



FIDUCIARY DUTY OF SHAREHOLDERS IN CLOSE CORPORATIONS: FREEZE-OUTS, A PATH TO LIQUIDITY?

BRODIE. v. JORDAN, 66 MASS. APP. CT. 371, 847 N.E. 2D 1125 (2006)

DAVID M. BELCHER, ESQ.[†]

August, 2006

(AUTHOR'S NOTE: The appellate court decision questioned in the article below was subsequently reversed by the Massachusetts Supreme Judicial Court in *Brodie v. Jordan*, 857 N.E.2d 1076, 447 Mass. 866 (2006). The reasoning for the reversal was consistent with the dissenting opinion of the Appeals Court and this author's opinion expressed herein.)

The Appeals Court of Massachusetts in *Brodie v. Jordan* recently established a new remedy for those minority shareholders who have been "frozen-out" of close corporations. The decision expressly affirmed a court's equitable right to force the majority shareholders to purchase the frozen-out minority shareholder's shares at a price set by an independent third party. By its own admission, the Court noted how no Massachusetts appellate court had previously ordered the purchase of shares under

similar circumstances. This article questions that extraordinary equitable remedy and highlights the desirability of a shareholders' agreement addressing buy-out mechanics.

Facts. *Brodie v. Jordan* involved facts similar to those which led the Supreme Judicial Court to establish in *Dona-hue v. Rodd Electro-type Co.*¹ that share-holders in a close

corporation owe one another a duty of the utmost good faith and loyalty. Mr. Brodie and two others had organized Malden Centerless Grinding, Inc. ("Malden") in 1973. In 1979 one of the founders, who was also president, resigned and Malden purchased his shares. Mr. Brodie then became president and he and the remaining founder were the only two officers and shareholders until 1984 when Mr. Jordan became a shareholder and assumed responsibility for the day to day operations of Malden. Subsequently, Mr. Brodie became inactive in the company, and in 1989 Mr. Brodie proposed that the company purchase his shares for \$145,000. Mr. Jordan flatly refused the proposal and other "points of friction" between the two culminated in Mr. Brodie being

removed from the board of directors in 1992. Mr. Brodie died in 1997.

After Mr. Brodie's death, his wife became owner of his Malden

Short of formal litigation, the Brodie decision may provide fodder for the 'gamesmanship' the legislators explicitly sought to avoid.

shares. At a special meeting called by Mrs. Brodie, Mr. Jordan and the other Malden shareholder defeated her attempt to be elected to the position of director previously vacated by Mr. Brodie. The

other shareholders offered no explanation for their refusal to vote for her. Mrs. Brodie's request for information on Malden's financial condition and an audit was also denied. Instead, Mr. Jordan suggested that if she was interested in offering Malden her shares for purchase she should follow the right of first offer provision in Malden's articles of organization. Six months later Mrs. Brodie filed suit against the other shareholders claiming they were in breach of their fiduciary duty and that she had been frozen-out of the corporation. While that suit was pending, Mrs. Brodie gave notice, in accordance with the articles of organization, that she wished to sell her shares for \$205,000, thereby giving the company a right to purchase the shares at that price or submit

Belcher, Kerwin & Starr LLP
112 Water Street
Boston, Massachusetts 02109
Telephone: (617) 368-6890
Facsimile: (617) 368-6891

[†]David M. Belcher is a founding partner of Belcher, Kerwin & Starr LLP and head of its business law practice. He frequently advises closely held companies with corporate governance and risk management issues. Prior to forming Belcher, Kerwin & Starr with his partners, Mr. Belcher was a senior associate at Goodwin Procter LLP. He is a *magna cum laude* graduate of the Boston College Law School where he was the Editor-in-Chief of the *Uniform Commercial Code Reporter-Digest*.

1. 367 Mass. 578, N.E. 2d 505 (1975).

the valuation of the shares to arbitration and decide whether to purchase the shares at such established price. The right of first offer procedure was delayed as the parties began mediation in Superior Court, but the mediation was unsuccessful. Before the arbitration Malden had initially elected began, Malden notified Mrs. Brodie that it waived its right of first offer and gave its consent for her to transfer her shares in “such manner as [she] may deem appropriate.”

Holding. The Appeals Court affirmed the lower court’s ruling that the defendants’ actions constituted a freeze-out² of Mrs. Brodie.

As evidence of the freeze-out, the Court cited how: (i) the defendants voted against Mrs. Brodie in the election for director of the company without a legitimate reason for doing so; (ii) they refused to provide her with more detailed financial information about Malden than annual, unaudited statements; and (iii) after commencing the arbitration process to determine a valuation for the shares under the right of first offer provision in the company’s articles of organization, they waived the transfer restrictions in what the Court determined was an arbitrary decision. The majority of the Court ruled that the remedy ordering the defendant shareholders to purchase Mrs. Brodie’s shares³ represented a restoration

of what she lost “in the only way possible.”

Comment. Share ownership in a close corporation is arguably overrated and misunderstood. Most often such companies do not pay meaningful and consistent dividends, instead choosing to reinvest profits and/or, subject to prudent tax-planning, distribute management bonuses. A public offering of the shares is typically only a very remote possibility. Since the market for private company shares is virtually nonexistent (and is often limited to existing shareholders), an owner is left to wait for some sale or liquidation event which enables him or her to obtain cash for those shares.

Of course the mere chance that an exit event will occur at a significant multiple of the value of the shares when they were received is reason enough to covet them. Share ownership also represents a right (albeit limited as a minority shareholder) to participate in the management and direction of the company. Shareholders in a close corporation are often also paid employees. They are owed a duty of care and loyalty by officers and directors and receive the protection from freeze-outs by a majority of the shareholders established in Donahue v. Rodd Electro-type Co. Whether that protection provides share liquidity in situations other than those already involving repurchases of shares of a majority

shareholder at a price higher than what was offered to a minority shareholder as in Donahue was an unanswered question prior to Brodie.

Mr. Brodie was a founder and one-third owner of Malden. Presumably he was involved in the adoption of Malden’s articles of organization containing a right of first offer on share transfers in favor of the company. He was well aware that neither the company nor its shareholders had an obligation to purchase his shares at any point. In fact, a few years after he was inactive in the company Mr. Brodie proposed that, upon the death of a shareholder, Malden be required to purchase his or her shares using the proceeds of life insurance on such shareholder, but Malden did not adopt that proposal. His employment likely represented the means by which he received economic benefit from the company which had a long-standing policy of not paying dividends. Mr. Brodie became inactive in Malden’s daily operations presumably by choice, although he was removed from the board a few years later. Even though inactive and not receiving compensation, his shares still had value – he would be paid on them *if and when* a company sale or liquidation event occurred or he succeeded in selling them on his own after complying with the right of first offer provision.

Upon Mr. Brodie’s death, Mrs. Brodie assumed his rights as a mi-

2. “Typical majority actions constituting a freeze-out include denying a minority a corporate office or employment, refusing to declare dividends, treating the value of the minority’s shares in an unequal manner, and excluding or isolating a minority shareholder from information, operations, and decision making.” Brodie at 1129.

3. The lower court had ordered the shares to be purchased by the defendants for \$94,500 plus interest.

4. Both of which would support derivative actions rather than Donahue-style direct actions. See *Remedies for the Aggrieved Shareholder in a Close Corporation*, Thomas P. Billings, 81 Mass. L. Rev. 3 (1996).

nority shareholder without an ability to force the company or anyone else to purchase those shares. Significantly, Mrs. Brodie offered no evidence that the defendants paid themselves salaries in excess of the value of the services they actually rendered or that they diverted funds from the company for their own personal use.⁴ Nonetheless, the majority opinion emphasized how the other shareholders derived benefit from their status as shareholders while Mrs. Brodie derived no benefit because she was excluded from any meaningful role in Malden's operations.⁵

Notably, the provisions of the Massachusetts Business Corporation Act permit companies to establish qualifications for directors.⁶ If Malden had adopted such criteria, Mrs. Brodie may have been ineligible to serve as director. Otherwise, the defendants could have articulated a legitimate reason for refusing to elect her from the start.⁷ Moreover, in addition to expressly approving of rights of first offer like the one in Malden's articles of organization, Massachusetts law permits a company (i) to require the holders of any class of shares or another person to approve the transfer of restricted shares, if the requirement is not

manifestly unreasonable and (ii) to prohibit the transfer of restricted shares to designated persons, if the prohibition is not manifestly unreasonable.⁸ In short, Massachusetts

If the Malden shareholders had a shareholders agreement prior to the breakdown of their relationship the costly lawsuit could have been avoided and the parties could have had established expectations regarding the liquidity of their shares – two goals any shareholder would want.

authorizes greater restrictions on the transfer of shares than Malden adopted.

Even if Malden had effectively prohibited share transfers one could question the majority opinion's assessment of what was actually lost by Mrs. Brodie and therefore what

needed "restoring." Mrs. Brodie did not lose a market for her shares. No real market existed for any shareholder. What she and other shareholders had was an ability to sell their shares after complying with a right of first offer provision - a provision Massachusetts law expressly authorizes. The defendants prevented Mrs. Brodie from holding a corporate office without a legitimate reason and refused to provide her with meaningful financials. Nevertheless, the majority opinion held that forcing the defendants to purchase Mrs. Brodie's shares was "the only way possible" to restore what she lost. That does not seem true; ordering the purchase of her shares actually does not restore what she lost (i.e., corporate office and access to financial information). The majority opinion questioned the dissent's

proposed remedies, including naming her a director, officer or employee if she so desired, as ones which would effectively force Mrs. Brodie into a relationship neither she nor the other directors wanted. However, Mrs. Brodie apparently did desire to serve as director when she unsuccessfully sought to be so elected. Furthermore, the restoration of what was actually lost without punishing the defendants should be the primary focus (even before the respective wishes of the parties).

The Massachusetts Business Corporation Act is based largely on the American Bar Association's Model Business Corporation Act (the "Model Act"). Section 14.30 of the Model Act provides that courts may dissolve a corporation in a proceeding brought by a shareholder where ". . . those in control of the corporation have acted . . . in a manner that is . . . oppressive . . ." However, Massachusetts did not adopt a similar provision after considering that text. Instead, it decided to continue Massachusetts general policy that,

involuntary dissolution should be available as a mechanism for resolving internal corporate disputes only in the case of true deadlock, and even then only when continuation of the deadlock will impose real and serious harm, and also that significantly broader availability of this remedy in such circumstances invites gamesmanship in the negotiation of internal corporate disputes and makes the

5. The other founder who apparently was not employed by the company at the time of the lawsuit, as was Mr. Jordan, derived economic benefit from the company as it leased the building he owned and he subcontracted work through another company to Malden.

6. M.G.L. c. 156D, § 8.02.

7. Mr. Jordan claimed at trial that he did not "feel [Mrs. Brodie] was adequate"; however, in a deposition he said the defendants voted against Mrs. Brodie because they chose to and for no other reason.

8. M.G.L. c. 156D, § 6.27(d). See Official Comment (" . . . the restrictions described in §§ 6.27(d)(3) and (4) may permanently limit the market for shares by disqualifying all . . . potential purchasers.")

9. M.G.L. c. 156D, §14.30, Official Comment.

dissolution remedy available in circumstances in which nothing so extreme is required or, in the end, normally consummated.⁹

One can envision circumstances where based on the reasoning in Brodie a court orders the majority shareholders (or the company) to purchase the shares of a minority shareholder at a price which exceeds the cash readily available to purchase the shares. In such a case, the shareholders (or company) may be forced to liquidate some of the assets of the company to pay the purchase price. Although the Massachusetts legislators affirmatively decided not to grant oppressed shareholders a right to petition a court to dissolve the company in circumstances involving oppression of minority shareholders, the effect of Brodie could be a court ordered dissolution (or at least partial liquidation) under the right circumstances. Short of formal litigation, the Brodie decision may provide fodder for the “gamesmanship” the legislators explicitly sought to avoid.

Although it remains to be seen whether the Brodie decision “. . . will now needlessly open the floodgates in this area of the law” as the dissenting opinion fears, the decision is inconsistent with the traditional approach of Massachusetts courts¹⁰ and arguably the intent of the legislature.

Lesson: Use a Shareholders’ Agreement. Shareholders of close corporations who view their share ownership as more than a mere

chance to cash in on a potential corporate exit event and instead something representing readily realizable value must have a shareholder’s agreement which provides for the purchase of their shares upon agreed to events. The agreement should specifically contain an agreed upon mechanic for determining the purchase price. The obligation to purchase the shares is often triggered upon the death or termination of employment of a shareholder. The purchase price following the death of a shareholder is often funded with an insurance policy on that shareholder’s life. If the Malden shareholders had such an agreement in place at the outset of their relationship (or even just prior to its breakdown) the costly lawsuit could have been avoided and the parties could have had established expectations regarding the liquidity of their shares – two goals any shareholder would want. □

10. The Massachusetts Supreme Judicial Court had previously declined to hold that the fiduciary duty of shareholders in a close corporation requires that the majority shareholders or company purchase the shares of the minority shareholders on the death of that shareholder where there was no oppressive conduct. Goode v. Ryan, 397 Mass. 85, 489 N.E. 2d 1001 (1986)