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THE EMPLOYEE-SHAREHOLDER: AT THE FRONTIER OF BUSINESS AND EMPLOYMENT LAW[1]

By David E. Belfort and Michael L. Mason

In many closely held corporations, the rights and responsibilities of shareholders, officers, and directors are impacted by these individuals' employment relationship with the company. Likewise, the traditional employment relationship may be significantly modified when an individual possesses an ownership interest in a corporation. This article explores the fundamental issues raised by the rights and obligations of the employee-shareholder in Massachusetts under rapidly evolving precedent.

1. Introduction: Rise of the employee-shareholder

Corporate law and employment law are traditionally conceived of as two distinct bodies of law, with corporate law governing the formation and governance of corporate business entities and employment law governing the respective rights and obligations of employers and employees. Changes in the business corporation statutes, tax regulations, insulation from liability and other factors have increasingly led co-venturers in small businesses to choose the corporate form over partnership. Statistics reveal that these small corporations are becoming an increasingly relevant segment of our economy. As of 2005, there were 637,800 small businesses in Massachusetts.[2] In 2003 alone, small businesses created 29,934 new jobs in Massachusetts, nearly a 30 percent increase from the previous year.[3]

In many so-called "closely held" corporations, shareholders who own and control the corporation also serve as employees.[4] Often, they are the only employees. As a result, the line of demarcation between the corporation and its employees, and, by extension the border between corporate law and employment law, is blurred.

In this context, overlapping issues arise to complicate the black letter law of corporations and employment, particularly during an employee-shareholder's separation from the corporation. When advising clients, corporate counsel must take into account the influence of employment law principles, and employment counsel must consider how an employee's corporate ownership alters the traditional employment relationship. For example, employment counsel may be called upon to determine to what degree one's status as a shareholder affects the typical "at will" nature of employment. Similarly, corporate counsel may be asked to give an opinion as to the degree to which one's status as an employee-shareholder affects his or her obligations to the corporation.

Massachusetts courts have increasingly dealt with these issues since the landmark *Donahue v. Rodd Electrotype* case was decided in 1975. In *Donahue*, 367 Mass. 578, 593 (1975), the Supreme Judicial Court held that shareholders in a closely held corporation owe one another a duty of "utmost good faith and loyalty." As the number of closely held corporations has grown, so has the number of employee-shareholders. While a number of gray areas remain, there exists a distinct and evolving body of case law to which both corporate and employment counsel may look for guidance in clarifying the employee-shareholder's rights and obligations. While specialized knowledge of both practice areas is not required, there is a significant interplay and overlap between corporate and employment law in cases involving shareholder-employee rights and obligations in closely held corpora-

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tions. In order to provide effective legal advice, counsel must recognize the areas of overlap and the nature of the interplay between these two areas of law.

2. Enhanced rights of the employee-shareholder

In general, the employee-shareholder enjoys enhanced job protection as compared to the ordinary "at will" employee. In *Wilkes v. Springside Nursing Home, Inc.*, 370 Mass. 842 (1976), the SJC applied the "utmost good faith and loyalty" standard applicable to shareholders in closely held corporations to the employment relationship. In the *Wilkes* decision, the SJC recognized that minority employee-shareholders were vulnerable to being deprived of their ownership rights and benefits through termination of their employment by the majority. *Id.* at 849. While the court confirmed the majority shareholders' discretion in managing corporate affairs, it also affirmed the employee-shareholder's right to enhanced protection against being "frozen out" of corporate affairs through termination.

The Court found that majority shareholders must demonstrate a legitimate business purpose for terminating the minority shareholder's employment. *Id.* at 851. If the majority is able to demonstrate a legitimate business purpose, the burden shifts to the minority shareholder, who must then demonstrate that the same objective could have been achieved through a less harmful course of action. *Id.* at 850-52. The court will then weigh the proffered legitimate business purpose against the practicability of the less harmful alternatives. Under the *Wilkes* doctrine, an employee-shareholder may not be terminated as long as a practical, less harmful alternative exists. As such, an employee-shareholder may enjoy significantly enhanced job protection as compared to the typical "at will" employee.

The line of cases following *Wilkes* illustrates the relative weight assigned to the employee-shareholder's rights as compared to the interests of the corporation. In *O'Connor v. U.S. Art Co., Inc.,* No. 031728BLS, 2005 WL 1812512 (Mass.Super. June 27, 2005), the Superior Court (van Gestel, J.) relied upon *Wilkes* in finding that an employee-shareholder who was terminated for "poor bookkeeping practices that left receivables unaccounted for and payables outstanding" was wrongfully terminated in contravention of the fiduciary duty owed by the majority. *Id.* at *9. "With an ordinary employee not entitled to partner-like treatment, the termination of O'Connor may have been justified," the court held. *Id.* at *10. "Given O'Connor's enhanced status as an owner, however, [the other shareholders] did not act in a manner demonstrating the utmost good faith." *Id.*

In finding for the plaintiff, the court identified several practical and less harmful alternatives available to the majority:

> For example, U.S. Art International's controlling group could have appointed [the majority shareholder] as president, hired a competent bookkeeper and made O'Connor vice president of marketing, with an adjustment in compensation to a modified salary-plus-commission based compensation. Or the company treasurer, who from day one always was [the majority shareholder], could have acted in a treasurer's function, not simply as a title holder. Or the stockholders could have called a real meeting and discussed among the four of them ways and means to correct the bookkeeping issues and still preserve a role for O'Connor in the international sales aspects of the business, in which no one said his skills were lacking. **Indeed, there are, this Court is confident, numerous other rational business means for solving the bookkeeping issues short of firing O'Connor and shutting down the business. (*Id.* at *10)**

As in *Wilkes*, the *O'Connor* court recognized that the plaintiff "was cut off from all further salary and received no compensation whatsoever for his . . . interest in the company." *Id.* Because the majority deprived the plaintiff of his return on investment and failed to pursue the least harmful means of achieving their stated purpose, the court held that it breached its fiduciary duty to the plaintiff.

Leslie v. Boston Software Collaborative, Inc., No. 010268BLS, 2002 WL 532605 (Mass. Super. Feb. 12, 2002), presents an even more extreme example of the primacy of employee-shareholder rights. In *Leslie*, the court found that an employee-shareholder who spent too much time working on personal matters in the office, swore too much at inappropriate times, used crude ethnic slurs, and was rejected by customers nevertheless was protected under the *Wilkes* doctrine. *Id.* at *3. Despite the business purpose underlying the plaintiff's termination, the court held that the majority nevertheless failed to afford him "the utmost good faith and fair dealing." *Id.* at *8. The court found that a number of less harmful alternatives existed, including insulating the plaintiff from employees, directing him to upgrade his technical skills, and utilizing "creative compensation techniques" to provide incentives for him to modify his behavior. *Id.*

Given the current interpretation of the *Wilkes* doctrine in the courts, it is fair to assume that, in determining whether an employee-shareholder has been wrongfully terminated in violation of the majority's fiduciary duty, a court will give great weight to the majority's consideration of alternative courses of action.

It is important to note that not every employee-shareholder is entitled to heightened job security. In *Merola v. Exergen Corp.*, 423 Mass. 461 (1996), the SJC found that the majority shareholders in a closely held corporation did not breach any fiduciary duty to the plaintiff employee-shareholder when the corporation terminated his employment. Although the court held that "there was no legitimate business purpose for the termination of the plaintiff," he nonetheless "failed to establish a sufficient basis for a breach of fiduciary duty claim." *Id.* at 466.

The *Merola* plaintiff did not own a significant number of shares in the corporation, and he was not an officer or director. Rather, the plaintiff was apparently an ordinary employee who had purchased his shares through an employee stock option program subsequent to his hiring. *Id.* at 463. In declining to find a breach of fiduciary duty in the plaintiff's termination, the Merola court relied upon the fact that, in this case, "investment in the stock was an investment in the equity of the corpo-

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ration which was not tied to employment in any formal way." *Id.* at 465. Unlike the *Wilkes* plaintiff, the *Merola* plaintiff did not depend on his salary as the principal return on his investment. *Id.* at 464-65. Rather, any return on his stock investment was "independent of the salary he received as an employee." *Id.* at 465.

In deciding whether a breach of fiduciary duty has occurred, it is not the mere fact of stock ownership that determines the duty owed to the employee-shareholder. Instead, *Wilkes, Merola,* and other cases reflect the fundamental principle that the *Wilkes* doctrine is intended to protect those whose employment and ownership interests are inextricably linked, and those whose employment provides a means of return on their investment.

Employee-shareholders who are wrongfully terminated may recover directly from the offending majority shareholders in the form of equitable remedies, including unjust enrichment, lost wages and compensation for lost ownership. *See Wilkes*, 370 Mass. at 853-54; *O'Connor*, 2005 WL at *11.

3. Obligations of the employee-shareholder

Employee-shareholders owe significant duties to the corporation and their fellow shareholders. Massachusetts courts have held that an employee-shareholder violates his fiduciary duty when he actively competes against the corporation. *Chelsea Indus., Inc. v. Gaffney*, 389 Mass. 1, 11-12 (1983); *Cain v. Cain*, 3 Mass. App. Ct. 467, 474 (1975). One also breaches his or her fiduciary duty by, *inter alia*, soliciting customers, accepting unauthorized commissions and kickbacks, and entering into a course of conduct designed to harm the employer's reputation during the period of employment. *See Augat, Inc. v. Aegis, Inc.*, 409 Mass. 165, 173 (1991); *In Re: Tri-Star Tech. Co.*, 257 B.R. 629, 636 (D. Mass. 2001); *Tech Plus, Inc. v. Ansel*, No. 96-01668-B, 1999 WL 482329, at *6 (Mass. Super. Mar. 22, 1999).

However, an employee-shareholder does not breach his fiduciary duty by merely preparing to compete with the corporation. *Chelsea Indus.*, 389 Mass. at 10 (finding that the employee defendants "had the right to plan and prepare for creation of a competing business while carrying on the normal duties of their employment and receiving compensation for their services without disclosing their plans to the plaintiff employer"); see also *Meehan v. Shaughnessy*, 404 Mass. 419, 435 (1989) (holding that departing law firm partners who secretly set up new law firm and made other "logistical arrangements" during their tenure did not breach their fiduciary duty); *Augat, Inc. v. Aegis, Inc.*, 409 Mass. 165, 172 (1991) (employee may plan to go into competition with employer and has no duty to disclose plans).

These obligations are in line with those owed generally by shareholders in closely held corporations, as well as by directors and officers. However, the duties owed by an employee-shareholder are greater than those owed by an ordinary employee. By way of contrast, an "at will" employee with no ownership interest may take active steps to compete with his employer during his employment, and he has no duty to disclose these plans. *Augat, Inc.*, 409 Mass. at 172. An employee-shareholder may not actively compete, and must disclose any plans to do so.

Employee-shareholders who are found to have violated their fiduciary duties by actively competing during their employment, soliciting customers or employees, usurping corporate opportunities, and the like, are liable for damages that include, *inter alia*, any "secret profit or benefit received" as a result of their wrongful activities, forfeiture of compensation paid by the employer "which exceeded the worth of the employee's services," and the employer's increased costs resulting from the employee-shareholder's breach. *See In Re: Tri-Star Tech. Co.*, 257 B.R. 629, 636-38 (D. Mass. 2001); Chelsea Indus., 389 Mass. at 16-18.

4. Effect of shareholder agreements

The rights and obligations detailed above can be modified through voluntary agreement, particularly in the form of shareholder agreements and employment agreements. The case law demonstrates that these agreements may supersede the general, common law principles in areas specifically addressed. However, the general principles will still govern the parties' relationship to the extent that any valid agreements do not apply.

In *King v. Driscoll*, 418 Mass. 576 (1994), the SJC held that the stock buy-back agreement between shareholders in a closely held corporation did not relieve them of their duty of utmost good faith and loyalty. *Id.* at 586. Although the plaintiff, a departing shareholder-employee, was subject to this agreement and did not take issue with its terms, the court nonetheless found that the plaintiff's fellow shareholders violated their duty of utmost good faith and loyalty during the series of events leading up to the plaintiff's termination, most notably their vote to terminate his employment in response to his participation in a derivative suit. *Id.* As such, even though the parties had entered into an agreement governing their separation, the *Wilkes* doctrine nevertheless protected the plaintiff employee-shareholder.

The *Blank v. Chelmsford OB/GYN* case presented the SJC with a variation on *King*. *See* 420 Mass. 404 (1995). In *Blank*, the SJC found that, where an employment agreement provided for termination by either party upon six months' notice and a shareholder agreement provided for stock buy-back, a shareholder-employee who was terminated with the specified notice and paid the agreed upon value for his shares could not state a claim for breach of fiduciary duty arising from his termination. While the court acknowledged that the mere fact of the parties' agreements did not relieve shareholders of the "high fiduciary duty" owed to one another, it held that the parties' contractual provisions governing termination and stock repurchase defined their duties:

> [Q]uestions of good faith and loyalty with respect to rights on termination or stock purchase do not arise when all the stockholders in advance enter into agreements concerning termination of employment and for the purchase of stock of a withdrawing or deceased stockholder. (*Id.* at 408, citing *Don-*

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ahue, 367 Mass. at 598 and *Evangelista v. Holland*, 27 Mass. App. Ct. 244, 248-49 (1989))

The SJC found that, even though the duty of utmost good faith and loyalty exists, it "is to be evaluated in light of an agreement that permits termination by either party without cause on notice." *Id.* at 408-09. Because the applicable agreements governed the plaintiffs' claims, and because he did not allege that the majority shareholders breached either agreement, the plaintiff's claims were dismissed. *Id.*

5. Conclusion

Applicable precedent clearly protects employee-shareholders whose employment represents a means of return on their investment from being "frozen out" by majority shareholders through termination. In addition, by virtue of their ownership interest in a closely held corporation, employee-shareholders owe strict duties to the corporation and to their fellow shareholders. Shareholder agreements and employment contracts do not obviate these rights and duties, but such covenants effectively alter shareholder employee rights and duties relative to the corporation.

In advising clients in cases involving employee-shareholders in closely held corporations, counsel should consider that an employee-shareholder's actions in the employment sphere may violate his or her fiduciary duties to the corporation. Likewise, counsel should be aware that employment determinations involving shareholders must be made with deference to the employee-shareholder's right to "utmost good faith and loyalty" on the part of the controlling shareholders. Whenever possible, contracts governing employee-shareholder rights and duties should be carefully considered and drafted to clarify these issues and to reflect the parties' intentions. In the context of closely held corporations, issues of corporate law and issues of employment law are often inextricably intertwined, and an understanding of the interplay between these areas of law is crucial to providing sound legal advice to closely held corporations and their employee-owners.

End notes

1. Many thanks to Claudia T. Centomini, Esq., Thomas M. Ciampa, Esq.,and Catherine E. Reuben, Esq., for their invaluable editorial assistance.
2. U.S. Small Business Administration, *Small Business Profile: Massachusetts* (2006).
3. *Id.*
4. By way of definition, Massachusetts courts have adopted the following three-part test to determine whether a corporation is "closely-held": First, the shares of the corporation must not be generally traded or offered for sale on any securities market, and there is no ready market for the corporation's stock. Second, the corporation has had, and continues to have, a small number of shareholders. Third, a substantial majority shareholder participation in the management, direction and operations of the corporation has existed since its formation. *Merola v. Exergen Corp.*, 38 Mass. App. Ct. 462, 463-64 (1995).