Ala. 2011).

<sup>45</sup> 768 So. 2d 356, 360 (Ala. 2000).

<sup>46</sup> See *Jones v. McLester*, 34 So. 174 (1903) (cited in Richard A. Thigpen, *Alabama Corporation Law*, § 11:8 (3d Ed. 2003)).

<sup>47</sup> *Elgin v. Alfa Corp.*, 598 So. 2d 807, 814 (Ala. 1992).

that the suit is not meritorious, they may move for dismissal from the Court.<sup>48</sup> The directors investigating the claims must be “disinterested,” *i.e.*, they must not be facing potential personal liability if the suit proceeds.<sup>49</sup> Further, these disinterested directors must investigate and evaluate the claims in “good faith” and must conduct a “thorough investigation.”<sup>50</sup> Further, the directors may not “approve acts that are ultra vires or illegal.”<sup>51</sup> If these factors are met, a court may dismiss the plaintiff’s claims on the special litigation committee’s recommendation pursuant to the business judgment rule.<sup>52</sup>

Often in closely-held corporations, minority shareholders forego the presuit demand, alleging that doing so would be futile. Alleging futility has the ancillary benefit of avoiding the appointment of a special litigation committee and allows the plaintiff to maintain control of his claims. Demand futility must be alleged with “factual particularity . . . .”<sup>53</sup> The most common context of demand futility is where a majority of the directors to whom the demand would be directed are accused of wrongdoing and that there is “such a degree of antagonism between the directors and the corporate interest that the directors would be incapable of performing their duty.”<sup>54</sup>

In closely-held company litigation, demand is often futile. The litigation involves outsider shareholders suing controlling shareholders who are usually responsible for the harm

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<sup>48</sup> Ala. R. Civ. P. 23.1.

<sup>49</sup> *Roberts v. Ala. Power Co.*, 404 So. 2d 629, 632 (Ala. 1981); *see also Stallworth v. AmSouth Bank of Ala.*, 709 So. 2d 458 (Ala. 1997) (holding that “the ‘business judgment rule’ prevents a derivative action where a special committee of disinterested directors determines in good faith, after a thorough investigation, that it is not in the corporation’s best interests for the derivative action to proceed”).

<sup>50</sup> *Roberts*, 404 So. 2d at 632.

<sup>51</sup> *Id.*

<sup>52</sup> *Id.* It follows that a plaintiff must challenge the committee’s decision on grounds that the directors were not disinterested, did not conduct a thorough investigation, or did not investigate the claims in good faith to defeat this recommendation.

<sup>53</sup> *Shelton v. Thompson*, 544 So. 2d 845, 850 (Ala. 1989).

<sup>54</sup> *Elgin v. Alfa Corp.*, 598 So. 2d 807, 814–15 (Ala. 1992).

giving rise to the claims. Very few closely-held corporations have independent directors capable of reviewing a presuit demand. By the time litigation is filed, there are usually plenty of facts demonstrating sufficient antagonism to excuse demand. Still, these situations require thoughtful analysis of how to proceed and whether to make a demand or plead futility.

### **CONCLUSION**

Mastering these issues is necessary to competently represent shareholders in derivative litigation. They must be answered before research can begin into the procedural law of the case. More importantly, they must be answered to accurately advise your clients about the value of their claims and likelihood of success.