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Preventive legal medicine to avoid shareholder disputes: workable fair-value buy-sell agreement - by Roger Durkin

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Durkin Law defends licensed real estate appraisers and CPAs who are charged with violation of license board regulations. Durkin Law also represents shareholders, partners, and LLC members in business ownership disputes. Shareholder legal disputes involve freeze-outs and/or a form of fiduciary embezzlement wherein controlling owners take unjustified high salaries, misuse credit cards, take other benefits of personal travel, company cars, retirement plans, charging personal purchases to the company, siphoning off available cash, or other breaches of fiduciary duty. We are to some extent experts in valuation issues, appraisal regulations, and shareholder disputes. Like, Farmers Insurance, “We know a thing or two because we’ve seen a thing or two”.

If you are a shareholder or business partner, or member of an LLC, you should consider preventive legal medicine in the form of a workable fair-value buy-sell agreement. This is especially true for family owned businesses. A buy-sell agreement is intended to avoid shareholder/LLC member legal disputes. Shareholder agreements are specifically recognized by Massachusetts statute and case law. [Mass. Gen. Laws ch. 156D, §§ 7.307.32 (2005)]. Delaware law for issues involving breach of fiduciary duty and Mass law for shareholder agreements and statute of limitations. Mass. shareholder agreements are valid for ten years if signed by the shareholders and approved by the directors. The court in Donahue v. Rodd Electrotype held that stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another. The court defined that standard of duty owed by partners to one another as the “utmost good faith and loyalty.” Cardullo v. Landau, 329 Mass. 5, 8 (1952). DeCotis v. D’Antona, 350 Mass. 165, 168 (1966). Stockholders in close corporations must discharge their management and stockholder responsibilities in conformity with this strict good faith standard. Donahue v. Rodd Electrotype Co. of New England, Inc. 367 Mass. 578 (Mass. 1975) continues to be the leading case regarding the fiduciary duties of shareholders in closely held Massachusetts corporations.

Many people start businesses with friends but what happens if one of the owners, partners, shareholders becomes physically sick, or sick of the business, dies, divorces, or just wants to retire? All business entities should have an agreement to enable its owners to end their relationship without

litigation. Statutes and case law require corporations or LLCs to treat minority shareholders with good faith and loyalty. Under the law, owning 51% of the shares does not give you total control.

If you operate a corporate enterprise with two or more shareholders, you could face emotional and financial costs of a serious shareholder legal dispute over the value of the business. You should have a workable shareholder exit strategy in the form of a buy-sell agreement that works! Do it before a shareholder dies, gets divorced, becomes seriously ill, or simply wants to leave the business.

There are many reasons that owners fail to create a buy-sell agreement including inertia, legal cost, fear of causing strife, and not believing such buy-sell agreements are necessary. Not having a buy-sell agreement could lead to uncertainty and costly litigation. The critical lesson for any owner comes too late. Owners should create the appropriate buy-sell agreements at the onset of the relationship and revise the agreement periodically. The owners' buy-sell agreement should address death, disability, retirement, or termination. The agreement transforms a previously illiquid investment into a liquid one. A buy-out mechanism is vital if owners no longer get along.1 Most buy-sell agreements are seriously flawed.

This flawed type buy-sell agreement leads to emotionally charged legal disputes. A buy-sell agreement should not be the common kind found in pre-printed By-Laws. The typical format requires one side to pick an appraiser and the other side to pick an appraiser. If the two appraisers cannot agree on a value, then the two appraisers get to pick a third appraiser. Then where two of the three agree, the value issue is settled. No, no, and no. The type of value is not fair market value or market value. The standard of value in Massachusetts for shareholder dissension is fair value defined in Massachusetts General Laws 156D, § 13.01: The Massachusetts approach to the determination of "fair value" is consistent with the position taken by the American Law Institute and the national trend of interpreting "fair value" as the proportionate share of a going concern without any discount for minority status or lack of marketability. [American Law Institute, Principles of Corporate Governance, § 7.22(a) (1994)] The old buy-sell system just does not work. Seriously flawed agreements are worse than no agreement. A situation where there is no agreement or there is a flawed agreement can and usually does lead to a costly legal dispute.

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1 Marc Laredo, Shareholder Duties & Disputes in Closely-held corporations in Massachusetts. 99 Mass Law Rev. 53 (2018)