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NO WAY OUT

***Brodie* compels shareholders to seek advice at the beginning of a business venture and write down agreements to avoid being stuck in a "shotgun business marriage" with no way out!**

Massachusetts law is generally very protective of shareholders in corporations with few shareholders, known as closely held corporations. However, a recent decision by the Commonwealth's highest court, the Supreme Judicial Court (SJC), has conclusively established that without proper planning a shareholder in a close corporation in Massachusetts is not entitled to the remedy of having his or her shares purchased either by the corporation or the other shareholders, even when they have been frozen out and not enjoyed the benefits of stock ownership.

In *Brodie v. Jordan*, 447 Mass. 866 (2006), a frozen-out minority (one-third) shareholder who was the surviving wife of a deceased shareholder was not entitled to a forced buyout of her shares by the majority, despite being awarded this remedy by the trial court.

The landscape of legal obligations to and from shareholders in close corporations is well established in Massachusetts. Unlike many jurisdictions, including Delaware, shareholders (both minority and majority) owe each other the highest duty recognized by law, a fiduciary duty. It is the same duty partners in a Massachusetts partnership owe each other. The trial courts have broad discretion to fashion remedies when violations of the fiduciary duty occurs.

The trial court in *Brodie* found that the majority shareholders had "frozen [Mrs. Brodie] out" from participation in the company, a machine shop, by refusing her access to company information and denying her any economic benefit from her shares. The trial court concluded that the majority shareholders breached their fiduciary duty to Mrs. Brodie. As remedy for this breach, the trial judge ordered the majority shareholders to purchase Mrs. Brodie's shares in the corporation at a price equal to her share of the corporation's net assets, as determined by a court appointed expert, plus prejudgment interest.

The Appeals Court agreed with the trial court. The majority shareholders, however, sought a further appeal to the SJC, who ultimately disagreed with the remedy of a forced buyout because there was no provision in the Incorporation Documents (the Articles of Organization), the By-Laws, or a shareholder agreement for such drastic action.

The SJC reasoned that despite the attractiveness of a "clean break" between the fiduciary parties, it could place the frozen-out party in a better position than if there had been no wrongdoing. Fundamentally, the remedy must be proportionate to the harm. Many close corporations have no market to sell their shares, and a forced buyout creates a market where none otherwise exists. The SJC remanded the case to the trial court for an evidentiary hearing to determine Mrs. Brodie's reasonable expectations of ownership; whether these expectations were frustrated; and, if so, by what means her interests may be vindicated.

> ***The SJC disagreed with the remedy of a forced buyout when there was no provision authorizing such action in the Incorporation Documents (the Articles of Organization), the By-Laws, or a shareholder agreement.***

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CALL TO ACTION

Brodie makes painfully clear the need for shareholders (as well as partners and LLC members) to consider and reduce to writing what should happen in the event of:

- Death;
- Disability;
- Retirement;
- Divorce;
- Dispute;
- Deadlock; or
- Termination of employment.

The shareholders should fully consider what their expectations are both for the business and themselves individually. They need to reach a consensus as to what should happen when a triggering event occurs. The consensus agreement must then be memorialized in writing either in the Articles of Organization, the By-Laws, or a shareholders agreement.

If a buyout is to occur (and probably should be mandatory in many circumstances such as death, retirement, or divorce) then funding or financing the buyout must be considered. Life insurance can be helpful as a funding mechanism in the event of death of a shareholder. Business owners often work with insurance professionals as well as legal counsel when exploring funding options for different scenarios.

If insurance is not available for any reason, the agreement should contemplate financing the purchase over time with a payment schedule spelled out (generally not more than five (5) years) as well as collateral in the form of a stock pledge and perhaps a mortgage or other lien on assets.

Shareholders in closely held corporations should realize the Probate and Family Court can order that shares be transferred to a divorcing spouse. This happened to one of our clients when a shareholder moved out of state, decided to divorce his spouse, and the Probate and Family Court concluded that since the soon-to-be ex-spouse was remaining in Massachusetts and had done some billing work for the company in the past, she should end up with the stock. The remaining shareholder who ended up with the ex-spouse as a new business partner was not happy with the Probate and Family Court's decision.

Generally speaking, the agreements between the shareholders are memorialized in a shareholders agreement. One of the important decisions is how the business will be valued upon the occurrence of a triggering event. Sometimes the valuation is an agreed-upon amount. More often, a formula is used to determine the value; or an appraisal is done by a business valuation expert. Establishing a valuation formula, moreover, can be very helpful in dealing with the IRS in the event of a death. The corporation's accountant frequently participates in the valuation process.

Shareholders should also consider other related issues such as whether they should have a right to a job. A time may come when a shareholder's skills may not be an optimum fit for the needs of the business. Discussing the employment expectations of each shareholder at the outset and memorializing agreements on this issue will minimize future stress.

It is critical to understand that a shareholder who is no longer an employee is still a shareholder unless the founders agree at the outset that if and when the employment of a shareholder terminates, the shares must be sold or redeemed by the company or the other shareholders. The terms of the redemption can be more favorable in some situations such as death or retirement, and less favorable in others such as voluntary termination or where there is wrongdoing. Many entrepreneurs are reluctant to do this necessary planning in the early stages of a new business venture when expectations for the future are bright and everyone seems to be on the same page; but it is naïve not to anticipate that circumstances inevitably will change and problems will arise that can be dealt with more easily and much less expensively if proper planning has been done.

The lesson to be learned from *Brodie*, therefore, is seek advice at the beginning of a business venture and write down your agreements with your partners to avoid being stuck in a "shotgun marriage" with no way out!

For questions, please contact Attorney Robert Berluti, the Firm's Litigation Partner, or John McLaughlin, the Firm's Corporate Partner.

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