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Good faith and loyalty: Navigating the troubled waters of company ownership disputes

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There has been an uptick in the number of stockholder and internal company disputes in closely held companies over the past couple of years. This trend likely has its genesis in the recessionary economy, and many of these disputes have erupted recently due to modest improvements in economic and market conditions. Poor economic conditions and difficult real estate market environments place a strain not only on business finances, but also on the personal and professional relationships of the owners. Many businesses have been holding on, tightening their belts, and waiting for market and economic conditions to improve. When all of the typical measures have been taken, it is natural for board-level executives and equity owners to look across the table to examine the overall contributions of their business partners. Now that some companies are seeing signs of better times ahead, some equity owners realize they are unwilling to carry underperforming partners into the improving economy. They might feel the arrangement cannot be sustained economically or morally.

Owner relationships can be complex, involving friendships, families, power dynamics and personalities. In close companies in Massachusetts, fiduciary duties of "utmost good faith and loyalty" among owners add additional concerns. Amidst all of these factors, the question often arises, "what can an owner do to address unequal or depleting contributions of bad business partners"? If those matters cannot be resolved cooperatively, there really are two avenues available to business owners that are legally tenable.

The first place for any business owner to turn is to the governing documents of the company. Corporations and limited liability companies are creatures of statute. The law creates a backbone for these types of entities, but the statutes really leave the fleshing out to the forming parties. Much that detail is found in the formation documents, which may include a stockholder agreement or operating agreement. Carefully drafted documents will address termination of stockholders or members with or without cause, and may also provide a mechanism for redeeming terminated interests at book or market value depending on the circumstances. Massachusetts courts have held that the typical fiduciary duties of good faith and loyalty with respect to rights on termination or stock purchase "do not arise when all of the stockholders in advance enter into agreements concerning termination of employment and for the purchase of stock." The bottom line is that Massachusetts law allows parties to draft agreements to address these issues, so the process for resolving the dispute may already have been scoped out in the governing documents.

The next logical question is "what happens when my governing documents do not provide for termination and redemption"? Admittedly, the path is harder without the help of contractual provisions, but not impassible. The fiduciary duties among close company owners do not prevent all action against minority interests. Massachusetts law recognizes that, even in close companies

where heightened duties apply between owners, the majority interests "must have a large measure of discretion" to run the business. The courts attempt to balance the rights of majority and minority interests. The majority owners can take action against a minority owner, including termination, when (1) it serves a legitimate business purpose, and (2) there is no less harmful alternative to achieve the same purpose. Terminating a minority owner and forcing them out of a company is a pretty extreme measure, so it is not an easy balancing test to meet. Ordinary differences of opinion or technical disagreements about business management may not be enough. The lens really must focus on matters related to the best interests of the business as a whole.

Intra-company disputes at the owner level are commonplace these days. Many sophisticated business owners and operators have faced them in the past and may be confronting them right now. Wading into these waters requires caution and sober judgment. There undoubtedly are safe courses to travel, but mistakes can be costly and land the owners of a business in court, where the focus is taken away from successfully running the business in a challenging economy.

This material is intended for informational purposes only. It is not meant to be construed as legal advice nor create an attorney client relationship. For a comprehensive understanding of the issues raised in this material please consult with a qualified attorney of your choice.

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