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Resolving freeze-out flaps without pricey court fights

A minority owner cannot force the major owners into a buyout of the minority shares. In *Brodie v. Jordan*, the Massachusetts Supreme Judicial Court ordered a hearing to determine the minority shareholder's "reasonable expectations" of stock ownership and a remedy based on those expectations other than a forced buyout.

Brodie is a lesson in what not to do, both in starting an enterprise and in handling the nearly inevitable conflicts that later arise between owners. Such disputes may occur because of family or business conflicts, employment termination, death, disability, retirement or simply as a result of control disparity.

Plaintiff Mary Brodie's husband, Walter Brodie, organized a manufacturing enterprise in 1973 with David Barbuto and Robert Jordan. Mr. Brodie, who has since died, ran the enterprise until the early 1980s, when Jordan became a shareholder and assumed all management responsibilities. Thereafter, Walter Brodie, Jordan, and Barbuto remained equal owners only because Mr. Brodie's requests to be bought out were denied. In 1992, Jordan and Barbuto removed him as a director. After he died in 1997, Mr. Brodie's widow made multiple unsuccessful attempts to be bought out or to participate in the business as a director through a nominee.

Stonewalled, Mrs. Brodie brought a freeze-out suit in 1998. After six years of mediation, multiple hearings and a trial, Jordan and Barbuto were determined to have breached their fiduciary duties to her and were ordered to purchase her shares for \$94,000. The trial was followed by two appeals. Mrs. Brodie

won the first, but in December 2006 lost the final appeal. Now, Mrs. Brodie must go back to a trial judge, who is to determine her "reasonable expectations of ownership" and fashion some appropriate remedy (excluding a buyout) for breach of those expectations.

Although the SJC acknowledged that closely held corporate stock has no ready market, it said forcing a buyout by the other stockholders provides a better result for the minority owner than if the majority had not breached their duty of good faith. The court can be criticized for its ruling banning forced buyouts because it has cut back on trial judges' flexibility in choosing a remedy, especially when a buyout may be the most equitable alternative. Moreover, Mrs. Brodie was neither involved in the creation of the enterprise nor in its 24-year life prior to inheriting her husband's stock. Thus, she could not possibly have any expectations — reasonable or not — about the appropriate remedy. Therefore the "reasonable expectations" standard created here by the SJC makes little sense. In cases such as *Brodie*, the question of appropriate remedy should be resolved by using a recognized Massachusetts objective standard of fundamental fairness or fair play, not by asking after the fact what plaintiff's "expectations" were and whether they were reasonable.

How can small-enterprise owners avoid years of costly litigation to resolve conflicts between minority and majority owners? First, all participants must recognize that business relationships are subject to the vicissitudes of life. Participants must preplan for such changes. Preplanning may include considering the following:

- Employment agreements and stock purchase agreements. The SJC has sanctioned agreements executed by all participants and has ruled that they trump the fiduciary duty

requirements, regardless of whether, for example, a buyout price in a purchase agreement is lower than fair market value or whether an employment agreement allows termination without cause. Such agreements must anticipate voluntary and involuntary exits of an owner from active participation.

- Voting trust agreements. The participants may choose to preselect independent voting trustees and make rules ahead of time as to how votes will be cast on important issues.

- Stock transfer or issuance restrictions. These may include rights of first refusal or first offer to other shareholders, prohibitions on transfer of more than certain numbers of shares, requirements that proposed purchasers offer to buy all shareholders' stock, and corporate consent requirements. Minority owners may seek stock issuance restrictions to avoid dilution. Such provisions, if used, must be drafted carefully so as not to hamper receipt of equity financing or investment.

Even if preplanning has not been done, majority owners can still avoid the enormous burden litigation inevitably causes by keeping in mind at all times that they remain in a fiduciary relationship with the minority owner. Minority owners also share this duty.

This does not mean, as one court so aptly put it, that the majority is "bound to employ any dolt who happened to inherit" the minority owner's stock. It means simply that they must deal fairly with one another.

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INSIDER VIEW

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