

AVOIDING EMPLOYMENT CLAIMS BY MINORITY SHAREHOLDERS IN CLOSE CORPORATIONS

Many businesses are managed by individuals who are both employees and shareholders. Massachusetts law provides a level of job protection to such individuals when they are minority shareholder employees of a "close corporation." This job protection runs contrary to the general rule of "at will" employment in Massachusetts, and it also often comes as a surprise to majority shareholders who assume they are free to do whatever they think is in the best interests of the corporation, including terminating difficult or poor performing employees without regard to their ownership interests. This edition of the *Employment Law Advisor* reviews this evolving area of the law and provides guidance in avoiding minority shareholder employee claims.

RIGHTS OF MINORITY SHAREHOLDERS IN CLOSE CORPORATIONS

Massachusetts courts define a "close corporation" as a corporation with (1) a small number of shareholders, (2) no ready market for its stock, and (3) substantial majority shareholder participation in its management, direction and operation. Because of these characteristics, minority shareholders in close corporations are vulnerable to oppressive measures by majority shareholders. For example, the majority may refuse to declare dividends, may drain off the corporation's earnings in the form of exorbitant salaries and bonuses to majority shareholder officers, or may sell the corporation's assets at an inadequate price to majority shareholders.

A minority shareholder *employee* can be especially vulnerable. He or she may purchase shares of stock with the expectation that the monetary investment and hard work, or "sweat equity," will lead to financial gain as the value of the business rises. An expectation of continued employment with the corporation is frequently one of the reasons why the minority shareholder invested in the business. Indeed, he or she may view the receipt of a salary as a principal return on his or her investment. Continued employment, however, is usually subject to the control of the majority shareholders.

Because of the nature of close corporations and the vulnerability of minority shareholders, Massachusetts law treats shareholders in a close corporation like partners in a partnership. Thus, like partners, the shareholders owe a fiduciary duty of "utmost good faith and loyalty" in their dealings with one another. This duty limits a corporation's ability to terminate the employment of minority shareholders when the termination would deprive the shareholders of their investment or unjustly enrich the majority shareholders. The duty applies to close corporations incorporated in Massachusetts as well as those incorporated in other states

where the duty is consistent with the law of state of incorporation (which, notably, does not include Delaware).

THE LEGITIMATE BUSINESS PURPOSE TEST

Massachusetts courts have created a two-part analysis, called the "legitimate purpose test," for examining a decision by majority shareholders to terminate the employment of a minority shareholder. Under the test, the majority shareholders must demonstrate that there was a legitimate business purpose for their decision. Note that this does **not** require that "just cause" exist for the termination. By requiring only a legitimate business purpose, the test leaves the close corporation a reasonable degree of flexibility and discretion in making personnel decisions concerning minority shareholder employees.

However, even when the majority shareholders can demonstrate a legitimate business purpose, under the second part of the test, the minority shareholder employee can still prevail by establishing that the business purpose could have been achieved through less drastic measures than termination. Thus, when termination decisions are challenged, courts will balance the demonstrated business purpose of the decision against the practicality of a less harmful alternative.

A RECENT EXAMPLE

A recent case, *O'Connor v. U.S. Art Co., Inc.*, illustrates how the test is applied. William O'Connor and Mark Lank were both in the business of transportation of fine arts. After meeting at various art trade shows, they began discussions which led them to form a Massachusetts corporation called U.S. Art International. O'Connor became a 37.5% shareholder and Lank became a 52.5% shareholder (two others each became 5% shareholders). O'Connor was made president and Lank was made treasurer and clerk.

After several years in business together, friction developed between O'Connor and Lank over O'Connor's bookkeeping methods and general business practices, and the two men discussed severing their business relationship. They each retained counsel to work out an agreement concerning the terms of the separation.

After several months of discussion, O'Connor and Lank appeared close to agreement. However, after an exchange of letters revealed that some significant disagreements remained, Lank abruptly took action against O'Connor. He delivered a letter to O'Connor asserting that O'Connor had "totally mismanaged the business" and advising O'Connor that the majority shareholders of the corporation had voted to terminate his services immediately. The letter instructed O'Connor to turn over all records and vacate the offices of the business. O'Connor complied but subsequently filed suit claiming that the corporation's majority shareholders violated their fiduciary duty to him.

Following a trial, a judge ruled that U.S. Art International was a close corporation and that, consequently, the four shareholders each had “some significant degree of fiduciary duty to one another, just like partners in a traditional partnership.” In deciding whether the majority shareholders breached their duty in terminating O’Connor, the judge first considered whether the majority was able to demonstrate a legitimate business purpose for the termination. Assuming it could, the judge said it must then weigh the business purpose against the practicality of a less harmful alternative.

The judge ruled that, even if O’Connor’s mismanagement and poor bookkeeping practices were the true reasons for the majority’s action, there “clearly were less harmful alternatives to firing O’Connor” and creating a situation such that O’Connor received nothing for his 37.5% ownership interest. As examples, the judge said: (1) the majority could have appointed Lank as president, hired a competent bookkeeper and made O’Connor vice president of marketing with his compensation adjusted accordingly; (2) Lank, as corporate treasurer, could have truly acted in that function and not simply as a title holder; or (3) the four shareholders could have called a meeting and discussed ways to correct the bookkeeping issues and still preserve a role for O’Connor in the international sales aspects of the business. Instead, by terminating him, the majority “assured that [O’Connor] would receive no return at all from the corporation.”

While the judge did not explicitly reject the majority’s stated legitimate business purpose (*i.e.*, to rid the corporation of O’Connor’s mismanagement and poor bookkeeping practices), he did view it with great suspicion, stating that it seemed “much more an act of pique or anger on Lank’s behalf, or perhaps some clumsy effort to gain leverage in any negotiations that might thereafter occur.” Although O’Connor’s termination may have been justified if he was just “an ordinary employee,” the judge said his enhanced status as an owner entitled him to “partner-like treatment.”

Concluding that the majority shareholders “did not act in a manner demonstrating the utmost good faith,” the judge turned to the remedy. Because the corporation was shut down following O’Connor’s termination, return to his former position was not possible. Instead, the judge focused on providing O’Connor fair compensation for his loss of wages from employment and for the loss of his 37.5% interest in the corporation. Based upon the evidence, the judge awarded O’Connor \$218,000 in damages.

WHAT SHOULD BUSINESSES DO?

What lessons can be learned from the *O’Connor* case? Clearly, in Massachusetts close corporations, management must take special care before terminating the employment of a

shareholder. In situations where the termination will serve to unjustly enrich the majority shareholders and/or deprive the minority shareholder employee of a fair return on his or her investment, any decision is subject to challenge. Even where the majority can demonstrate a legitimate business purpose for the termination, courts may hold the majority to a very high standard in considering whether the majority should have pursued an alternative less harmful to the interests of the employee.

Close corporations can reduce their exposure to minority shareholder employee claims by addressing both (1) the expectation of continued employment and (2) stock repurchase rights in written agreements with employees. Massachusetts courts recognize that an individual may contractually give up rights that he or she holds as a minority shareholder.

Thus, to avoid conferring an unintended level of job security on an employee shareholder, a corporation can address the grounds for the individual’s termination in an employment agreement. Further, the corporation can explicitly state in its stock purchase and option agreements that stock ownership confers no right to continued employment. A minority shareholder employee who expressly agrees to the grounds under which he or she may be terminated should not receive the benefit of the legitimate business purpose test, at least in circumstances where the termination does not serve to unjustly enrich the remaining shareholders.

Similarly, a buy-back provision requiring terminated shareholders to let the corporation repurchase their stock based on some agreed upon formula is generally enforceable and precludes employees from claiming that they did not receive a fair return on their investment (assuming all shareholders are subject to the same pricing formula). The shareholder employees are generally held to their express bargains. However, there are limits to a corporation’s ability to repurchase stock at a bargain price, and Massachusetts courts have warned that buy-back provisions should not be exercised oppressively or with a discriminatory purpose. Thus, for example, majority shareholders would likely be found to have breached their duty of utmost good faith and loyalty if they terminated a minority shareholder employee and repurchased his or her shares in advance of a sale of the business to deprive the employee of the additional gain the employee would have received as a result of the sale.

Lastly, the law of the state of incorporation generally governs claims concerning the internal affairs of a corporation. Thus, by incorporating under the laws of a state which does not recognize a partner-like fiduciary relationship between shareholders in close corporations (such as Delaware), a corporation reduces the risk of minority shareholder claims alleging a breach of the duty of good faith and loyalty.

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