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IN THE WAKE OF BLANK-CHOKEL-MERRIAM

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I. BACKGROUND

Business people forming closely held business entities, and their lawyers, have long sought ways to address in advance potentially contentious issues that may present themselves when the "partners," who were closely aligned when forming the entity, find themselves in disagreement, even at swords-point, years later. Well-counseled entrepreneurs may enter into contracts to address employment rights, management rights and obligations, sales of shares, and other matters, hoping to minimize the disruption of future disagreements. The imperative to address such issues in advance became greater with *Donahue v. Rodd Electric Co. of New England*, 367 Mass. 578 (1975) and its progeny establishing fiduciary obligations between and among shareholders of closely held corporations.

Fiduciary obligations implicate equitable remedies, which have the advantage of flexibility to resolve a dispute, but the disadvantage of an unpredictable outcome should a court disagree with the correctness of a shareholder or closely held entity's course of action and fashion a creative remedy with far reaching consequences for the company.[2] Thus, for example, a majority that believes it has ample justification to terminate the employment of a co-owner, absent an agreement, acts at its peril in effecting the termination and faces unpredictable and potentially harmful consequences, if the trial court hearing the dispute finds that a freeze-out or other fiduciary breach occurred and employs the flexibility of equity to impose an unanticipated remedy.

While the SJC has encouraged parties to address such fiduciary issues in advance by contract, *Merriam v. Demoulas Supermarkets, Inc.*, 464 Mass 721, 726

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[2] Consider, for example *Pointer v. Castellani*, 455 Mass. 537 (2009). In that case, the trial judge found that a minority member had been frozen out and ordered a liquidation of the company. That order was stayed pending appeal, but for 2 1/2 years, the company, which was engaged in the long lead time business of providing granite to the construction and road building industry, lived under a corporate death sentence. The SJC reversed that portion of the trial decision.

(2013), it has also cautioned that a contract among owners "does not relieve stockholders of the high fiduciary duty owed to one another in all their mutual dealings," *Blank v. Chelmsford OB/GYN. P.C.*, 420 Mass. 404, 408 (1995). That pair of pronouncements left open questions as to when a contract governed a shareholder dispute and when the litigants might find themselves back into the realm of "high fiduciary duty." *Blank*, for example, concluded that an employment agreement and stock buyout agreement protected the majority in terminating the employment of one of their co-owners and repurchasing his shares, but noted that it reached the conclusion based on the further conclusion that the majority had acted "in accordance" with the relevant contracts, leaving open the question of whether the remedy would be limited to a contract remedy, had the trial court found some contractual breach by the majority. *Id*. This, and other issues, contributed to the hazy lines between when a dispute between owners of closely-held entities would be resolved by a contract analysis and when it would be resolved under fiduciary principles.

II. CHOKEL

The Supreme Judicial Court's decision in *Chokel v. Genzyme Corporation*, 449 Mass 272 (2007), appeared to provide some clarity. In that case, a shareholder complained about the directors' determination to force an exchange of Genzyme tracking stock shares for other Genzyme shares at a time that was disadvantageous to the shareholders. The corporation's articles of organization provided for such an exchange and said the exchange could occur at any time. After stating that the articles were a contract between the corporation and shareholders, the court stated:

> When rights of stockholders arise under a contract, however, the obligations of the parties are determined by reference to contract law, and not by fiduciary principles that would otherwise govern.
>
> …

When a director's contested action falls entirely within the scope of a contract between the director and the shareholders, it is not subject to questions under fiduciary duty principles.

449 Mass at 278.

The *Chokel* Court concluded that the directors' action in effecting the exchange when they did "fell entirely within the scope" of the articles. Accepting as true the allegation that the exchange was timed "to occur when the [plaintiff's stock] was substantially undervalued", the court determined that there was, nonetheless, no breach of fiduciary duty. *Id.*

The above-quoted passages went beyond finding no fiduciary breach in the Genzyme directors' action. The court appeared to be adopting the Delaware Chancery Court's approach as reflected in *Gale v. Bershad*, 1998 WL 118022 (Del. Chancery, 1998), at *5 and *Solow v. Aspect Resources*, 2004 WL 2694916, at * 4 (Del. Chancery, 2004) where the court stated:

Because of the primacy of contract law over fiduciary law, if the duty sought to be enforced arises from the parties' contractual relationship, a contractual claim will preclude a fiduciary claim. This manner of inquiry permits a court to evaluate the parties' conduct within the framework created and crafted by the parties themselves.

The SJC's pronouncement in *Chokel* that "[w]hen a director's contested action falls entirely within the scope of a contract between the director and the shareholders, it is not subject to questions under fiduciary duty principles," is consistent with the Delaware formulation, and seemingly established a bright line rule that where a contract is on point, determinations of liability and remedy will be made in accordance with contract law, even if the party relying on the contract to fend off fiduciary claims was in breach of the contract. The uncertainty on that point left by *Blank* was now resolved, or so it seemed. The SJC decisions that followed *Chokel* clouded this momentary clarity and left those who follow the court to wonder whether it was perhaps uncomfortable with where *Chokel* might lead.

III. PUBLIC V. PRIVATE

Because Genzyme was a publicly-held company, arguments were advanced that *Chokel's* holding did not control in a closely-held entity dispute. The SJC has ruled both ways on this issue since it decided *Chokel*. It is probably now clear that *Chokel* does in fact apply to closely held entities, but the SJC's short swing inconsistent history of dealing with the question is worth a look and may be indicative of concerns it had with the potential impact of the decision.

The SJC's first post-*Chokel* pronouncement on the public/private issue occurred in its *Pointer* decision, two-and-a-half years later. In *Pointer* the defendants, relying on *Chokel*, argued that the termination of Pointer could not be a freeze-out because Pointer was employed under an employment agreement that provided circumstances under which he could be terminated. The termination, defendants argued (and the Court did not say otherwise), fell "entirely within the scope of a contract." The SJC said, however, that *Chokel* was "easily distinguished" because it involved "a corporation whose stock was publicly traded." *Pointer v. Castellani*, 455 Mass. at 554.

Three short months later, the plaintiffs in *Fronk v. Fowler*, 456 Mass 317 (2010) were undoubtedly surprised to learn that the holding in *Chokel* so clearly applied to private entities that their failure to recognize the principle when they pressed a fiduciary claim notwithstanding the existence of an on-point contract provision, rendered their claim one that was sanctionable as frivolous. *Id.* at 515-516. The court, in part, supported its holding by asserting that *Chokel* did not assert a new rule, but essentially restated the principle set out in *Blank. Id.* at 331.

The SJC decisions since *Fronk* uniformly have applied *Chokel* to closely held entities. *See Merriam v. Demoulas Supermarkets, Inc.*, 464 Mass. 721 (2013); *Selmark Associates, Inc. v. Ehrlich*, 467 Mass. 525 (2014). This now seems to be a settled point, but it certainly travelled a peculiar path through *Pointer* and *Fronk.*

III. WHEN THE CONTRACT IS BREACHED

The Delaware articulation referred to above and the language of *Chokel,* delivered the message that where a contract entirely covers the subject of a closely held entity controversy, "the obligations of the parties are determined by reference to contract law, and not by fiduciary principles," and "not subject to questions under fiduciary duty principles." 449 Mass at 278. The plain import of these words is that fiduciary duties are irrelevant whether or not the party relying on the contract is found to have breached it; a contractual remedy, not a fiduciary one, will apply in the event of a breach.

The point is an important one. Parties can breach contracts in good faith. The majority may genuinely believe that they have cause to terminate an underperforming co-owner only to be told at the end of the trial that the trial judge disagreed. A different judge might have agreed with them. If the application of the *Chokel* rule depends upon whether a breach of contract occurred, the rule does little to provide predictability to owners of a closely held entity who attempt to corral future uncertainty by carefully crafted contracts. The post-*Chokel* cases appear to retreat from the *Chokel* line and make breach again relevant.

The SJC in *Pointer* distinguished *Blank and Merola v. Exergen Corp*, 423 Mass. 461 (1996), two cases in which contracts precluded fiduciary liability, by noting that those cases involved terminations that were consistent with applicable employment contracts. *Pointer*, 455 Mass. at 554. In *Merriam* the court said that "[w]e have allowed a party to proceed with fiduciary claims [notwithstanding a contract that covered the subject of the dispute] where the contract was breached," 464 Mass at 727, n. 14 citing to *Pointer*, *Id*.

There is perhaps room to argue that neither *Pointer* nor *Merriam* intended to limit the contract protection to circumstances where the party seeking to fend off a fiduciary breach claim had not breached the contract relied upon, and that the words of *Chokel* are to be taken at face value. In light of the *Pointer* and *Merriam* decisions, however, counsel advising owners should, at the very least, caution them that the contract protection they think they have may be illusory.[3]

IV. "ENTIRELY WITHIN"

Another source of uncertainty with respect to where the line between contract and fiduciary duty principles lies is the *Chokel* formulation that the directors' contested action must fall "entirely within" the scope of a contract in order for contract analysis to preempt fiduciary principles. Little has been written to give guidance as to what "entirely within" means. In *Beninati v. Borghi*, 2014 WL 4639447 (Sup. Ct. July 2014), a defendant who was an owner of a closely held entity (the "Original Entity") engaged in operating health clubs went about setting up facilities that would compete with facilities owned by the Original Entity. When he was sued by his co-owners, the defendants relied on a contract provision that permitted owners of the Original Entity to operate competing facilities so long as those facilities were not within a 50-mile radius of a health club facility owned by the Original Entity. The defendant argued that plaintiff could only have a breach of contract remedy and could only recover damages to the extent they arose from competition in contravention of the agreement. The court rejected that argument, in part, because defendants' conduct went beyond opening health clubs within the prohibited radii and included misappropriation of confidential information belonging to the Original Entity and the use of employees of the Original Entity, while those employees were being paid by the Original Entity. *Id*. at *26. The court, thus, reached the conclusion that the contested activity was not entirely within the scope of the contract provision because the defendant's fiduciary breaches went beyond engaging in competition within the protected geographic spheres.

In *Gatof v. Northland Investment Corporation*, 2014 WL 5819364 (Mass. Sup. Oct. 2014) the plaintiff was party to a non-competition agreement with defendant. Defendant alleged that the plaintiff usurped a corporate opportunity and

[3] Two Superior Court decisions seemingly go the opposite way on this issue. In *Beninati v. Borghi*, 2014 WL 4639447, at *26 (Mass. Sup, July 2014). Judge Sander's comments suggest the *Chokel* rule will apply only when there is no breach of contract. However, in *Gatof v. Northland Investment Corporation*, 2014 WL 5819364 Mass. (Sup. Oct. 2014), Judge Curran's dismissal of fiduciary claims in the face of potential contract breaches, adopted the other view.

assisted, advised and invested in a competing business. The court concluded that usurping a corporate opportunity was "competition" and, therefore, the conduct in issue fell entirely within the non-competition agreement. *Id*. at *3. The breach of fiduciary duty counterclaim asserted against the plaintiff was dismissed. *Id*.

As noted in footnote 2, the court in *Gatof* appeared to be of the view that whether or not the contract breached was irrelevant, while the court in *Beninati* appeared to be of the view that a breached contract will not preclude a fiduciary claim. It is a little difficult in the *Beninati* case to separate that issue from the "entirely within" analysis, but the two cases illustrate that what is "entirely within" the scope of a contract asserted to preclude fiduciary breach claims can be subject to interpretation dependent on a myriad of fact patterns and the source of uncertainty when analyzing a shareholder dispute.[4]

V. GENERAL/SPECIFIC

In *Puro v. Popkins* 2009 WL 3082924, (Mass. Superior, August 2009), defendants argued that there should be a distinction between general and specific contract provisions and that the teaching of *Chokel* should only apply to specific provisions. In that case, defendants challenged the trustees' fifty-year extension of the duration of a trust formed to hold real estate. Defendants asserted that they had assurances that their interest would be liquidated well before the end of the initial expiration period and asserted fiduciary breach claims challenging the extension. The trustees moved for summary judgment based, in part, on *Chokel*, asserting that the trust instrument expressly permitted the trustees to amend the trust instrument. Defendants argued that that generic provision was too general to preclude all fiduciary claims arising from extending the trust. The court denied the motion on other grounds, but defendants' argument in that case raises a significant issue. Can open-ended, generic grants of authority be given effect under *Chokel* to preclude fiduciary breach claims for all actions that fit within the broad stroke grants of power?

The SJC in *Selmark Associates Inc. v. Ehrlich*, 467 Mass. 525 (2014), came close to addressing the general/specific issue. In discussing the *Chokel* analysis, it stated: "As the *Blank* and other cases make clear, to supplant the otherwise

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4 In *One to One Interactive v. Landrith*, 76 Mass. App. Ct. 142, (2009) defendants asserted that fiduciary duty claims were precluded by *Chokel* based on a term sheet that covered the subject matter of the dispute. In the early phases of the litigation, defendants maintained that the term sheet was not a binding contract. They asserted the *Chokel* defense only after the trial court ruled that the term sheet was a binding contract. *Id.* at 146. Under the forceful language of *Chokel*, the defendants' original position should not matter. If a contract governs, the fiduciary claim should fail. Defendants also did not object to fiduciary duty instruction to the jury so this could be a waiver-based decision, but the decision seems to say that a party cannot both deny a contract is binding and rely on it to bar fiduciary claim, even if the court determines the contract to be binding.

applicable fiduciary duties of parties in a close corporation, the terms of the contract must clearly and expressly indicate a departure from those obligations." *Id.* at 539. "Clearly and expressly" is not necessarily the same as "specifically," and some courts might find a general grant of authority "clear and express", but the *Selmark* formulation suggests that the SJC does expect contract language sufficiently specific to eliminate doubt that fiduciary standards are being overridden.

VI. GOOD FAITH AND FAIR DEALING

In some circumstances, succeeding with an argument that fiduciary obligations are eclipsed by a contract that entirely preempts an issue, may bring a party full circle to an analysis not that different from the fiduciary breach.

The covenant of good faith and fair dealing is implied into every contract in the Commonwealth and, as noted in *Chokel*, in entity formation documents such as articles of organization. *Chokel* 449 Mass. at 275. The articulation for a fiduciary breach and a breach of the covenant are not very different. With respect to the covenant, the SJC said in *Chokel*, "[a] breach occurs when one party violates the reasonable expectations of the other." *Id.* at 276. In *Brodie v. Jordan*, 447 Mass. 866, 870 (2006), in defining one form of fiduciary breach among owners of a closely held entity, the court stated that "the wrongdoing in a freeze-out is the denial by the majority of the minority's reasonable expectations."

The *Merriam* decision shed some light on when conduct otherwise apparently permitted by formation documents could be a violation of the covenant of good faith and fair dealing. In that case, the court concluded that shareholders who had complied with provisions in corporate articles with respect to offering their shares to the corporation were free to sell those shares to a third party, even if the sale would destroy the company's Subchapter S election under the Internal Revenue Code. *Merriam*, 464 Mass. at 729. The Court noted that might not always be the conclusion. It pointed to the First Circuit's decision in *A.W. Chesterton Co. v. Chesterton*, 128 F. 3d. 1, 4 (1st Cir. 1997), which held that a shareholder who orchestrated a sale of his shares in a closely held corporation to a shell corporation for the sole purpose of terminating the closely held company's favorable tax status, breached his fiduciary duty. The SJC said such facts would give rise to a viable claim for breach of the covenant of good faith and fair dealing:

> In factual circumstances like those presented in *Chesterton*, our decision in *Blank*…would control, providing a viable claim of breach of the implied covenant of good faith and fair dealing.

Id at 15.

And so, a course of conduct facially permissible under a governing contract might nonetheless give rise to a claim under the implied covenant where the actor had an improper purpose or vindictive motive. A case in which the trial court determined fiduciary claims were barred by an all-encompassing contract may end up being litigated over questions of intent, and if an improper intent found, the contract protection lost.

VII. HYPOTHETICAL

The issues raised by the authority cited above may be illustrated by the following hypothetical facts:

> Six investors form Wonder Widgets LLC ("WW") to exploit technology developed and owned by Eddy Equity, one of the members. Eddy's investment took the form of granting WW a royalty-free license. The six investors agree at the outset that all six will be equal 1/6 members, but designate three to be managers. Eddy is not a manager but he is on the payroll and has unfettered access to WW's financial records and compensation records reviewed by the managers. The WW Operating Agreement provides that a manger may be removed by a majority vote of the members, but he/she continues as a manager until removed. It also provides that the managers may select the executive officers of the company and that executive compensation is left to the sound discretion of the managers, but requires annual consultation with the full group of members and with WW's accountants before setting compensation. Available profits are to be distributed pro rata. The Operating Agreement permits any member to be a passive investor in other businesses, even those that compete with WW.

After several profitable years, the managers, who from the beginning served as executives of WW, decide to modify their compensation plan to include a formula-based bonus. The first year, before the plan was implemented, the managers consulted with all members and the accountants, as required. The bonus plan rewards the executives more than expected and leaves little profit to be distributed, but the managers renew it each year, without consulting with the members and the accountants.

Eddy Equity objected to the executive compensation formula from the outset and after a few years he seeks a vote of all members to end it, but is unsuccessful. The managers eliminate Eddy's position and curtail his access to the firm's records. With that, he has had his fill of the managers' conduct and the lack of profits. Under the license agreement, he is obligated to license to WW any refinements and improvements of the original technology so long as there are no breaches of the Operating Agreement or license but WW has no claim to any invention of Eddy based on a different technology. Eddy develops a different technology that will accomplish the same end as the WW technology and invests in World Wide Widgets by granting it a royalty-free license in the new technology. WWW begins competing with WW and Eddy begins to enjoy profits.

The WW managers threaten to sue Eddy for fiduciary breach for providing technology to a competitor and Eddy threatens to sue the managers for denying the WW members reasonably expected profits and for freeze-out. Both sides assert they are protected by the terms of the Operating Agreement.

It would be difficult assessing for either side their prospects for succeeding in the litigation based on the analyses set forth in cases discussed above. The Operating Agreement addresses the issue of executive compensation and vests the managers with the exclusive authority to set the compensation. Certainly, a good argument could be made that establishing the bonus plan was squarely addressed by contract and so, under *Chokel*, there is no room for a fiduciary breach claim. But, as time went on, the managers did not act in full compliance with the agreement. Does that breach throw the whole dispute back into the fiduciary arena? And, the members might plausibly argue that their reasonable expectation of sharing in profits through fairly allocated distributions had been thwarted by the managers' overly generous compensation to themselves. Is the Operating Agreement sufficiently specific to preclude a fiduciary breach claim, and might there be a claim for violating the covenant of good faith and fair dealing.

Eddy's side has some blemishes, too. Does the Operating Agreement's consent for Eddy to invest in competing organizations go so far as to permit him to create a new competing technology to help launch a competing business? He invested in WW by providing technology, so maybe that helps him argue he did nothing more than make the permitted passive investment. But what about his motives? Might this have been a vindictive plan to get even that opens the specter of a good faith and fair dealing claim against him?

VIII. CONCLUSION

There is no doubt that the best course of action for those forming closely held entities is to enter into agreements to address the relationships among and between the equity owners and to provide solutions for predictable types of disputes. In most circumstances, the agreements formed in advance will address the problems that arise. But in the wake of *Blank-Chokel-Merriam*, there are still uncertainties about the boundaries that will define when contract and fiduciary principles control. It may not be until litigation is concluded that parties will know if challenged conduct is "entirely within the scope" of a contract provision, whether that provision is sufficiently explicit to trump fiduciary principles, or whether the covenant of good faith and fair dealing will implicate an analysis not very different from the fiduciary one. The measure of clarity promised by *Chokel*, continues to be elusive.

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