# MD Court of Appeals Recognizes Applicability of "Reasonable Expectations" Doctrine To Disputes Among Shareholders of Closely-Held Corporations

*By Geoffrey H. Genth, Esq.*

In its October 25, 2011, decision in *Boland v. Boland*, 423 Md. 296, 31 A.3d 529, 542-543 and 573-575 (2011), the Court of Appeals of Maryland recognized the "reasonable expectation" doctrine's applicability to disputes among shareholders of closely held corporations. (***Author's Note:*** A paginated version of Boland from the Maryland Reports is not yet available.) The Court of Special Appeals of Maryland had previously recognized the "reasonable expectations" doctrine in its reported decision in *Edenbaum v. Schwarcz-Ostreicherne*, 165 Md. App. 233, 254-261, 885 A.2d 365 (2005). To provide clients with competent advice and advocacy, Maryland litigators and transactional lawyers representing closely held corporations and/or their shareholders must be familiar with the "reasonable expectations" doctrine as recognized by Maryland's appellate courts. This doctrine, which the majority of states now recognize, represents a significant departure from a narrower view of minority shareholders as being mere at-will employees of closely held corporations, and therefore generally subject to termination for any reason or no reason absent a written employment agreement or other writing to the contrary.

As in many other states, Maryland's "reasonable expectations" doctrine has evolved to give meaning to a statutory prohibition of "oppressive" conduct by the directors or those in control of the corporation. *See* Md. Code Ann., Corps. & Ass'ns § 3-413(b)(2). Section 3-413(b)(2) authorizes any shareholder entitled to vote in the election of directors of a corporation to "petition a court of equity to dissolve the corporation on grounds that . . . [t]he acts of the directors or those in control of the corporation are illegal, oppressive, or fraudulent."

Writing for the Court of Special Appeals in *Edenbaum*, Judge Peter Krauser observed that, although the statute does not define "oppressive" conduct, "oppression" has been commonly defined to include "conduct that defeats the reasonable expectations of a stockholder." 165 Md. App. at 256. Judge Krauser stated that:

> the typical characteristics of a closely held corporation are: "(1) a small number of stockholders; (2) no ready market for the corporate stock, and (3) substantial majority stockholder participation in the management, direction and operation of the corporation". . . . "[T]he shareholder in a [closely held] corporation considers himself or herself as a co-owner of the business and wants the privileges and powers that go with ownership." Employment by the corporation is one such privilege and often is the shareholder's main source of income." Moreover, "'providing for employment may have been the principal reason why the shareholder participated in organizing the corporation.'"
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> But the very nature of a closely held corporation makes it possible for a majority shareholder to "freeze out" a minority shareholder, that its, "'deprive a minority shareholder of her interest in the business or a fair return on her investment.'"
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> The "reasonable expectations" view of oppressive conduct "[r]ecogniz[es] that a minority shareholder who reasonably expects that ownership in the corporation would entitle him to a job, a share in corporate earnings, and place in corporate management would be 'oppressed' in a very real sense [sic] when the majority seeks to defeat those expectation and there exists no effective means of salvaging the investment." But, we caution, "oppression should be deemed to arise only when the majority conduct substantially defeats expectations that, objectively viewed, were both reasonable under the circumstances and were central to the petitioner's decision to join the venture." It "should not be deemed oppressive simply because the petitioner's subjective hopes and desires in joining the venture are not fulfilled."

*Id.* at 257-258 (citations omitted).

At least as important as the Edenbaum decision's recognition of the "reasonable expectations" doctrine was the decision's clarification that, in addition to the relatively drastic remedy of dissolution, a Circuit Court sitting in equity has broad discretion to craft and to use a wide variety of other equitable remedies in cases of shareholder oppression. Judge Krauser wrote:

> While . . . § 3-413 only mentions dissolution as a remedy for oppressive conduct, we join other courts today "which have interpreted their similar statutory counterparts to allow alternative equitable remedies not specifically stated in the statute." Alternative forms of equitable relief were

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outlined . . . in [*Baker v. Commercial Body Builders, Inc.*, 507 P.2d 387, 395-396 (Or. 1973)]. They include:

(a) The entry of an order requiring dissolution of the corporation at a specified future date, to become effective only in the event that the stockholders fail to resolve their differences prior to that date;
(b) The appointment of a receiver, not for purposes of dissolution, but to continue the operation of the corporation for the benefit of all the stockholders, both majority and minority, until differences are resolved or "oppressive" conduct ceases;
(c) The appointment of a "special fiscal agent" to report to the court relating to the continued operation of the corporation, as a protection to its minority stockholders, and the retention of jurisdiction of the case by the court for that purpose;
(d) The retention of jurisdiction of the case by the court for the protection of the minority stockholders without appointment of a receiver or "special fiscal agent";
(e) The ordering of an accounting by the majority in control of the corporation for funds alleged to have been misappropriated;
(f) The issuance of an injunction to prohibit continuing acts of "oppressive" conduct and which may include the reduction of salaries or bonus payments found to be unjustified or excessive;
(g) The ordering of affirmative relief by the required declaration of a dividend or a reduction and distribution of capital;
(h) The ordering of affirmative relief by the entry of an order requiring the corporation or a majority of its stockholders to purchase the stock of the minority stockholders at a price to be determined according to a specified formula or at a price determined by the court to be a fair and reasonable price;
(i) The ordering of affirmative relief by the entry of an order permitting minority stockholders to purchase additional stock under conditions specified by the court;
(j) An award of damages to minority stockholders as compensation for any injury suffered by them as the result of "oppressive" conduct by the majority in control of the corporation.

165 Md. App. at 260-261 (citations omitted).

Until *Boland*, no reported Maryland case had directly addressed or discussed the holdings or reasoning of *Edenbaum*. In *Boland*, 31 A.3d 529, 542-543 and 573-575 (2011), the Court of Appeals recited those holdings and reasoning with apparent approval.

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data, however, the physical servers that host the virtualized servers can change from day to day. Cloud providers can move or copy virtualized servers and information at any time and information may reside in places not contemplated by attorneys and non-IT employees of a company.

While cloud computing is revolutionizing the computer industry, it is also creating additional E-discovery challenges that are difficult to articulate to a Court or negotiate with opposing counsel. The key to tackling these challenges is to be proactive: 1) Understand what types of data may be stored online with a cloud provider and its relevancy; 2) Create a data map to share with opposing counsel; 3) Determine how the information can be retrieved and test your results, and 4) Attempt to forge an agreement with opposing counsel prior to production. In the event you are unable to reach consensus with opposing counsel regarding the sources, methods of culling, and production this information should be laid out clearly to the Court at the earliest stages of litigation.

Maryland has thus fully adopted the prevailing judicial view that "'[o]ppression' and other similar terms in state statutes provide broad grounds for relief which cannot be stated with precision in advance without destroying their utility in new and unforeseen situations." *See* O'Neal and Thompson, *Oppression of Minority Shareholders and LLC Members*, § 7.12. Despite the cases' fact-dependent nature, decisions from around the country have established guidelines that include the following:

(1) Expectations need not be evidenced by a written instrument;
(2) Expectations must be important to the investor's participation;
(3) Expectations must be known to the other parties;
(4) The relevant expectations are those that exist at the inception of the enterprise, and as they develop thereafter through a course of dealing concurred in by all shareholders;
(5)Expectations can be different where the employment aspect of the relationship dominates as opposed to a situation when a shareholder has expectations of employment and ownership; and
(6)Expectations can be evidenced in an agreement, but agreements are not always complete.

*Id.* It should be noted that the holdings in *Edenbaum* and *Bo-*

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*land* apply to corporations that can or should be characterized as "closely held" in a general sense, regardless of the whether or not the shareholders have elected statutory "close corporation" status under title 4 of the Maryland Corporations and Associations Article. Conversely, those decisions do not appear to apply to disputes in which the pertinent corporation is not closely held in a general sense. Application of the "reasonable expectations" doctrine in the middle of the spectrum between closely held and public corporations is uncertain.

Maryland's recognition of the "reasonable expectations" doctrine and the variety of available equitable remedies have a substantial impact on the representation of majority and minority shareholders of Maryland closely held corporations. Depending on the facts and circumstances, it may be incorrect for a lawyer to advise a client that a minority shareholder is merely an at-will employee, whom the majority can terminate for an insubstantial reason or for no reason at all.

Having represented the minority shareholder in *Edenbaum* as well as numerous other majority or minority shareholders in shareholders' disputes both before and after *Edenbaum*, I offer the following practice tips:

(1)To try to avoid or reduce the potential for expensive, uncertain litigation, transactional counsel involved at the inception of a closely held corporation should, if possible, clearly define by written agreement the shareholders' mutual understandings as to employment duration, potential termination grounds, method for determining stockholder-employee compensation, stockholder participation in management, dispute resolution, and similar issues; at least in their traditional form, corporate by-laws and corporate "buy-sell" agreements may be totally insufficient for those purposes in view of the "reasonable expectations" doctrine;

(2) If potentially irresolvable frictions develop among the shareholder of a closely held corporation without written agreements clearly setting forth the stockholders' "reasonable expectations," shareholder counsel (whether minority or majority), as well as (if appropriate and feasible) independent corporate counsel, should carefully assess the situation and its history, in light of the numerous factors that may come into play in the event of a proceeding for dissolution and/or alternative equitable relief under § 3-413(b)(2);

(3) In the event of such frictions, minority shareholders should be sure to refrain from any conduct that, in traditional circumstances, would justify a "for cause" termination of an employee; before deciding whether or not to terminate a shareholder's employment, the corporation should perform a careful review of the situation and its history to try to assess the chances that, if challenged, a Maryland court would find the termination to have been "oppressive"; relevant factors include the length of a minority shareholder's involvement relative to the corporation's history and the majority shareholders; all other factors being equal, courts seem to regard the expectations of "original partners" with more sympathy than the expectations of employees who join an already successful going-concern and receive an equity interest as part of an employment-compensation package; the reasonable expectations doctrine is also likely to be applied in other situations where there is not a significant difference in the relative seniority of shareholders – for example, if all current stockholders received their shares from a common ancestor who founded the corporation;

(4) If settlement discussions occur before potential termination of a minority shareholder's employment, the parties should try to agree whether such discussions will be admissible or inadmissible in any subsequent proceeding; particularly given that "strong arm" negotiations may be admissible to prove over-reaching or "oppression" by the majority or by the minority, counsel and stockholders should not rely too heavily on the negotiations' presumptive inadmissibility;

(5) Counsel for majority shareholders should carefully consider the potential consequences of threatening to terminate a minority shareholder's employment if he or she does not agree to sell his or her equity in the corporation; courts frequently view such threats as persuasive evidence of "oppression," on the ground that a refusal to sell one's stock interest does not by itself constitute a valid cause for terminating employment;

(6) If at all possible, in the absence of substantial or irrefutable evidence that termination is in a corporation's best interest, counsel and the parties should make all reasonable efforts to resolve the pertinent issues before a corporation involuntarily terminates an "original partner's" employment;

(7) If litigation becomes necessary, counsel should carefully consider venue selection, particularly because of the broad discretion that the law affords a Circuit Court judge sitting in equity; and

(8) Litigation counsel should carefully consider the potential interplay between an equitable claim under § 3-413(b)(2) and other, legal claims for money damages.

With these and other factors in mind, Maryland lawyers can provide competent representation in disputes among the shareholders of closely held corporations.