Limits Of Contractually Sanctioned Freeze-Outs

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When relationships sour in closely held corporations, disgruntled majority owners typically resort to written employment agreements and stock buy-back arrangements to oust the unwelcome minority. The bullet behind such a "freeze-out" is *Blank v. Chelmsford OB/GYN, P.C.*, 420 Mass. 404 (1995), which, under certain circumstances, allows those agreements to defeat the majority's well-established fiduciary duty to keep the minority shareholder employed with stock benefits preserved.

As explained below, *Blank* and its progeny only allow the majority to escape their fiduciary duty, and corresponding liability for an unlawful freeze-out, when they follow both the letter and spirit of the contractual provisions. Even then, the majority are still subject to the lesser but still significant duty imposed by the implied covenant of good faith and fair dealing, and their actions leading up to the exercise of their contractual rights remain subject to their heightened fiduciary duty.

'Absolute loyalty'

In a close corporation (i.e., one with few stockholders, no ready market for the stock, and substantial majority stockholder participation in management and operations), the fiduciary duty owed among stockholders requires "trust, confidence and absolute loyalty." Stockholders may not act out of "avarice, expediency or self-interest in derogation of their duty of loyalty." *Donahue v. Rodd Electrotype Company of New England, Inc.*, 367 Mass. 578, 586-87, 593 (1975).

In *Blank*, Dr. Blank was a physician whose interest in and employment by a small professional corporation was terminated by the majority shareholders, raising a classic freeze-out claim. A "freeze-out" occurs when "[t]he squeezers (those who employ the freeze-out techniques) … deprive minority shareholders of corporate offices and of employment," deny or withhold dividends, or otherwise frustrate the minority's reasonable expectation of benefits from ownership of shares. *Donahue*, 367 Mass. at 588-89; *Brodie v. Gordan*, 447 Mass. 866, 869

(2006). But in Blank's case, his termination was effectuated in accordance with an employment contract and stock repurchase agreement that provided for such termination without cause on six months' notice and repurchase of his shares at book value.

When Blank sued for breach of contract, breach of fiduciary duty and other alleged injuries, the termination was held to be proper, "because the terminating shareholders had acted in accordance with their agreement." *In Re Wet-Jet International, Inc.*, 235 B.R. 142, 150 (D. Mass. 1999), citing *Blank,* 420 Mass. at 406-09. In other words, as noted by U.S. Bankruptcy Court Judge Henry J. Boroff, "the actions taken by the defendants — termination and stock repurchase — fell squarely within the ambit of the agreements governing these matters, made at the outset of the relationship between the plaintiff and the defendants." *Wet-Jet,* 235 B.R. at 150. Several years later, the Supreme Judicial Court also confirmed that, for *Blank* to apply, the contested action must fall "*entirely* within the scope of a contract." *Chokel v. Genzyme Corp.*, 449 Mass. 272, 278 (2007), citing *Blank*, 420 Mass. at 408 (emphasis added).

The absence of a fiduciary duty, however, does not equate to an absence of the duty to act fairly. The *Blank* court held that the majority's actions were governed by the general covenant of good faith and fair dealing applicable to contractual agreements, rather than the much higher standard of utmost good faith and loyalty owed among stockholders in a close corporation. *Id.* 420 Mass. at 407-09. Where there is no indication of any failure in the duty of good faith and fair dealing at the time that stockholder agreements are executed, issues of breach of fiduciary duty do not arise when one party simply seeks to exercise its rights under those agreements. *Wet-Jet,* 235 B.R. at 150, citing *King v. Driscoll*, 418 Mass. 576, 586 (1994).

Furthermore, compliance with the letter and spirit of contractual provisions is not enough. Conduct leading up to the exercise of contractual rights is still subject to scrutiny under the heightened fiduciary duty standard applicable to majority action. The SJC has recognized that, "where the controversy between the shareholders arises not from the subject matter of a stockholder agreement related to stock repurchase or employment termination, but from the conduct of the majority shareholders leading up to such repurchase or termination, that conduct will be evaluated in light of the high fiduciary duty owed to fellow shareholders in a close corporation." *Wet-Jet,* 235 B.R. at 150, citing *King,* 418 Mass. at 586.

The *Wet-Jet* court observed that, in *King*, the plaintiff, a vice president and shareholder in a close corporation, participated in a derivative suit arising from an internal power struggle between two other shareholders. The winner of the struggle ultimately fired King, who then sued, claiming that his termination was against public policy in breach of the other shareholders' fiduciary duty. *Wet-Jet*, 235 B.R. at 150, citing *King,* 418 Mass. at 579-80.

The majority sought shelter in the shareholder agreement, but the SJC found for King, ruling that "the complained of conduct of the majority shareholders did not arise solely under the provisions of the stock repurchase and employment agreements, but instead preceded the exercise of those rights." *Wet-Jet*, 235 B.R. at 150. As stated in *Wet-Jet*, "in the case of disputes arising under stock repurchase and employment agreements, many of the concerns underlying the adoption of the *Donahue* standard diminish considerably when the minority and majority shareholders execute an agreement setting out their respective roles, rights and responsibilities at the outset of

their relationship. *A distinction ought therefore to be drawn between actions taken by stockholders with respect to one another, which are explicitly covered by their unfettered agreement to be bound, and actions taken outside of such an agreement.* Such a distinction 'does not relieve stockholders of the high fiduciary duty owed to one another in all their mutual dealings.'" *Wet-Jet,* 235 B.R. at 151, quoting *Blank,* 420 Mass. at 408 (emphasis added). A "high level of scrutiny" will apply to majority dealings "that fall outside the terms of the shareholder agreement." *Wet-Jet,* 235 B.R. at 151.

Applying this law to the shareholder agreement and conduct of the parties in *Wet-Jet,* the court stated, "the inquiry then is whether the acts taken by [the majority stockholders] were consistent with that Shareholder Agreement and whether they acted in furtherance of that agreement in a manner consistent with their duties to one another." *Id.* at 151. The 1st U.S. Circuit Court of Appeals has similarly ruled that a shareholder breaches his fiduciary duty even when he acts within the letter of corporate documents and agreements if he is using the agreements in a manipulative manner. *A.W. Chesterton Co. v. Chesterton*, 907 F. Supp. 19, 23 (D. Mass. 1995), aff'd 128 F. 3d 1 (1st Cir. 1997).

Less harmful alternatives?

A subsequent decision considering *Blank* makes clear that *Blank* affords no refuge to stockholder actions leading up to the exercise of contractual rights. Such actions will be held to the high fiduciary duty standard applicable to stockholders in a close corporation. In *Pointer v. Castellani*, 455 Mass. 537, 542 (2009), Pointer, the terminated minority stockholder, was subject to an employment agreement that required one year's advance notice of termination excepting only if, among other things, "he engaged in dishonest or disloyal behavior, committed a material breach of the operating agreement, or substantially failed to perform a material duty." *Id.* The court found a breach of fiduciary duty because the majority stockholder "never truly … attempted" to resolve the "*supposed* complaints [against Pointer] by less drastic measures than termination." *Id.* at 554 (emphasis in original).

The court rejected the majority stockholder's argument (which relied on *Blank)* that, "because Pointer was president under an employment contract, the terms of the contract control rather than their fiduciary duty." *Id.* The court rejected *Blank* as controlling law because, in *Blank,* termination was "consistent with terms of applicable contracts." *Pointer,* 455 Mass. at 554, citing *Blank,* 420 Mass. at 406-09.

The majority's obligation to take measures to avoid firing a minority stockholder is implied in the broad fiduciary duty owed under *Donahue* and made explicit in *O'Connor v. U.S. Art Co., Inc.*, 66 Mass. App. Ct. 1118 (unpub.) app. den., 447 Mass. 1112 (2006). In upholding a decision by Judge Allan van Gestel, the Appeals Court ruled that, where an employee is also an owner of a corporation, his employment may not be terminated if there are less harmful alternatives to firing him. Less harmful alternatives may include: (1) calling a meeting to discuss "ways and means to correct the … issues and still preserve a role" for the employee, (2) monitoring the employee's business dealings, (3) supervising the employee, or (4) hiring "professional support to fill gaps" in the employee's skill set. It is no defense to claim that the

majority stockholder had no choice and "lacked other recourse" where the majority stockholder takes no action to seek out less harmful alternatives to firing. *Id.* at *3-*4.

Although majority stockholders in a close corporation retain "a large measure of discretion" in ruling their roost, this discretion is tempered by their fiduciary duty to the minority to achieve their objectives through alternative courses of action, "less harmful to the minority's interest." *Wilkes v. Springside Nursing Home, Inc.*, 370 Mass. 842, 851 (1976). When the majority seeks to avoid their fiduciary duty, relying on *Blank* to oust an unwanted minority, the majority must comply with both the letter and spirit of contractual provisions to support their actions, and their conduct leading up to the exercise of their contractual rights must be above reproach, lest they be found liable for an unlawful freeze-out.