

OPINION

Closely Held Corp.'s Governing Documents Critical in Litigation

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Disputes among co-venturers and shareholders in closely held entities continue to be a common source of litigation. This article will highlight significant developments in Massachusetts caselaw, including the importance of an entity's governing documents in determining liability and remedies.

Duty of utmost good faith

In *Donahue v. Rodd Electrotype Company of New England, Inc.*, 367 Mass. 578 (1975), the Supreme Judicial Court defined both the distinguishing characteristics of a closely held corporation and the nature of the duties that shareholders in such an entity owe each other.

In particular, *Donahue* announced the now well-established rule in Massachusetts that shareholders in a closely held corporation, notwithstanding the corporate form, owe each other the same fiduciary duty as partners — that is, a duty of “utmost good faith and loyalty.” *Donahue*, 367 Mass. at 593 (internal quotation marks and citations omitted).

Shareholders carrying out the business of the corporation “may not act out of avarice, expediency or self-interest in derogation of their duty of loyalty to the other stockholders and to the corporation.” *Id.* at 593.

Shortly after announcing the *Donahue* standard, however, the SJC acknowledged the need to impose some limits on its reach. Accordingly, in *Wilkes v. Springside Nursing Homes, Inc.*, 370 Mass. 842 (1976), the SJC articulated a burden-shifting framework to analyze the conduct of the controlling shareholders.

The court first must ask whether the majority can demonstrate “a legitimate business purpose for its action.” Once the majority articulates a legitimate business purpose, the minority may show that “the same legitimate objective could have been achieved through an alternative course of action less harmful to the minority.” *Wilkes*, 370 Mass. at 851-52. That is, a court must “weigh the legitimate business purpose, if any, against the practicability of a less harmful alternative.” *Id.* at 852.

Recent trends

Post-*Donahue* and *Wilkes*, courts, from time to time, would order the majority to buy out the shares of the “frozen-out” minority shareholder as a remedy for the majority's breach of fiduciary duty.

In *Brodie v. Jordan*, 447 Mass. 866 (2006), the SJC made clear that such a remedy typically will not be appropriate. Rather, the minority's reasonable expectations serve as the touchstone for determining both whether there has been a breach of the majority's fi-

duciary duty and, if so, the remedy available to the minority. *Brodie*, 447 Mass. at 869-70.

In particular, the SJC held that the “proper remedy for a freeze-out is to restore [the minority shareholder] as nearly as possible to the position [s]he would have been in had there been no wrongdoing. Because the wrongdoing in a freeze-out is the denial by the majority of the minority's reasonable expectations of benefit, it flows that the remedy should, to the extent possible, restore to the minority shareholder those benefits which she reasonably expected, but has not received because of the fiduciary breach.” *Id.* at 870-71 (internal quotation marks and citation omitted) (alterations in original).

The SJC's decision in *O'Brien v. Pearson*, 449 Mass. 377 (2007), demonstrates that a minority shareholder may be able to prevail on liability based on his reasonable expectations but be left without a meaningful remedy because the damages sought were not within what he reasonably could expect from the corporation:

“While O'Brien hoped that Summerhill would acquire and build the subdivision, he had no reasonable expectation that the proper conduct of his fellow shareholders made this result a foregone conclusion. O'Brien has not shown with reasonable certainty that he suffered compensable damages as a result of the defendants' breach.” *O'Brien*, 449 Mass. at 390.

An issue that has percolated through the caselaw is whether, and to what extent, contractual terms override otherwise applicable

principles of fiduciary duty in the close corporation context.

For example, in *Evangelista v. Holland*, 27 Mass. App. Ct. 244 (1989), the Appeals Court concluded that “[q]uestions of good faith and loyalty do not arise when all the stockholders in advance enter into an agreement for the purchase of stock of a withdrawing or deceased stockholder.” *Evangelista*, 27 Mass. App. Ct. at 248-49.

The SJC subsequently distinguished *Evangelista*, explaining that *Evangelista* “does not stand for the proposition that the existence of a buy back agreement completely relieves shareholders of the high duty owed to one another in all dealings among them.” *King v. Driscoll*, 418 Mass. 576, 586 (1994).

In *King*, the plaintiff did not allege that the repurchase of his shares pursuant to the stock buy-back agreement constituted the breach of fiduciary duty. Rather, the defendants’ breach of fiduciary duty arose from their pattern of conduct toward the plaintiff, which ultimately resulted in the plaintiff’s termination. The plaintiff’s termination, in turn, triggered the terms of the stock buy-back agreement. *King*, 418 Mass. at 586.

In *Blank v. Chelmsford OB/GYN, P.C.*, 420 Mass. 404 (1995), the SJC drew on the principles articulated in both *Evangelista* and *King*. Citing *Evangelista*, the SJC concluded that there was no breach of fiduciary duty where a plaintiff was terminated in accordance with the terms of his employment contract and his shares were repurchased by the corporation pursuant to the terms of the parties’ stock purchase agreement. See *Blank*, 420 Mass. at 408.

Relying on *King*, however, the SJC cautioned that the mere existence of governing documents “does not relieve stockholders of the high fiduciary duty owed to one another in all their mutual dealings.” *Id.*

The SJC explained that “[a] duty of good faith and fair dealing exists during the course of events leading up to and including termination, but that duty is to be evaluated in light of an agreement that permits termination by either party without cause on notice.” *Id.* 408-09.

In *Chokel v. Genzyme Corp.*, 449 Mass. 272 (2007), the SJC addressed that issue in the context of a public company, holding that where a contract provision is directly on point, it, not general fiduciary principles, controls.

“Directors owe a fiduciary duty to their shareholders. When rights of stockholders arise under a contract, however, the obligations of the parties are determined by reference to contract law, and not by the fiduciary principles that would otherwise govern. When a director’s contested action falls entirely within the scope of a contract between the director and the shareholders, it is not subject to question under fiduciary duty principles.” *Chokel*, 449 Mass. at 278 (citing *Blank*) (emphasis added).

The SJC subsequently distinguished *Chokel* on the grounds that it involved a public company. See *Pointer v. Castellani*, 455 Mass. 537, 554 (2009). The SJC’s analysis in *Pointer*, however, was consistent with the principles articulated in *Chokel* and *Blank*.

On one hand, the SJC rejected the defendants’ argument that the terms of the plaintiff’s employment agreement controlled “rather than their fiduciary duty.” *Pointer*, 455 Mass. at 554. As in *King*, the defendants engaged in a pattern of conduct that ultimately resulted in the plaintiff’s termination; that pattern of conduct gave rise to the plaintiff’s breach of fiduciary duty claim.

On the other hand, the SJC affirmed the judgment in favor of the plaintiff on the defendant’s usurpation of corporate opportunity counterclaim, holding that there was no corporate opportunity. In reaching that conclusion, the SJC, consistent with *Chokel*, looked to the terms of the operating agreement, which articulated a limited business purpose for the entity and allowed the shareholders to carry on business activities outside of the joint venture. Because the plaintiff’s conduct was entirely addressed by the operating agreement, the defendants did not state a claim for breach of fiduciary duty against the plaintiff. See *id.* at 555-56.

More recently, the SJC again applied the principle articulated in *Chokel* outside the public company context.

For example, in *Fronk v. Fowler*, 71 Mass. App. Ct. 502 (2008), the Appeals Court applied *Chokel* in the partnership context, holding that the challenged conduct fell within express provisions of the partnership agreement and was controlled by the agreement, not by general fiduciary duty principles.

That case subsequently came before the SJC on appeal from the trial court’s award of fees and costs to defendants under G.L.c. 231, §6F. In affirming the trial court’s §6F decision, the SJC commented that *Chokel* “did not announce a new rule of law; rather, it affirmed a long-standing rule in Massachusetts.” *Fronk v. Fowler*, 456 Mass. 317, 331 (2010).

As a result, the SJC concluded that a claim filed pre-*Chokel* asserting that “the unambiguous terms of a partnership agreement had no bearing on the partners’ fiduciary duties had no basis in the law of Massachusetts and was frivolous.” *Id.* at 332.

Taken together, these cases suggest that an entity’s governing documents will play a critical role in determining the parties’ respective rights and liabilities. Where the challenged conduct falls “entirely” within the terms of the governing documents, courts likely will find that the contract, and not fiduciary duties, controls.

Even where fiduciary duties are found to apply, the governing documents will play a critical role in determining a minority shareholder’s reasonable expectations, and therefore the majority’s liability, and in defining the minority shareholder’s remedy, if any.

In particular, how narrowly and clearly the purpose of the joint venture is articulated in the governing documents has the potential to dictate the result of the action.

As a result, in preparing documents that define the scope of the joint venture, it is critical to avoid the temptation to use a “form” document. Rather, each set of documents should be tailored precisely to define the scope and purpose of the joint venture.

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