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The basic dynamic of a mortgage and foreclosure is deceptively simple. A mortgage is the transfer of an interest in land to a lender to secure repayment of a loan. In the event of the mortgagor’s failure to repay the loan, the lender may foreclose on the real property. Like any other security interest, however, a mortgage is subject to competing claims and interests. Among the potential hurdles to foreclosure are the debtor’s filing for bankruptcy protection, and the recording of mechanic’s liens on the property. This article provides an overview of the impact of bankruptcy on foreclosure, including the impact of select provisions of the federal Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which became effective on October 17, 2005 (“BAPCPA”), as well as a discussion of mechanic’s liens in Massachusetts as such liens affect, and are in turn affected by, mortgage foreclosures and bankruptcy proceedings.
I. Impact of Bankruptcy on Foreclosure

A. Bankruptcy Overview

Title 11 of the United States Code sets forth the federal statutory law known as the United States Bankruptcy Code (the “Code”). The Code allows both individual consumer debtors and business entities to restructure and resolve their debts through a court-supervised proceeding that may include an orderly distribution of the debtor’s assets to creditors. Consumer debtors may petition for bankruptcy under chapters 7, 11 or 13 of the Code, while business debtors are eligible to file under chapters 7 and 11.

The Code contemplates two basic types of bankruptcy proceedings: liquidation and rehabilitation. In a chapter 7 liquidation, a trustee is appointed to investigate, collect and reduce to cash all of the debtor’s assets (with certain exceptions that are exempt from collection under applicable federal or state law). In contrast, chapters 11 and 13 allow a debtor to “reorganize” — that is, to restructure debt and be rehabilitated to continue operations pursuant to a plan approved by the bankruptcy court. A business debtor may also choose to liquidate its assets in a chapter 11 case, generally without the involvement of a bankruptcy trustee but under the supervision of the bankruptcy court. Under each chapter, available assets (if any) are distributed to creditors on a pro rata basis in accordance with a statutory priority scheme.

In a chapter 7 liquidation, unsecured creditors generally receive heavily discounted returns on their claims even when the trustee determines that the estate possesses nonexempt assets. More often, a chapter 7 case will be declared a no-asset case, and the debtor will be discharged from all unsecured debts, without repayment. Business and consumer debtors are also given an opportunity to reorganize under chapters 11 and 13 in order to maximize repayment to creditors. Chapter 13 allows the consumer debtor to retain essential property while repaying creditors over a period of three to five years, while offering a more generous discharge of debts than chapter 11. Consumers who file to resist imminent foreclosure generally choose chapter 13, which allows a debtor to cure arrearages and reinstate the mortgage, while paying a compromised amount to unsecured creditors. Most consumers elect to liquidate their assets under chapter 7, which allows the debtor to surrender his or her assets and discharge debts without undertaking a repayment plan.

BAPCPA effected significant changes in the Code. Many of these changes make it more difficult for a consumer debtor to discharge unsecured debts without completing a repayment program. In addition to budget and credit counseling requirements, a new “means test” assesses chapter 7 eligibility by comparing the debtor’s income and reasonable expenses to the state median income — in Massachusetts, $52,633 for one earner and $91,892 for a family of four (for cases filed through March 2008) — and budget guidelines. BAPCPA presumes abuse by chapter 7 debtors with income levels exceeding the state median income. If a debtor cannot rebut the presumption by showing “special circumstances,” such as a serious health problem, the case will be dismissed or converted to a case under

5. Business entities are not eligible to file for relief under chapter 13. 11 U.S.C. § 109(e) (2006). The Code includes several other operating chapters that are not typically used to prevent foreclosure and hence are not generally discussed in these materials: 9 (which provides a reorganization alternative for municipalities); 12 (which extends bankruptcy relief to family farmers); and 15 (newly created to apply to certain cross-border and ancillary cases). See id. §§ 901-46, 1201-31, 1501-31.
7. Under Massachusetts law, debtors may protect from their creditors an estate of homestead as well as certain personal property. See MASS. GEN. LAWS ch. 188, §§ 1-10 (2006) (homestead) and MASS. GEN. LAWS ch. 235, § 34 (2006) (property exempt from execution). In Massachusetts, an exempt homestead is a principal residence that has a value not exceeding $500,000. MASS. GEN. LAWS ch.188, § 1 (2006). Alternatively, debtors may elect to exercise exemption rights under the Code. 11 U.S.C. § 522(d) (2006). Massachusetts debtors may opt to exercise either the state or the federal exemptions, but not both. See 11 U.S.C. § 522(a)(2) (2006) (“Property listed in this paragraph [as exempt] is property that is specified under subsection (d), unless the State law that is applicable to the debtor under paragraph 3(A) specifically does not so authorize.”). As a practical matter, the Massachusetts exemption is more favorable to debtors than the federal exemption and will invariably be selected. However, pursuant to BAPCPA, if a debtor owns the homestead for less than 40 months, amended Section 522 imposes a $125,000 homestead cap that overrides any higher state homestead exemption cap. See In re Virissimo, Nos. BK-S-13605-LBR, BK-S-05-15667-LBR, 2005 WL 2854341, at *6 (Bankr. D. Nev. Oct. 31, 2005) (“Congress wanted to close what it perceived was the abuse of exemptions caused, in part, by the varying state laws and overly generous homesteads.”).
8. See, e.g., Nobleman v. American Sav. Bank, 508 U.S. 324, 326 (1993) (debtors filing under chapter 13 have right to set up a repayment plan for their mortgage, but Court denied debtors’ attempt to bifurcate mortgagee’s claim into a secured claim for one amount, and a worthless unsecured claim for the remainder); Toibb v. Radloff, 501 U.S. 157, 163 (1991) (individual debtor without “an ongoing business” may nevertheless utilize chapter 11).
10. See id. §§ 1322(b)(3), 1322(c), 1322(b)(1).
11. See id. § 727.
12. Id. § 109(b)(1).
13. Id. § 707(b). See also In re Moates, 338 B.R. 716, 717 (Bankr. N.D. Tex. 2006) (noting that individual debtor whose debts are not primarily consumer debts may not be subject to means testing); Massachusetts median income information, available at: http://www.usdoj.gov/ust/eo/bapcpa/20080201/bci_data/median_income_table.htm.
chapter 11 or 13. Debtors placed under chapter 13 must participate in a repayment plan that may be extended to as long as five years to maximize creditors’ recovery.15

B. Effects of Bankruptcy Filing: Proofs of Claim and Arrearages

Every bankruptcy case begins with the filing of a petition, notice of which must be given to all creditors.16 A bankruptcy proceeding may either be filed voluntarily by a debtor or initiated by creditors against an involuntary debtor.17 The filing of a petition creates a bankruptcy estate, which is comprised of all legal and equitable interests of the debtor in property as of the commencement of the case.18 To protect its interest in the estate – including the proper classification of its secured claim and the treatment of pre-petition arrearages – every creditor should timely file a proof of claim in the case or risk being forever barred, absent what the courts have termed “excusable neglect.”19 The Code establishes the priority of each creditor’s interest in the estate,20 which rarely will contain sufficient assets to pay all creditors’ claims in full.

C. The Automatic Stay and Creation of the Bankruptcy Estate

The bankruptcy estate is subject to the protections of the “automatic stay,” a statutory injunction that arises automatically pursuant to section 362(a) of the Code. Immediately upon a bankruptcy filing, creditors may not seek to collect debts or proceed against a debtor or its property in any way outside of the bankruptcy proceeding.21 Consequently, creditors must cease all attempts to collect mortgage loan arrearages and should not initiate foreclosure without filing a motion for relief from the automatic stay and obtaining a bankruptcy court order.22 Even if a valid foreclosure has taken place (either pre-petition or post-petition with bankruptcy court approval), the actual eviction of the debtor is regarded as a separate proceeding against the debtor that requires the party seeking eviction to obtain an order lifting the stay before proceeding.23 The automatic stay remains in place, absent a court order, until the property at issue is no longer property of the estate, or the case is closed, dismissed or the debtor is granted or denied a discharge.24

Violations of the automatic stay may render a foreclosure void and subject the violator to tort damages and sanctions under the Code.25 For this reason, it is imperative that, before taking any action against the debtor or any act to obtain possession of, or exercise control over, property of the estate, the creditor first determine whether the stay applies, and if any uncertainty exists, how most effectively to obtain relief.26 Note, however, that a creditor or its counsel may engage in post-petition negotiations with the debtor to secure an agreement to reaffirm a debt27 without violating an automatic stay, provided that

17. Id. §§ 301, 303.
18. Id. § 541(a)(1).
19. The Supreme Court has held that the concept of “excusable neglect,” within the meaning of Federal Rule of Bankruptcy Procedure 9006(b)(1), permits the courts to accept late filings caused by “inadvertence, mistake, or carelessness,” but the standard for obtaining such relief is stringent and seldom satisfied. See Pioneer Inv. Servs. Co. v. Brunswick Assocs. Ltd. P’ship, 507 U.S. 380, 383 (1993).
21. The Code creates an automatic stay upon filing, but also establishes exceptions from the stay for certain interests judged by the legislature to be deserving of special protection from a public policy perspective. 11 U.S.C. § 362 (2006). For example, the Code does not stay criminal actions against the debtor, civil actions with respect to child custody and visitation, dissolution of marriage (except to the extent that such proceeding seeks to determine the division of property of the estate), or exercises of the state’s police power such as suspension of driving or professional licenses or exclusion from Medicare, among others. See id. § 362(b).
22. Two of these exceptions may be relevant in the context of a foreclosure. One such exception is for actions by the Secretary of Housing and Urban Development to foreclose a mortgage or deed of trust formerly insured under the National Housing Act that covers property consisting of five or more living units. Id. § 362(b)(8).
23. See In re Crichtlow, 334 B.R. 321, 324 (Bankr. D. Mass. 2005) (highest bidder’s successful motion to lift stay for purpose of eviction pursuant to foreclosure upheld; debtor’s motion to stay eviction denied where debtor lacked likelihood of success on appeal, and purchaser was likely to suffer irreparable harm if eviction were delayed); see also MASS. GEN. LAWS ch. 239, §§ 1-13 (2006) (Massachusetts summary process statutes) and MASS. GEN. LAWS ANN., COURT RULES, Trial Court Rules § 1 (Thomson/West 2006) (Massachusetts Uniform Summary Process Rules).
25. See id. § 362(b); see also In re Kane, 248 B.R. 216, 224 (B.A.P. 1st Cir. 2000), aff’d, 254 F.3d 325 (1st Cir. 2001) (post-petition notice of automatic foreclosure of tax lien violated the stay and was rendered void); In re Weber, 283 B.R. 630, 636 (Bankr. D. Mass. 2002) (reopens case to void foreclosure of debtor’s right of redemption in real property that was obtained by means of state court proceedings in violation of automatic stay; hearing on 362(h) sanctions to follow). But cf. In re Heron Pond, L.L.C., 258 B.R. 529, 530 (Bankr. D. Mass. 2001) (a single continuation of foreclosure sale is neither commencement nor continuation of action or proceeding against debtor if, before continued sale date, creditor obtains appropriate order granting relief from stay; in all other instances of continued sales, cases will be treated individually).
26. Given the scope of the automatic stay, the difficulty in interpreting the limits of its reach, and the substantial risk incurred by a creditor who fails to comply, the safe course is to consult with experienced bankruptcy counsel when such an issue arises. 27. Reaffirmation reflects an agreement between the debtor and the creditor, whereby the creditor can proceed to enforce its rights as if bankruptcy had not intervened. A reaffirmation agreement must (1) be executed before general discharge has been granted in the bankruptcy; (2) be in consideration for dischargeable debt, whether or not the debtor waived discharge of debt; (3) include clear and conspicuous statements that the debtor may rescind reaffirmation agreement at any time prior to granting of general discharge, or within 60 days after execution of agreement, whichever occurs later, and that reaffirmation is neither required by the Code nor by nonbankruptcy law; (4) be filed with the bankruptcy court; and (5) be accompanied by affidavit of the debtor’s attorney attesting that the debtor was fully advised of the legal consequences of the agreement, that the debtor executed the agreement knowingly and voluntarily, and that the agreement would not cause the debtor undue hardship. 11 U.S.C. § 524(c) (2006).
the creditor does not engage in coercive or harassing tactics, including threatening foreclosure. 28

The Code’s creation of an expansive bankruptcy estate and court-supervised division and distribution of that estate ultimately benefits creditors. Upon a bankruptcy filing, all nonexempt assets become property of the bankruptcy estate 29 and the debtor loses the right to dispose of those assets 30 (except, in the case of business debtors, in the ordinary course of business). 31 Likewise, a filing halts a “race to the courthouse” by creditors seeking to create and perfect liens against the debtor’s assets. 32 Additionally, certain pre-petition transfers of property, secured interests, and liens claimed by particular creditors may be delayed or invalidated for the benefit of the creditor body as a whole. 33 Even property in which the debtor no longer has a possessory interest may be deemed part of the bankruptcy estate. 34

In view of the current subprime mortgage crisis, the courts are becoming increasingly protective of debtors, particularly with regard to enforcing the protections afforded by the automatic stay. 35 Thus, it is more important than ever that creditors seeking to enforce their rights ensure that they have timely and precisely complied with all legal requirements before seeking relief from the courts.

28. See Jamo v. Katahdin Fed. Credit Union (In re Jamo), 283 F.3d 392, 400-01, 402 (1st Cir. 2002) (creditor’s decision to withhold reaffirmation of secured debt unless debtor agrees to reaffirm other, unsecured debts is not per se violation of automatic stay; however, threats of foreclosure or repossession, as distinguished from benign references made to foreclosure during reaffirmation negotiations, would have constituted violation of automatic stay).
30. Id. § 542(a).
31. Id. §§ 1107, 1304.
32. See id. § 362(a).
33. See id. §§ 544, 545, 547, 548, 553(b), 724(a), 749(a).
34. United States v. Whiting Pools, Inc., 462 U.S. 198, 209 (1983) (bankruptcy estate includes property of debtor that had been seized by IRS prior to filing of bankruptcy petition).
35. See In re Soderman, Nos. 07-41651-JBR, 07-42284-JBR, 2008 WL 397706, at *1 (Bankr. D. Mass. Feb. 11, 2008) (continuations of foreclosure sales during pendency of bankruptcy case violate automatic stay when “the sale [is] postponed in order to harass the debtor, gain advantage for the creditor; or revive the financial pressures that drove the debtor into bankruptcy”); In re Maisel, 379 B.R. 19, 20-21 (Bankr. D. Mass. 2007) (court takes seriously responsibility to ensure debtors “receive the full protection of the Bankruptcy Code, including the benefit of an automatic stay,” by ensuring lenders’ compliance with all requirements of the Bankruptcy Code); In re Foreclosure Cases, Nos. 1:07CV2282, 07CV2532, 07CV2560, 07CV2602, 07CV2631, 07CV2638, 07CV2681, 07CV2695, 07CV2920, 07CV2930, 07CV2949, 07CV2950, 07CV3000, 07CV3029, 2007 WL 3232430, at *1 (N.D. Ohio Oct. 31, 2007) (court dismissed foreclosure cases where lenders failed to produce assignments showing lenders as holders and owners of notes and mortgages as of date of filing of complaint).
36. Turnover is not required in three situations: when (i) the property is of inconsequential value or benefit to the estate; (ii) without notice or actual knowledge of the bankruptcy, the holder of the property transferred it in good faith to an entity other than the trustee; or (iii) transfer of the property is required to be made automatically to a life insurance company to pay a premium or carry out a nonforfeiture insurance option. 11 U.S.C. § 542(a), (c)-(d) (2006).
39. See id.
40. “[F]all of the hammer at the auction signifies the acceptance of the bid and an agreement between the parties, but will not alone terminate a debtor’s equity of redemption [in mortgaged property] under the Statute.” In re Grassie, 293 B.R. 829, 831 n.2 (Bankr. D. Mass. 2003) (where purchaser had not signed sale document on foreclosed property at time debtor/seller filed petition, sale memorandum did not extinguish debtor’s equity of redemption, and property became property of estate, subject to automatic stay); see also In re Mellino, 333 B.R. at 578 (redemption right expired pre-petition with execution of memorandum of sale; hence, debtor had no legal interest in foreclosed property as of commencement of case and automatic stay did not apply). In re Dow, 250 B.R. 6, 7-8 (Bankr. D. Mass. 2000) (where creditor foreclosed a few minutes before debtor filed, and thereafter signed memorandum of sale, but never delivered foreclosure deed, debtor retained its equity of redemption under Massachusetts law and memorandum of sale was void as violation of automatic stay).
41. A mortgagee may seek to void a foreclosure sale on the basis of procedural defects; but defects that are technical in nature may not require that a sale be voided. See Farm Credit Bank v. Ferrera-Gottia, 316 F.3d 62, 65-66 (1st Cir. 2003) (denying mortgagor’s motion for relief under rule 60(b)(4) from order confirming sale of real property where motion was not filed within reasonable time and alleged defects in mortgage foreclosure proceeding were technical in nature). A foreclosing creditor may also lose its right to a deficiency claim if it fails to use good faith and reasonable diligence in conducting the foreclosure sale. In re LaPointe, 253 B.R. 496, 499-501 (B.A.P. 1st Cir. 2000) (finding that creditor failed to use good faith and reasonable diligence in conducting foreclosure sale without public notice and remanding with direction to reduce damages award to amount not to exceed difference between fair market value of property at time of foreclosure, and foreclosure sale price; because mortgagee did not engage in any marketing, obtained an appraisal, contact a real estate broker, inquire into the market regarding either value or prospective buyers, inspect the property, or publish sufficient newspaper notice). compare BFP v. Resolution Trust Corp., 511 U.S. 531, 545 (1994) (foreclosure sale could not be avoided where price received at mortgage foreclosure sale conclusively established “reasonably equivalent value” of mortgage property, as long as requirements of state’s foreclosure law were met).
Secured creditors enjoy special protection under the Code. Even when property seized prior to the filing of a petition must be turned over to the bankruptcy trustee, a secured creditor’s interest in the property remains intact.\(^{44}\) Further, under section 363 of the Code, the secured creditor is entitled to “adequate protection” of its interests.\(^{45}\) The purpose of section 542(a) is essentially procedural: to require secured creditors to protect their interests utilizing bankruptcy procedures, as by filing a motion to lift stay or an objection to the debtor’s proposed plan of reorganization, rather than withholding property of the estate that may be used for the collective benefit of all creditors and to rehabilitate the debtor.

As federal law, the Code preempts state law. Accordingly, states may not regulate bankruptcy.\(^{46}\) Nonetheless, substantive state and federal (nonbankruptcy) law governs other aspects of the debtor-creditor relationship that are relevant to foreclosure and mortgages. These laws include debt collection statutes, fraudulent transfer statutes, and laws regulating lending to protect consumers.\(^{37}\) Creditor's should be particularly aware of the Fair Debt Collection Practices Act,\(^{48}\) the Massachusetts Consumer Protection Act,\(^{49}\) and the Massachusetts Consumer Credit Cost Disclosure Act,\(^{50}\) which is based on the Federal Truth in Lending Act\(^ {51}\) and the Consumer Credit Protection Act,\(^ {52}\) and the Servicemembers Civil Relief Act.\(^ {53}\)

Given the Code’s preemption of state law, creditors should further be aware that their rights, however well established under state law, are subject to modification under the Code.\(^ {54}\)

By way of illustration, under state law, and subject to the nature and terms of the agreements providing for a deposit account and loan respectively, a lending institution may generally exercise a right of setoff when a delinquent loan customer has otherwise deposited funds with the bank. In the event that a customer files bankruptcy, however, under certain circumstances, the trustee may lawfully recover from the bank the amount of the setoff. Section 553(b) of the Code subjects pre-petition setoffs to an empirical “insufficiency” test to ascertain the extent to which the creditor may have improved its position by effecting the setoff, which in turn will determine the amounts (if any) that the trustee may recover.\(^ {55}\)

In some instances, a creditor’s rights may be modified even to the extent of avoidance of a lien.\(^ {56}\) For example, section 522(f) of the Code allows for avoidance of a “judicial lien” on the debtor’s interest in real property to the extent the lien impairs an exemption.\(^ {57}\) A judicial

44. See Pileckas v. Marcucio, 156 B.R. 721, 725 (N.D.N.Y. 1993) (“It is well settled that before a secured creditor may be compelled to turnover property under the Code, the debtor must demonstrate that the secured creditor’s interest is ‘adequately protected.’”) (emphasis in original).
45. “Adequate protection” may consist of cash payments, additional or replacement liens, or other relief “as will result in the realization … of the indubitable equivalent of such entity’s interest in such property”. 11 U.S.C. § 361 (2006).
46. See Kalb v. Feuerstein 308 U.S. 433, 439 (1940) (“The Constitution grants Congress exclusive power to regulate bankruptcy.”).
47. See Hart v. GMAC Mortgage Corp. (In re Hart), 246 B.R. 709, 709 (Bankr. D. Mass. 2000) (holder of mortgage note and its servicing agent alleged to have violated automatic stay, Massachusetts Consumer Protection Act, Fair Debt Collection Practices Act (FDCPA) and Federal Truth in Lending Act (TILA). Lender found liable under FDCPA, but not TILA, for unfair debt collection and trade practices for continuing foreclosure after misapplication of payments due to inadequacies in computer systems and in communications among creditor’s business divisions.).
53. 50 U.S.C. app. §§ 501-596 (2000 Supp. V) formerly titled the Soldiers’ and Sailors’ Civil Relief Act of 1940. See also Pamela Smith Hollemann, Servicemembers Civil Relief Act, paper presented at the Bankruptcy Court Practice 2004-14th Annual Bankruptcy Court Meets Bar Conference (available upon request from the author at pholleman@sandw.com).
54. Attorneys should also take note of 940 CMR 25.02(2), which has been described as “a new regulation designed to protect property owners from corrupt foreclosure rescue schemes.” David E. Frank, Lawyers: Unclear Foreclosure Regs Forcing Them to Turn Down Business, MASS. LAWYER’S WEEKLY, January 28, 2008 at 1 (discussing competing interpretations of the regulation). The regulation provides, with certain exceptions, that \[\text{[it]}\text{ is an unfair or deceptive act in violation of G.L.M. c.93A, § 2(a) to, for compensation or gain or for potential or contingent compensation or gain … engage in, arrange, offer, promote, promise, solicit participation in, or carry out a Foreclosure Rescue Transaction in the Commonwealth or concerning residential property in the Commonwealth.} \]
940 CMR 25.02(2). By its terms, the regulation does not prohibit a licensed attorney from soliciting or accepting an advance fee or retainer for legal services in connection with the preparation and filing of a bankruptcy petition or court proceedings, or to avoid a foreclosure. Id. Concern has been expressed, however, that the regulation may prevent lawyers from accepting advance fees or retainers to represent clients in need of foreclosure-related services, such as negotiating a loan modification with a mortgage lender on behalf of a consumer borrower. If so, lenders’ counsel may find themselves increasingly dealing with unrepresented debtors in such situations. See id. (discussing competing interpretations of the regulation).
55. The section 553(b) test commences by taking a snapshot of whichever day is later: the 90th day preceding the debtor’s filing for bankruptcy or the first day during the 90 days pre-petition in which the debtor’s deposit with the lender is less than the debtor’s outstanding note (“Day X”). The amount by which the debtor’s deposit with the lender is less than her outstanding note is termed the “insufficiency.” After determining the insufficiency on Day X, the test requires determining the insufficiency, if any, on the actual day of the setoff (“Day Y”). If the insufficiency existing on Day X exceeds any insufficiency on Day Y, the lender is deemed to have impermissibly “improved its position.” The trustee is then authorized to recover the difference between the two insufficiencies, up to, but no more than, the amount set off. Notably, section 553(b) does not apply to setoffs taken under certain types of contracts, such as commodities contracts, forward contracts, and certain executory contracts given particular treatment under the Code. See 11 U.S.C. §§ 553(b), 362(b)(6), 365(h), 365(i)(2), 546(h) (2006).
56. See In re Lazarus, 478 F.3d 12, 13 (1st Cir. 2007) (where a failure to avoid the mortgage would give lender a mortgage lien, which was more than it would receive as a general creditor, new mortgage granted to new lender was avoided as preferential).
lien is defined as a “lien obtained by judgment, levy, sequestration, or other legal or equitable process or proceeding”. The term ordinarily does not include a consensual lien such as a mortgage, but the United States Court of Appeals for the First Circuit has held that a deficiency judgment obtained upon foreclosure of the mortgage – unlike the mortgage itself – is a nonconsensual lien like any other and is therefore subject to avoidance under section 522(f). 59

In other instances, bankruptcy courts may allow a debtor to “strip off” a seemingly valid lien (typically that of a wholly unsecured junior lienholder) “if there is no security available to the lienholder to foreclose on in the event the debtor fails to fulfill the contract payment obligations” – i.e., where the collateral has no value. Similarly, an unsecured creditor’s lien may be “stripped down” to the value of the collateral. 60

E. BAPCPA 2005: Select Provisions Affecting Mortgages and Foreclosure

Significant changes to the prerequisites for obtaining the protection of the automatic stay have already affected the interplay between foreclosure and bankruptcy. In summary, as noted above, would-be individual debtors are now subject to means testing pursuant to section 707(b) of the Code and are required to have completed budget and credit counseling as recently as within the “180 days” preceding a filing for bankruptcy protection. 61 Moreover, the availability of the automatic stay has been severely curtailed with regard to repeat bankruptcy filers, 62 signifying the end of the cycle of foreclosure attempts and bankruptcy filings sometimes commenced under the prior Code. BAPCPA also expanded the Code definition of a “single asset real estate debtor,” making it more difficult for such debtors to retain the protections of the automatic stay. Finally, under BAPCPA it is clear that a consumer debtor wishing to retain personal property in which a lender holds a security interest must reaffirm or redeem the debt (thus eliminating the so-called “ride through” option), but it is arguable that real property may now ride through the bankruptcy without a reaffirmation agreement or redemption. 63

The new budget and credit counseling requirement imposed by section 109(h)(1) of the Code provides that an individual may not be a debtor in a bankruptcy case unless such individual has, during the 180-day period preceding the date of filing of the petition by such individual, received from an approved nonprofit budget and credit counseling agency … an individual or group briefing (including a briefing conducted by telephone or on the Internet) that outlined the opportunities for available credit counseling and assisted such individual in performing a related budget analysis. 64

The requirement is being strictly construed by bankruptcy courts, which have denied relief where the requirement has not been met. 65 The plain language of the statute is unambiguous and provides only limited enumerated exceptions to the requirement that an individual obtain counseling before filing a petition. 66 Pursuant to section 521(b) of the Code, the debtor must then file with the court “a certificate from the approved nonprofit budget and credit counseling agency describing the services provided to the debtor” 67 and also file a copy of any resultant repayment plan. 68

These new requirements will invariably curtail the heretofore common practice of filing bankruptcy at the eleventh hour to prevent imminent foreclosure. Bankruptcy courts have yet to reach a consensus as to whether the appropriate response to a bankruptcy filing by an ineligible debtor is to strike the petition, rendering it void ab initio, or to dismiss the petition. 69 The distinction is legally

58. See id. § 101(36).
59. See In re Hart, 328 F.3d 45, 48 (1st Cir. 2003) (bank obtained deficiency judgment in connection with foreclosure; reasoning that § 522(f)(2)(C) is not an exception to otherwise avoidable liens, but merely clarifies that judgments authorizing foreclosure are not judicial liens subject to § 522(f)).
60. Domestic Bank v. Mann (In re Mann), 249 B.R. 831, 840 (B.A.P. 1st Cir. 2000) (wholly unsecured second mortgage may be stripped off the lien voided under chapter 13 plan, leaving creditor with wholly unsecured claim; reasoning that creditor would have gotten nothing in foreclosure sale, and bankruptcy court confer no greater rights upon creditors than available outside bankruptcy).
61. See id.
62. 11 U.S.C. § 109(h) (2006). Section 109(h)(1) refers to the requirement as a “briefing” to be received from an “approved nonprofit budget and credit counseling agency,” but § 109(h)(3)(A)(ii) refers to “credit counseling services.”
65. 11 U.S.C. § 524(c) (2006); In re Wilson, 372 B.R. 816, 816 (Bankr. D.S.C. 2007) (allowing chapter 7 debtor to retain real property, without reaffirmation or redemption, so long as debtor remained current on payments to secured creditor and complied with all other contractual obligations; concluding that BAPCPA did not eliminate such “ride through” option with respect to real property).
68. Principal exclusions permit relief from the credit counseling requirement for debtors who reside in districts for which approved nonprofit budget and counseling agencies are not able to provide adequate services to accommodate all debtors needing such services; debtors with exigent circumstances that the court determines warrant a waiver of the counseling requirement; debtors who requested such services but were unable to obtain them during the five-day period beginning on the date of making the request; and debtors suffering from incapacity or disability or who are on active military duty in a military combat zone. See 11 U.S.C. § 109(h) (2006); In re Duplessis, No. 06-14747 (JNF), 2007 WL 118945, at *3 (Bankr. D. Mass. Jan. 11, 2007) (rejecting debtor argument that failure to file evidence of receipt of pre-petition credit counseling was fault of credit counseling agency).
70. Id. § 521(b)(2).
71. See In re Elmendorf, 345 B.R. 486, 504 (Bankr. S.D.N.Y. 2006) (struck petition of ineligible debtor, as debtor’s ineligibility meant that case could never have been commenced); In re Salazar, 339 B.R. 622, 624 (Bankr. S.D. Tex. 2006) (striking petition is appropriate remedy and operates as judicial recognition that bankruptcy case was never commenced and is void ab initio; hence, post-petition foreclosure did not violate automatic stay where debtors found to be ineligible for relief under BAPCPA); Adams v. Finlay, Nos. 06 Civ. 6039(CLB), 06-6040, 06-6041, 06-6042, 06-6075, 06-6077, 2006 WL 3240522, at *4 (S.D.N.Y. Nov. 3, 2006) (same). But cf. In re Falcone, 370 B.R. 462, 466-67 (Bankr. D. Mass. 2007) (dismissed case of ineligible debtor, noting that this was majority position) (cases cited within); In re Brown, 342 B.R. 248, 253 (Bankr. D. Md. 2006) (dismissal was appropriate response to ineligibility, rather than “striking” petition to render it void from the outset; debtor’s ineligibility not ascertained until a court ruling, hence foreclosure sale violated automatic stay; finding Salazar “unpersuasive”).
significant because if the bankruptcy petition is struck, it will be as though the automatic stay never existed, and a foreclosure conducted post-petition will remain valid. Conversely, if the petition is dismissed, a foreclosure conducted post-petition, but prior to dismissal, would be in violation of the automatic stay. Where a bankruptcy is dismissed and successfully reinstated, First Circuit case law suggests that the reinstatement of the case will not act to invalidate a foreclosure sale conducted post-dismissal but before refiling.72

BAPCPA also added several sections to section 362 that pertain to the availability of the stay for repeat filers. First, new section 362(c)(3) provides that if a debtor has had even one prior bankruptcy case dismissed within one year before the current filing, the stay terminates after 30 days, absent a court order granting an extension.73 There has been some confusion among bankruptcy courts as to whether new section 362(c)(3)(A) terminates the automatic stay with regard to the debtor, property of the debtor and property of the estate, or only with regard to the debtor and property of the debtor.74 The Bankruptcy Appellate Panel for the First Circuit has concluded that the automatic stay does not terminate with respect to property of the estate.75

Second, new section 362(c)(4) states that if a debtor has been the subject of two or more prior cases dismissed within the prior year, no automatic stay goes into effect upon the filing.76 Under section 362(c)(4), the debtor must petition the court to put the stay into effect. The stay will be effectuated or extended only if the new filing is in good faith as to the creditors that will be subject to the stay.77 A lack of good faith is presumed under the following circumstances, and may only be overcome by clear and convincing evidence: (1) the debtor had more than one bankruptcy case already pending within the preceding year; (2) a previous case was dismissed after the debtor’s failure to (a) file or amend the petition or other documents required by the Code or the court without substantial excuse, (b) provide court-ordered adequate protection, or (c) perform the terms of a confirmed plan; or (3) there has been no substantial change in the debtor’s financial or personal affairs since the last dismissal or any other reason to conclude that the current case will result in a chapter 7 discharge or a confirmed and fully performed chapter 11 or 13 plan.78 In addition, there is a presumptive lack of good faith as to a particular creditor who had obtained stay relief or had a stay relief motion pending as of the dismissal of a prior case.79

Finally, new section 362(d)(4) provides that, upon finding that a bankruptcy filing “was part of a scheme to delay, hinder, and defraud creditors” that involved either “(1) the transfer of all or part ownership (or other interest) in the real property without court approval or the consent of the secured creditor or (2) multiple bankruptcy filings affecting such property,”80 the court shall lift the automatic stay as to a secured creditor proceeding against such property in satisfaction of its valid lien.81 If such an order is “recorded in compliance with applicable state laws governing notices of interests or liens in real property,”82 it will be binding in any other bankruptcy case, filed within two years, that affects that real property.83 The debtor may, however, in a subsequent case, move for relief based upon changed circumstances or for other good cause shown.84

A more subtle change to the Code affects the “single asset real estate debtor.” In a single asset real estate bankruptcy, a debtor must file a feasible plan of reorganization or commence monthly interest payments in order to maintain the protections of the automatic stay. Pre-BAPCPA, a single asset case was defined as one in which the following four factors existed: (i) a single real property or project (excluding residential property with fewer than four units) (ii) that generates substantially all of the debtor’s income (iii) on which the debtor conducts no substantial business other than operation of the property and (iv) on which there is no more than $4 million in secured debt.85 BAPCPA has amended this definition to exclude the fourth requirement of a $4 million cap on secured debt.86 Consequently, filing a plan or making monthly payments to secured creditors is now essentially mandatory for all single asset real estate debtors that desire to maintain the automatic stay.

Another relevant BAPCPA development is actually based on the complete silence of the Code as to any restrictions on the “ride-through” of real property. This omission stands in stark contrast to the substantial new restrictions on the ride-through protection available for personal property. Pre-BAPCPA, several courts of appeals held that

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72. In re Lomagno, 320 B.R. 473, 492 (B.A.P.), aff’d, 429 F.3d 16, 18-19 (1st Cir. 2005) (reinstatement of dismissed case did not operate to retroactively reinstate automatic stay; foreclosure sale conducted post-dismissal was valid sale).
74. In re Curry, 362 B.R. 394, 398 (Bankr. N.D. Ill. 2007) (holding that automatic stay terminates in its entirety, including property of estate, while noting that this is minority view). See In re Holcomb, 380 B.R. 813, 813 (B.A.P. 10th Cir. 2008) (holding that automatic stay terminates only with regard to debtor, noting that this is majority view). In re Stanford, 373 B.R. 890, 890-91 (Bankr. E.D. Ark. 2007) (same).
75. In re Jumpp, 356 B.R. 789, 796 (B.A.P. 1st Cir. 2006) (reversing Massachusetts bankruptcy court to hold that Code § 362(c)(3) is unambiguous and stay does not terminate as to property of bankruptcy estate).
77. In re Kurtzahn, 337 B.R. 356, 356 (Bankr. D. Minn. 2006) (chapter 13 debtor whose previous chapter 13 case had been dismissed less than one year earlier due to failure to make payments required under the plan failed to rebut strong statutory presumption that current case was not filed in good faith; motion requesting extension of temporary 30-day stay denied); see also 11 U.S.C. § 362 (c)(3) (2006).
79. Id. § 362(c)(3).
80. Id. § 362(d)(4).
81. Id. § 362.
82. Id.
83. Id.
84. Id. §§ 362(d)(4), 362(b)(20).
the Code permitted debtors to retain certain personal property without being required to reaffirm or redeem the debt as long the debtor stayed current on payments. Hence, the property was said to “ride through” the bankruptcy.\textsuperscript{97} These courts, however, were split as to whether the debtor enjoyed the same privilege with regard to real property. Following BAPCPA, sections 362(h) and 521(a)(6) of the Code now prohibit ride through – but only as to personal property collateral.\textsuperscript{98}

Since a common rule of statutory construction presumes the legislature to be aware of such divisions, the enactment of legislation prohibiting ride through only as to personal property may be construed to mean that Congress intended that real property may ride through.\textsuperscript{89}

II. Interplay of Massachusetts Mechanics’ Liens, Mortgage Foreclosures and Bankruptcy Proceedings

A. Overview of Mechanics’ Liens in Massachusetts

In Massachusetts, mechanic’s liens are created and governed purely by statute.\textsuperscript{90} The governing statute, General Laws chapter 254, provides, in pertinent part:

A person entering into a written contract with the owner of any interest in real property, or with any person acting for, on behalf of, or with the consent of such owner for the whole or part of the erection, alteration, repair or removal of a building, structure, or other improvement to real property, or for furnishing material or rental equipment, appliances, or tools therefore, shall have a lien upon such real property, land, building, structure or improvement owned by the party with whom or on behalf of whom the contract was entered into, as appears of record on the date when notice of said contract is filed or recorded in the registry of deeds for the county or district where such land lies, to secure the payment of all labor, including construction management and general contractor services, and material or rental equipment, appliances, or tools which shall be furnished by virtue of said contract.\textsuperscript{91}

“The primary purpose of the lien is to provide security to contractors, subcontractors, laborers, and suppliers for the value of their services and goods provided for the owner’s real estate.”\textsuperscript{92} “Because a mechanic’s lien is purely a creation of statute, the courts have consistently required exact compliance with the statute in order to create, perfect, and enforce such a lien.”\textsuperscript{93}

B. Notice of Contract

A contractor seeking to obtain a lien must record a “notice of contract” in the registry of deeds for the county in which the property is located.\textsuperscript{94} The statute calculates a deadline for the recording of a notice of contract based upon whether (and how) the contract is either terminated or completed. If the owner and contractor have filed a notice of substantial completion under section 2A (indicating that “work under the written contract is sufficiently complete so that it can be occupied or utilized for its intended use”)\textsuperscript{95}, the notice of contract must be filed no later than 60 days after the notice of substantial completion was filed.\textsuperscript{96} If the owner has filed a notice of termination under section 2B, the notice of contract must be filed no later than 90 days after the notice of termination was filed.\textsuperscript{97} Absent a notice of substantial completion or notice of termination, the notice of contract must be filed no later than 90 days after the contractor “last performed or furnished labor or materials or both labor and materials.”\textsuperscript{98} A notice of contract may be recorded “at any time after the execution of the written contract,” as long as it is recorded before the applicable deadline.\textsuperscript{99} A subcontractor or supplier seeking to obtain a lien must also give actual notice to the owner of such filing.\textsuperscript{100}

C. Statement of Account

Enforcement of the lien requires further steps. Pursuant to General Laws chapter 254, section 8, the contractor must record a statement of account, setting forth the amount due or to become due.\textsuperscript{101} It must be recorded within 90 days of the filing of a notice of substantial completion; 120 days of the filing of a notice of termination; or 120 days after the contractor last performed or furnished labor, materials, equipment, appliances, or tools for the project, whichever is earliest.\textsuperscript{102}

87. \textit{See In re} Bennet, No. 06-80241, 2006 WL 1540842, at *1 (Bankr. M.D.N.C. May 26, 2006) (where mortgage lender and debtors sought court approval of reaffirmation agreement, court found that debtors were current on mortgage payments at time of bankruptcy filing and remained current during pendency of the case; noted that Congress specifically limited “ride-through” option to “personal property” in BAPCPA; and accordingly refused to approve reaffirmation, holding that debtors have right to retain real property without being required to reaffirm or redeem if they are current on the obligation). \textit{But cf.} BankBoston v. Burt (\textit{In re} Burt), 160 F.3d 843, 849 (1st Cir. 1998) (construing pre-BAPCPA Code § 521 to preclude ride-through option).

88. 11 U.S.C. § 362(h) (2006) terminates the stay as to “personal property” of the estate when the debtor does not state or perform an intention to reaffirm or redeem. 11 U.S.C. § 521(a)(6) (2006) refers to the debtor not retaining “personal property” without redeeming or reaffirming.

89. 11 U.S.C. § 521(a)(2) (2006) (broadly refers to “debts which are secured by property of the estate…”).


95. Id. § 2A.

96. Id. § 2.

97. Id.

98. Id.

99. Id.

100. Id. § 4.

101. Id. § 8.

102. Id.
Failure to file a statement of account within these time frames results in dissolution of the lien.103

D. Commencing and Recording an Action

After filing the statement of account, the contractor has a brief period of time in which to enforce the lien. Within 90 days of recording the statement of account, the contractor must file a civil action in the superior court for the county in which the real property is located and, within 30 days of filing suit, must record in the registry of deeds an attested copy of the complaint, which should contain a brief description of the property sufficient to identify it and a statement of the amount due.104 If either deadline is not met, the lien will be dissolved.105

In filing an action, the plaintiff-contractor (or subcontractor) will name, as defendants, the owner and any higher-tier contractor. As with any civil litigation, the defendants may raise defenses to the action or bring an action to dissolve the lien.106

E. Dissolution of Liens

Once perfected, a lien may be dissolved in several ways. A contractor may voluntarily dissolve its lien by notice pursuant to General Laws chapter 254, section 10.109 The court will also enter a judgment dissolving a lien if it appears that no person is entitled to a lien, or that every lien has been discharged by payment.110 Such a judgment has the effect of dissolving the lien. The recording of a bond under General Laws chapter 254, section 14 will also result in dissolution of the lien. Under that section, any person in interest may dissolve a lien by recording the bond in the registry of deeds.111 The bond must be issued by a surety company authorized to do business in Massachusetts for a sum equal to the amount of the lien sought to be dissolved.112 Notice of the recording must be given by serving the claimant with copies of the bond and notice of bond.113 Service must be made by an officer authorized to serve process or by delivering the notice and copy of the bond to the claimant.114 The claimant may enforce the bond by commencing a civil action within 90 days after filing a statement of account or receipt of the notice of bond recording, whichever is later.115 The bond gives the claimant no greater rights than it would have had, or impair any defense that the obligor would have had, in an action to enforce a lien.116

Finally, General Laws chapter 254, section 15A establishes a summary process whereby an owner may seek a discharge of a defective mechanic’s lien or notice by filing a separate action, generally in the superior court for the county in which the real property is located. There is some doubt, however, as to whether a contractor’s appeal of a judgment dissolving the lien will effectively resurrect the lien as a cloud on the title during the pendency of the appeal.117

F. Lien Priority

A successful final judgment establishing the lien provides a basis for the lienholder to seek recovery through a court-ordered sale of the property (similar to an execution sale).118 The debtor retains redemption rights for 90 days after the sale.119 The cost of redemption may include costs associated with establishing the lien.120

Upon such sale, or upon foreclosure, the recording of the notice of the contract establishes the priority of the mechanic’s lien. As a general matter, the lien takes priority over all later-recorded encumbrances on the property, but if there is more than one lien creditor, each will receive a pro rata distribution regardless of the date upon which the lien creditor filed a notice of contract.121 Hence, ordinarily, a duly recorded prior mortgage will trump subsequent mechanics’ liens. Massachusetts law generally prohibits any agreement, in connection with (or collateral to) contracts related to improvement to real property that bar filing a notice of contract, taking steps to enforce a

103. Id.
104. Id. § 5. The action may also be commenced in the district court in the judicial district where the land lies, but as a practical matter, the amount in controversy is likely to be large enough to warrant a superior court filing.
105. See id. §§ 5, 11.
106. Id.
107. See, e.g., BloomSouth Flooring Corp. v. Boys’ & Girls’ Club of Taunton Inc., 440 Mass. 618, 620-24 (2003) (denying recovery to subcontractors, despite liens being filed within statutory deadlines, because there was no amount “due or to become due under the original contract” where subcontractors filed notices of contract after general contractor had abandoned project prior to substantial completion); Nat’l Lumber Co. v. Walsh, No. 0312-CV-0439, 2007 WL 1491105, at *2-*3 (Mass. App. Div. May 21, 2007) (following BloomSouth).
109. Id. § 10.
110. See id. § 15. A certificate reflecting the judgment is sent by the clerk to the register of deeds and is filed and recorded in the registry as provided in MASS. GEN. LAWS ch. 254, §§ 8-9 (2006).
112. Id.
113. Id.
114. Id.
115. Id.
116. Id. Alternatively, an owner or other person may prevent the attachment of a lien by filing a bond at the outset of the project. MASS. GEN. LAWS ch. 254, § 12 (2006) provides, in part, that “[a]ny person, including the owner, in interest in connection with a written contract covered by section two or section four may cause to be recorded in the registry of deeds in the county or district where the land lies a bond of a surety company authorized to do a surety business in Massachusetts and in a penal sum equal to the contract sum or, if the contract does not contain a contract sum, in a penal sum equal to that person’s fair estimate of the contract sum, all as set forth in the certificate on the bond.” After the recording of any such bond no lien under this chapter shall thereafter attach in favor of any person entitled to the benefit of such bond and not named as a principal thereon for labor or for labor and materials performed under the contract in respect to which such bond is given.
119. Id. §§ 19-20.
120. Id. § 22.
121. Id. § 21.
liens, or purporting to subordinate such rights to the rights of other persons. There are, however, important exceptions. For example, a so-called “section one” lien for labor will subrogate a mortgage that was recorded before the sworn statement for the labor, if the labor protected by the lien began before the mortgage was recorded. Another exception to this general rule of lien priority is the so-called “rolling lien” provided by General Laws chapter 254, section 32(4), which creates a procedure for partial waivers and subordination of lien rights in exchange for advances by secured lenders.

G. Mechanics’ Liens in Bankruptcy

A question that frequently arises with respect to mechanic’s liens in bankruptcy is whether steps may be taken to perfect the lien after the debtor has filed for bankruptcy relief. As discussed above, section 362 of the Code generally enjoins any act to create, perfect or enforce any lien against property of the estate. Sections 362(b)(3) and 546(b) of the Code, taken together, set forth an exception from the stay for acts to continue perfection of certain interests in property. The United States Court of Appeals for the First Circuit explained the operation of these provisions in a decision dealing with environmental “superliens,” as follows:

[T]he automatic stay [is] inapplicable to “any act to perfect, or to maintain or continue the perfection of, an interest in property to the extent that the [bankruptcy] trustee’s rights and powers are subject to such perfection under section 546(b) of [the Bankruptcy Code]...[which] limits the debtor’s powers to avoid statutory liens by

providing that they are “subject to any generally applicable law that permits perfection of an interest in property to be effective against an entity that acquires rights before the date of perfection.” Thus sections 362(b)(3) and 546(b)(1)(A), read together, plot the boundaries of the exception to the automatic stay.

General Laws chapter 254 is “generally applicable law” that authorizes a contractor to perfect a lien that has retroactive effect, and thus falls within the purview of the section 546(b) exception to the automatic stay. More particularly, chapter 254 (like General Laws chapter 21E, the environmental superlien statute reviewed by the First Circuit) authorizes both the creation and perfection of a lien through the single act of a recording with the registry of deeds. Consequently, if a contractor has recorded a pre-petition notice of contract, it is generally believed that the Code allows for a continuation of the perfection.

A contractor that recorded a pre-petition notice of contract is well advised, however, to move for relief from the stay before taking any action to maintain or continue perfection of its lien. Indeed, from a contractor’s standpoint, the best practice is to protect its lien in two ways: first, by filing with the bankruptcy court and serving on all creditors and parties in interest a notice of perfection of mechanic’s lien pursuant to section 546(b) of the Code, with statement of account and other relevant documentation attached, and, second, petitioning the court for relief from stay, if and to the extent that such relief is needed, in order to take the further steps required to maintain and continue perfection pursuant to General Laws chapter 254.
Conclusion

Counsel to both creditors and debtors in Massachusetts are well-advised to pay close attention to the intricacies of various state and federal laws that affect mortgage foreclosures. These include, but are not limited to, General Laws chapter 254 and the United States Bankruptcy Code.\(^\text{131}\) Secured creditors have generally benefited from recent changes in the Code discussed herein, such as the “means test,” budget and credit counseling requirements and new provisions curtailing the availability of the automatic stay to repeat filers. These changes are likely to reduce the number of last-minute bankruptcy filings designed to stave off impending foreclosure. Nonetheless, the Supreme Judicial Court’s opinion in *Tremont Tower* – concluding that the right to file a mechanic’s lien may be resurrected after the lien is once dissolved – serves as a reminder that a foreclosing mortgagee must pay scrupulous attention to statutes designed to protect various constituencies.\(^\text{132}\) These constituencies include not only the debtor-mortgagor, but also contractors, subcontractors and materialmen who have provided labor and materials to improve the mortgaged property. Where – as here – complex statutes intersect, there is little room left for the generalist.

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131. See supra notes 48-53 for other relevant laws.
“True” Breaches of Contract: Judicial Review and the Finality of Decisions of an Awarding Authority on Claims of a Contractor on Public Construction Projects in Massachusetts

by Richard T. Holland

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It is well known that a breach of contract may be “material,” but less familiar, perhaps, is that a breach of contract may also be “true.” On a public construction project, not every alleged breach of contract by an awarding authority will be a true breach of contract. Whether a breach of contract is true can have important consequences for both the general contractor and awarding authority. The distinction between a breach of contract that is true and one that is not derives from the practice of including provisions in construction contracts that allow the contracting parties to assert and obtain relief for claims during the course of a construction project. Generally, such provisions, referred to as the contract claims procedure, allow the parties to request adjustments to the contractor’s compensation (the contract price) and the time within which the contractor must complete the work (the contract time).

This article addresses the consequences of a contractor’s failure to comply with the contract claims procedure. It also addresses the availability of judicial review of an awarding authority’s denial, through its architect or engineer, of a contractor’s claims, and reviews relevant legal decisions discussing that issue. As discussed below, a contractor who, in asserting a claim, fails to comply with the contract claims procedure will generally be precluded from recovering on that claim in subsequent litigation with the awarding authority.

I. The Contract Claims Procedure

The contract claims procedure is usually contained in the section of the construction contract known as the “general conditions.”¹ The most common forms of general conditions are those published by the American Institute of Architects (“AIA General Conditions”) and Engineers Joint Contract Documents Committee (“EJCDC General Conditions”).²

Under the AIA General Conditions, a claim must be initiated by written notice submitted to the project architect and awarding authority within 21 days of the event giving rise to the claim, or within 21 days after the claimant first recognizes the conditions giving rise to the claim.³ Claims are referred to the project architect for initial decision and, unless the architect fails to render a decision within 30 days from receipt of a claim, a decision by the architect is required before the parties may initiate mediation, arbitration or litigation.⁴ Once rendered, the architect’s decision is “final and binding on the parties but subject to mediation and arbitration.”⁵

Unlike the AIA General Conditions, the EJCDC General Conditions require two written notices to perfect a claim.⁶ The first written notice must describe the general nature of the claim and be

1. The general conditions are, simply, terms of the construction contract. Although considered part of the contract, the general conditions are commonly contained in a document separate from the written agreement signed by the contractor and awarding authority. The general conditions, together with the signed agreement, drawings and specifications, and such other documents as the parties may agree upon, constitute the “contract documents,” to which the contractor is bound. The contract documents are usually identified in the written agreement or the general conditions.

2. References to the AIA General Conditions are to the 1997 edition of the American Institute of Architects, AIA Document A201, General Conditions of the Contract for Construction. Before publication of this article the American Institute of Architects issued its 2007 edition of the AIA General Conditions, which slightly modifies the claims procedure contained in the 1997 edition. References to the EJCDC General Conditions are to the 2002 edition of the Engineers Joint Contract Documents Committee, EJCDC C-700 Standard General Conditions of the Construction Contract. In Massachusetts, the AIA General Conditions are commonly used on public building projects, which are subject to Mass. Gen. Laws ch.149, § 44A (2006), whereas the EJCDC General Conditions are commonly used on public works (non-building) projects, which are subject to Mass. Gen. Laws ch. 30, § 39M (2006).

3. AIA General Conditions, ¶ 4.3.1 and 4.3.2. The AIA General Conditions define a “claim” as a “demand or assertion by one of the parties seeking, as a matter of right, adjustment or interpretation of Contract terms, payment of money, extension of time or other relief with respect to the terms of the Contract. The term ‘Claim’ also includes other disputes and matters in question between the Owner and Contractor arising out of or relating to the Contract.” Id. ¶ 4.3.1.

4. Id. ¶ 4.4.1.

5. Id. ¶ 4.4.5.

6. EJCDC General Conditions, ¶ 1.01(A)(10). The EJCDC General Conditions define a “claim” as a “demand or assertion by owner or contractor seeking an adjustment of Contract Price or Contract Times, or both, or other relief with respect to the terms of the Contract. A demand for money or services by a third party is not a Claim.” Id.
bidders by assuring them that they can be compensated by formulae for overcoming subsurface conditions and for extra work not anticipated in their bid estimates, or suggested by available data or by site inspection.\textsuperscript{16}

In addition, since the contractor will (and should) be required, in accordance with the contract claims procedure, to notify the awarding authority of unforeseen conditions upon discovering and before unilaterally incurring expenses to address them, the awarding authority can exercise greater control over construction costs by addressing such conditions as they arise. Therefore, familiarity and compliance with the contract claims procedure is critical, and a contractor's failure to follow that procedure has important consequences for both the awarding authority and contractor.

II. Contractors Must Comply with the Claims Procedure

“The law has long been settled in this Commonwealth . . . that a contractor cannot recover on the contract itself without showing complete and strict performance of all its terms. . . .”\textsuperscript{17} This requirement of complete and strict performance with the terms of the construction contract includes compliance with the contract claims procedure.\textsuperscript{18} A contractor's failure to comply with the claims procedure may preclude it from recovering on its claims in subsequent litigation. The requirement of compliance with the contract claims procedure is well established by a long line of judicial opinions, some of which are discussed below.

In Glynn, the contractor, R&J Salvucci Corporation (“Salvucci”), alleged that it had sustained significant damages as a result of conduct of the awarding authority, the City of Gloucester.\textsuperscript{19} The master appointed to hear the evidence found that the city had breached its contract with Salvucci.\textsuperscript{20} Although Salvucci had failed to comply with the contract claims procedure for requesting additional compensation—it argued that the city had waived that procedure\textsuperscript{21}—the master found that the city had nonetheless been aware that Salvucci was incurring extra costs and intended to make a claim for payment of those costs.\textsuperscript{22} The superior court adopted the master’s findings and entered judgment in favor of Salvucci.\textsuperscript{23}

delivered to the project engineer and awarding authority no later than thirty days after commencement of the event giving rise to the claim.\textsuperscript{7} The second written notice must substantiate the claim and be delivered to the engineer and awarding authority within 60 days after the commencement of that event.\textsuperscript{8} “No Claim for an adjustment in Contract Price or Contract Times will be valid if not submitted in accordance with this” procedure.\textsuperscript{9}

Under the EJCDC General Conditions, the engineer's decision on a claim is final and binding on both parties to the construction contract unless one of the parties requests mediation of the claim in writing within 30 days of the engineer's decision.\textsuperscript{10} If the claim is not resolved within 60 days of a request for mediation, the engineer's decision on the claim is final and binding, unless, within 30 days of the termination of mediation, either of the following occurs: (1) one of the parties invokes in writing any dispute resolution procedures that may have been included in any supplementary conditions;\textsuperscript{11} (2) both parties agree to submit the claim to another dispute resolution process; or (3) one of the parties gives written notice of its intention to seek judicial relief.\textsuperscript{12}

The purpose of a contract claims procedure is, simply, to manage risk by allocating that risk between the awarding authority and contractor.\textsuperscript{13} The claims procedure is intended primarily to make more certain the circumstances under which a contractor may obtain equitable adjustments to the contract price or contract time.\textsuperscript{14} This increased certainty, it is hoped, results in lower bid prices for the awarding authority. It is expected that allowing equitable adjustments for unforeseen conditions will discourage bidders from increasing their bid prices to insure against the cost of such conditions. As the Appeals Court stated in Glynn v. City of Gloucester:\textsuperscript{15}

The adjustment remedies [i.e., the contract claims procedure] benefit both the contractor and the public agency. The agency customarily relies on the changed conditions and extra work clauses to remove unknown risks from competitive bidding and to obtain favorable bid prices stripped of such risk factors. Such a policy benefits the agency by keeping costs down and benefits the work. These provisions are incorporated into public construction contracts by operation of law. See Sutton Corp. v. Metro. Dist. Comm’n, 423 Mass. 200, 207 n.14 (1996); Reynolds Bros. Inc. v. Commonwealth, 412 Mass. 1, 5 (1992); Mayor of Salem v. Warner Amex Cable Comm’n, Inc., 392 Mass. 663, 666 (1984).

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7. Id. ¶ 10.05B.
8. Id.
9. Id. ¶ 10.05F.
10. Id. ¶¶ 10.05E and 16.01A. “The mediation will be governed by the Construction Industry Mediation Rules of the American Arbitration Association. . . .” Id. ¶ 16.01A.
11. The parties may amend and supplement the standard forms of general conditions through “supplementary conditions.” See AIA General Conditions, ¶ 1.1.1; EJCDC General Conditions, ¶ 1.01A(47).
12. EJCDC General Conditions, ¶ 16.01C.
14. Some provisions addressing equitable adjustments to the contract price and contract time are statutorily prescribed, such as the provisions contained in Mass. Gen. Laws ch. 30, § 39N (2006), which sets forth the circumstances under which a contractor (or awarding authority) may be eligible for an equitable adjustment to the contract price if unforeseen subsurface or latent physical conditions are encountered, and Mass. Gen. Laws ch. 30, § 39O (2006), which outlines the circumstances under which a contractor may be eligible for an equitable adjustment to the contract price where the awarding authority delays or suspends

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The city appealed the denial of its motions challenging the sufficiency of the master’s report.24 The Appeals Court ruled that the report was insufficient and returned the case to the trial court for additional findings.25 It also outlined the legal principles by which the trial court should be guided in determining whether Salvucci was eligible for additional compensation:

On a public construction project, if actions or requirements of the public agency necessitate changes in the work as it progresses, thereby causing the contractor to perform extra work or incur added expense, or if the contractor encounters materially different conditions from those predicted by the plans, specifications, preliminary borings and estimates, the contractor must follow the procedures spelled out in the contract . . . to adjust the price before unilaterally accruing expenses to be pursued later on breach of contract or quantum meruit theories.26

Regarding Salvucci’s argument that the city had waived compliance with the contract provisions, the Appeals Court noted the strict Massachusetts rule for proving waiver: “[I]f the contractor argues (as it does here) that the agency waived compliance with the contract’s provisions, it is incumbent on it to show . . . that there was clear, decisive, and unequivocal conduct on the part of an authorized representative of the agency indicating that it would not insist on adherence to the agreement.”27 It also noted that the facts contained in the master’s report, without more, would not support a finding of waiver by the city: “The present finding of the master that ‘the extra work and intended to bring a claim to recover for that work is inadequate without supporting subsidiary findings to warrant a conclusion of waiver by an authorized representative of the city.”28

Some six years later the Appeals Court issued its second decision in Glynn v. City of Gloucester.29 It reiterated the principles articulated in its earlier decision, calling them “settled law,” and concluded that Salvucci could not recover for its claims: “Salvucci’s failure to follow the remedies established by the contract (and statutes governing public construction projects) compels the conclusion that the additional costs were incurred [by Salvucci] unilaterally at its own expense. Were it otherwise, the contractual and statutory framework for the resolution of disputed claims would be virtually meaningless.”30

Similarly, in Skopek Brothers, Inc. v. Webster Housing Authority,31 the contractor, Skopek Brothers, Inc. (“Skopek”), alleged that it had encountered subsurface rock not shown in the plans, specifications and test boring information included in the contract documents.32 Skopek alleged that it was, therefore, eligible for an equitable adjustment in the contract price under section 39N of chapter 30 of the General Laws,33 which prescribes the circumstances under which a contractor (or awarding authority) will be eligible for such an adjustment when unforeseen subsurface or latent physical conditions are encountered.34 On appeal by both parties from a judgment of the trial court, the Appeals Court ruled that Skopek was not eligible for an equitable adjustment because it had failed to give written notice of its claim to the awarding authority “as soon as possible” after the discovery of the subsurface rock, as required by section 39N.35 It stated that the general conditions of the contract, of which section 39N was a part, were designed to provide for the resolution of the contractor’s claim “by the architect . . . rather than by a court.”36

The same result was reached in D. Federico Co., Inc. v. New Bedford Redevelopment Authority.37 In that case, the contractor, D. Federico Co., Inc. (“Federico”), encountered subsurface obstructions not shown on the contract drawings and requested additional compensation for the extra work it had performed as a result of those obstructions.38 Yet, Federico failed to deliver written notice of its claim to the awarding

24. Id. at 454-56.
25. Id. at 457, 464.
26. Id. at 460.
29. Id. at 390 (1986).
30. Id. at 395, 398. The court held that the city’s contemporaneous awareness that Salvucci was performing extra work did not support a finding that the city had waived the requirement of written notice contained in the contract. Id. at 395 n.8.
32. Id. at 947.
34. Section 39N states in relevant part as follows:
If, during the progress of the work, the contractor or the awarding authority discovers that the actual subsurface or latent physical conditions encountered at the site differ substantially or materially from those shown on the plans or indicated in the contract documents either the contractor or the awarding authority may request an equitable adjustment in the contract price of the contract applying to work affected by the differing site conditions. A request for such an adjustment shall be in writing and shall be delivered by the party making such claim to the other party as soon as possible after such conditions are discovered.
36. Id.
38. Id. at 892.
authority until after it had discovered the obstructions and completed the extra work, contrary to the written notice requirement in the construction contract.\textsuperscript{39} Although the court found that Federico had verbally informed the project engineer of the extra work, and had been verbally instructed by the engineer to proceed with that work as quickly as possible, it ruled that those facts neither satisfied the written notice requirement in the contract nor constituted a waiver of that requirement by the awarding authority.\textsuperscript{40}

The cases discussed above raise an important question: If a contractor complies with the contract claims procedure and the architect arbitrarily denies the contractor’s claim, will the contractor be eligible for a remedy greater than the relief provided for its claim in the construction contract? Stated differently, is the arbitrary denial of a properly made claim a “true” breach of contract? To answer this question, we must first define a true breach of contract.

### III. A True Breach of Contract Defined

Perhaps the best way to define a true breach of contract is to state what it is not. Generally, if a contract provides relief for a particular claim, the awarding authority’s good-faith rejection of that claim, even if that rejection is arbitrary, will not constitute a true breach of contract.\textsuperscript{41} This does not, however, leave the contractor without a remedy if its claim is arbitrarily denied. Rather, it limits the contractor to the relief expressly provided in the contract for the claim.\textsuperscript{42} In other words, the contractor will be limited to the relief that it had agreed was appropriate for the claim.

The decision in Sutton Corporation v. Metropolitan District Commission,\textsuperscript{43} is a good illustration of the meaning of a true breach of contract. In that case, the contractor, Sutton Corporation (“Sutton”), was required to install sand drains in preparation for construction of a bridge for the Metropolitan District Commission (“MDC”), the awarding authority.\textsuperscript{44} Soon after commencing its work, Sutton discovered unusual soil conditions, necessitating a change to a more costly installation method.\textsuperscript{45} Sutton ceased the installation work, notified the MDC in writing that it had encountered a changed condition under section 39N, and made a claim for the resulting increase in its cost to perform the work.\textsuperscript{46} The MDC denied the claim on the grounds that Sutton had not encountered an unforeseen subsurface condition under section 39N and failed to comply with the procedure in its contract for making a claim for extra work.\textsuperscript{47}

The superior court ruled in favor of Sutton, and the MDC appealed.\textsuperscript{48} The Appeals Court reversed on the ground that Sutton had failed to comply with the contract provisions for making a claim for extra work, which were more stringent than the notice requirement contained in section 39N.\textsuperscript{49} The Supreme Judicial Court (“SJC”) disagreed and held that Sutton’s claim was not a claim for extra work because the installation of sand drains was required by the contract.\textsuperscript{50} Rather, the claim was for an increase in the contract price under section 39N.\textsuperscript{51} Because Sutton had indeed encountered an unforeseen subsurface condition under section 39N and complied with the section 39N notice requirement, the SJC ruled that an equitable adjustment was mandatory, and that the MDC’s denial of Sutton’s claim was, therefore, an error of law.\textsuperscript{52}

Having established liability, the SJC next turned to the question of damages. Sutton argued that the MDC had committed a true breach of contract and, consequently, that it was entitled to damages greater than the relief provided in the contract for the claim.\textsuperscript{53} The SJC disagreed: “A claim for an equitable adjustment under the changed conditions provision is a claim for relief under the contract, and is not a ‘true’ breach of contract claim.”\textsuperscript{54} It explained:

When the contract makes provision for equitable adjustment of particular claims, such claims may be regarded as converted from breach of contract claims to claims for relief under the contract. . . . Recovery for such claims is limited to the remedies provided in the contract. When a particular claim falls outside the contract, such that it is not redressable under specific contract adjustment provisions, it is a “true” breach of contract claim that may justify an award of damages.\textsuperscript{55}

\begin{itemize}
\item \textsuperscript{39} Id.
\item \textsuperscript{40} Id. at 898-99. The court noted that there was no evidence that the project engineer had had the authority to waive contract provisions. Id. at 893, 898-99.
\item \textsuperscript{42} An exception to the definition of a true breach of contract provides that a bad faith rejection of a claim (for which the contract provides relief) may constitute a true breach of contract. See Glynn v. City of Gloucester, 21 Mass.App.Ct. at 397. Even under this exception, however, the contractor may be foreclosed from litigating its bad faith claim if it fails to comply with the contract claims procedure. Id. at 397-98 (“only after a claim has been validly processed through the stages established by the contract . . . could it be determined whether the city had acted in bad faith.”); see also JRJ Constr. Co. v. R.W. Granger & Sons, Inc., No. 97-2194, 1999 WL 706717, at *11 (Mass. Super. Ct. July 29, 1999) (“even in a claim for a true breach of contract, the contractor is required to comply with the written notice and claim provisions of the contract”). But see Petruzzi v. Massachusetts Tpk. Auth., No. 9400690, 1998 WL 11181734, at *5 (Mass. Super. Ct. Sept. 21, 1998) (on summary judgment, one of contractor’s four claims was sent to jury on question of bad faith even though contractor had failed to comply with contract claims procedure).
\item \textsuperscript{43} Sutton Corp., 423 Mass. at 213.
\item \textsuperscript{44} Id. at 203.
\item \textsuperscript{45} Id. at 205.
\item \textsuperscript{46} Id. at 204.
\item \textsuperscript{47} Id. at 204.
\item \textsuperscript{49} Id. at 766.
\item \textsuperscript{50} Sutton Corp., 423 Mass. at 207.
\item \textsuperscript{51} Id. at 206.
\item \textsuperscript{52} Id. at 206-08.
\item \textsuperscript{53} Id. at 212-13.
\item \textsuperscript{54} Id. at 213.
\end{itemize}
Since Sutton’s claim was a claim for relief under the contract—section 39N was, by operation of law, deemed a part of the contract—it was not a true breach of contract claim. Therefore, Sutton’s damages were limited to those provided by the terms of the contract and the statutes governing public construction projects.

To understand the potential significance of limiting a contractor to the relief provided in the construction contract, consider the following example: A contractor prepares a bid for a “unit price” contract for the installation of a public sewer. The bid form requires bidders to insert a separate unit price for each of the various items of work listed on the form, including ledge excavation (per cubic yard), and it provides an estimated quantity for each item. The contract documents state that payment for all work performed will be measured by the contractor’s unit prices, and that such prices will not be adjusted regardless of whether the quantity of work performed exceeds the estimated quantities on the bid form.

The awarding authority will determine the low bid, for the purpose of awarding the construction contract, by multiplying the estimated quantity of each work item by its corresponding unit price, and then adding together the resulting products for each item. The contractor thus recognizes that its total bid price, rather than how that price is allocated among the separate work items on the bid form, will determine whether it will be the low bidder and awarded the contract. It therefore estimates a single bid price for all work to be performed, and then decides how best to allocate that price among the various work items.

The contractor anticipates that its actual cost to excavate a cubic yard of ledge will be $50, but based on its review of the boring logs included in the bid documents, it concludes that the quantity of ledge estimated by the awarding authority is excessive. Therefore, the contractor assumes that it will be required to excavate less ledge. It recognizes, however, that if it bids $50 and its assumption proves correct, it will not be paid for the entire estimated quantity of ledge excavation contained on the bid form, since it will only be paid for work actually performed. To ensure that it will be paid its total bid price, and gambling that its assumption is indeed correct, the contractor bids “one penny” for ledge excavation and allocates its remaining bid price to the items of work it is certain to encounter, such as the installation of pipe.

During construction and contrary to its assumption, the contractor excavates ledge in a greater quantity than estimated by the awarding authority. In an effort to make good the loss resulting from its penny bid, the contractor makes a claim to recover its actual costs for all ledge excavation. The awarding authority’s project engineer denies the claim in good faith on the ground that the contractor did not comply with the contract claims procedure, and the contractor is paid nothing. The contractor sues the awarding authority and succeeds in proving that the engineer’s decision regarding its compliance with the contract claims procedure was arbitrary. Even so, the contractor will be paid no more than one penny for each cubic yard of ledge excavation.

IV. Limits on De Novo Review of Claims Decisions

It is common practice to authorize the project architect or engineer to make decisions on claims and other matters arising during construction, as has been recognized by the Appeals Court:

Construction contracts frequently contain provisions giving the architect the power to decide disputes which arise under a construction contract. Such is the number of details in construction drawings and specifications that inevitably there are disputes about methods, materials, and the extent of what a contractor is to do and for what the owner is to pay. It is important that someone more or less on the spot can resolve those disputes, and the architect, as we have seen, is commonly the designated referee.

57. Id. at 213. Since there was no contractual or statutory method to determine Sutton’s equitable adjustment under § 39N, the court stated that “it is reasonable to refer to the contractual damages formula concerning payment for extra work.” Id. at 212. Limiting the contractor to the relief specified in its contract is consistent with the general rule of damages for breach of contract. “Contract damages are ordinarily based on the injured party’s expectation interest and are intended to give him the benefit of his bargain by awarding him a sum of money that will, to the extent possible, put him in as good a position as he would have been in had the contract been performed.” Restatement (Second) of Contracts § 347 cmt. a (1981). For legal decisions discussing this general rule of damages, see Boylston Hous. Corp. v. O’Toole, 321 Mass. 538, 562 (1947), and Doering Equip. Co. v. John Deere Co., 61 Mass.App.Ct. 850, 856 (2004).
58. Under paragraph 12.01B of the EJCDC General Conditions, adjustments to the contract price must be determined by application of the contract unit prices, if any. Under paragraphs 7.2.2 and 7.3.3 of the AIA General Conditions, however, the contract unit prices may, but need not, be used to determine adjustments to the contract price. Unlike in the above hypothetical, the EJCDC General Conditions (¶ 11.03D) and AIA General Conditions (¶ 4.3.9) allow for an equitable adjustment to the contract price or applicable unit price, respectively, if the quantity of unit-price work stated in the contract is materially exceeded.
59. For example, assume the bid form contains two items of work: (1) installation of pipe (per linear foot), and (2) excavation of ledge (per cubic yard). The estimated quantities listed on the bid form are 10 cubic yards for ledge excavation and 10 linear feet for pipe installation. A bidder bids $1.00 for ledge excavation and $1.00 for pipe installation. The bid price is calculated as follows: $(1.00 x 10) + ($1.00 x 10) = $20.00.
60. “Penny bids,” as they are known, have been ruled legal under the public bid laws. See Department of Labor and Indus. v. Boston Water and Sewer Comm’n, 18 Mass.App.Ct. 621, 625-26 (1984) (stating that public bid laws do not forbid penny bidding and acknowledging that such bids may result from bidder’s unique skills and advantages).
61. A bad faith denial of a claim may constitute a true breach of contract for which the contractor may be eligible to recover damages greater than the relief provided in the contract for its claim. See Glynn v. City of Gloucester, 21 Mass.App.Ct. 390, 397 (1986).
62. See Sutton Corp., 423 Mass. at 207 (denial of contractor’s § 39N claim was in error, but contractor was restricted to the relief provided in its contract for its claim).
63. For the remainder of this article references to “architect” will, unless otherwise indicated, mean architect or engineer.
In addition, “[i]t is well established that, where a building contract makes the architect an arbitrator between the parties to determine practical questions of construction that arise under the plans and specifications in the execution of the work, his decision upon these matters is binding.” Moreover, so long as the architect acts fairly and in good faith, its decision may bind the parties even if the architect was mistaken in that decision. As stated in Hurley v. City of Boston, which involved the question of whether the parties were bound by the architect’s decision fixing the wrong date of completion of the construction work:

The parties were bound by his [the architect’s] decision that the work was completed on August 8, if he honestly decided the matter, although as a matter of fact it was not completed until a later date, because they elected to take his judgment and be bound by his decision, for it was a part of their contract that the architect was to decide the question of the date of completion of the work. . . . The finding of the architect cannot be impeached merely because he was careless in his inspection, or mistaken in his conclusion. His judgment may have been wrong, and a more careful examination might have disclosed his error. As long as he acts fairly and in good faith, is not the victim of the fraud of others, and exercises his own honest judgment, the finding, or decision, is binding. Therefore, de novo review of an architect’s good faith claims decision may not be available to a contractor.

This limitation of judicial review is the logical consequence of the parties’ agreement that the architect’s decisions will be final and binding. In other words, the courts’ refusal to review such decisions de novo is nothing more than the enforcement of that agreement. Such refusal is also consistent with the well established principle prohibiting parties from relitigating matters previously adjudicated. Simply put, courts will hold the parties to their agreement, contained in the construction contract, to be bound by the architect’s decisions.

In 1961, this limitation of judicial review was codified by the Massachusetts General Court for public construction projects. Section 39J of chapter 30 of the General Laws provides as follows:

Notwithstanding any contrary provision of any contract for the construction, reconstruction, alteration, remodeling, repair or demolition of any public works by the commonwealth, or by any county, city, town, district, board, commission or other public body, when the amount of the contract is more than five thousand dollars in the case of the commonwealth and more than two thousand dollars in the case of any county, city, town, district, board, commission or other public body, a decision by the contracting body or by any administrative board, official or agency, or by any architect or engineer, on a dispute, whether of fact or of law, arising under said contract shall not be final or conclusive if such decision is made in bad faith, fraudulently, capriciously, or arbitrarily[,] is unsupported by substantial evidence, or is based on error of law.

As interpreted by the courts, section 39J, like the line of court decisions preceding it, limits judicial review of decisions rendered by an awarding authority (or its architect) on a public construction project. If the project architect denies a contractor’s claim, that denial will not be subject to de novo review unless the contractor can show that it was “made in bad faith, fraudulently, capriciously, or arbitrarily[,] is unsupported by substantial evidence, or is based on error of law.”

66. 244 Mass. 466 (1923).
67. Id. at 470.
68. Id. (citations omitted). As will be discussed later in this article, the Hurley court ultimately ruled that the architect’s decision fixing the completion date was not final and binding because the architect had failed to perform an inspection of the construction work, as required by the terms of the construction contract, and, therefore, had not exercised “honest judgment.” Id. at 471-72.

This provision [making final and binding the engineer’s certification of payment] is not illegal as an attempt to oust the court of its jurisdiction respecting the subject-matter, because by the terms of the contract the contractor can have no right of action to which the jurisdiction of any court can attach. . . .

Id. at 493.
70. See Hurley, 244 Mass. at 470; Marsch, 230 Mass. at 493, 495.
73. By the very language of § 39J, the limitation of judicial review applies to decisions by “the contracting body or by administrative board, official or agency.” Id. This language indicates that decisions by the awarding authority itself, as well as decisions by its architect-representative, will be final and binding.

No provision of any contract entered into by the United States, relating to the finality or conclusiveness of any decision of the head of any department or agency or his duly authorized representative or board in a dispute involving a question arising under such contract, shall be pled in any suit now filed or to be filed as limiting judicial review of any such decision to cases where fraud by such official or his said representative or board is alleged: Provided, however, That any such decision shall be final and conclusive unless the same is fraudulent or capricious or arbitrary or so grossly erroneous as necessarily to imply bad faith, or is not supported by substantial evidence.

Id. With a few exceptions, the Wunderlich Act was superseded by the Contract Disputes Act, also known as the “CDA,” 41 U.S.C. §§ 601-13 (2000 & Supp. V), as amended by Pub. L. No. 109-435, 120 Stat. 3232 (2006). See Parker v. United States, 77 Cl. Ct. 279, 287 (2007), aff’d, No. 2007-5163, 2008 WL 2329271 (Fed. Cir. June 4, 2008) (Wunderlich Act remains applicable “(1) when the contracting agency in question is not within the executive branch; or (2) when the contract at issue was entered into before the final effective date of the CDA”). Under the CDA, decisions of agency boards of contract appeals “on any question of fact or of law” shall be final and conclusive and shall not be set aside unless the decision is fraudulent, or arbitrary, or capricious, or so grossly erroneous as to necessarily imply bad faith, or if such decision is not supported by substantial evidence.” 41 U.S.C. § 609(b) (2000 & Supp. V).
The following court decisions discuss the finality of a project architect’s claims decisions.

A. The Architect’s Decision Is Final Where the Architect Acts within the Scope of Its Authority

So long as the architect acts within the scope of its authority granted in the construction contract, its good faith decisions will be final and binding. In Fontaine Brothers, Inc. v. City of Springfield, the contractor sought additional compensation for extra work. The dispute turned on an interpretation of the plans and specifications. The architect interpreted the plans and specifications and decided that the contractor was not eligible for additional compensation. The contractor sued the awarding authority, the City of Springfield, arguing that the architect had exceeded its authority, and won a jury verdict.

The city appealed the trial court’s denial of its motion for a directed verdict. Although the Appeals Court agreed with the architect’s interpretation of the plans and specifications, it nonetheless declared that its own opinion was irrelevant: “The question in the case . . . is not what we think the specifications mean. Rather, the question is: was the architect authorized to decide definitively what the specifications mean?” The court found that the architect was so authorized. The construction contract stated that the “work shall be done under the general direction of the Architect and his decision as to the . . . meaning of the drawing and specifications shall be final,” and that the architect’s decisions on disputed claims “shall be final and binding on the parties.” Since there was no evidence that the architect had acted fraudulently or arbitrarily, the Appeals Court ruled that the contractor was bound by the architect’s decision.

B. The Architect’s Decision Is Not Final if the Architect Acts beyond Its Scope of Authority

If the architect acts beyond the scope of its authority, its decisions will not be final and binding. The case of Henry B. Byors & Sons, Inc. v. Board of Water Commissioners involved the construction of a 73-unit housing facility by the Northborough Housing Authority. The Northborough Board of Water Commissioners notified the plaintiff, a plumbing subcontractor, that it was required to pay a fee for each housing unit before it would be permitted to connect the facility to the municipal water source. The architect decided that the subcontractor was indeed responsible for the fee. The subcontractor sued the general contractor, with whom it had a contract, the Housing Authority and the Board of Water Commissioners.

Reversing the trial court’s judgment against the plaintiff subcontractor, the SJC explained that “[t]he issues over which the architect is given power of decision must . . . be determined by the reasonable interpretation of the contract provision creating such power. . . . The decision of the architect is not conclusive where he exceeds the authority conferred upon him. . . .” Although the architect was broadly empowered to interpret the construction contract, that authority “did not give him the power to make a new contract for the parties. He could translate the contract and ascertain its meaning but he could not add to or detract from the text.” Since the construction contract did not expressly require the subcontractor to pay the fee, the court considered the architect’s contrary decision a rewriting of the specifications, rather than an interpretation of the same, and ruled that such decision was, therefore, “a nullity.”

77. Id. at 155.
78. Id.
79. Id.
80. Id.
81. Id. at 156.
82. Id. at 157.
83. Id. at 156-57.
84. Id. at 157-58.
85. Id.
86. Id. at 159-60. The court also addressed the plaintiff’s argument that the architect “may not by his power of decision change the contract.” Id. Although the court agreed that the architect may not change the terms of the parties’ contract, it found that the architect had interpreted, not changed, the specifications: “Contract terms are not changed when the architect decides in the course of a job what a specification means or whether one specification trumps another.” Id. But see Henry B. Byors & Sons, Inc. v. Bd. of Water Comm’rs, 358 Mass. 354, 364 (1970) (architect’s interpretation constituted unauthorized rewriting of specifications).
89. Id. at 356.
90. Id.
91. Id. at 357.
92. Id.
93. Id. at 363-64 (citations omitted).
94. Id. at 364 (quoting Morgan, 316 Mass. at 420).
95. Id.
C. The Architect’s Decision Is Not Final if Not Based on Required Inspections

If the architect is required by the construction contract to investigate a matter submitted to it for decision, the architect must do so, or its decision on such matter will not be final and binding. In Hurley v. City of Boston, a dispute arose about whether the plaintiff subcontractors had filed sworn statements of their payment-bond claims within sixty days of completion of the work, as required by statute. Before that question could be answered, however, the court needed to determine when the work had been completed.

During the course of the project, the architect determined the date of completion of the work, as it was required to do by the construction contract. Yet, in making that determination, the architect “failed to make any examination or inspection of the . . . work . . . although the inspection of this work was a part of his duty.” Instead, the architect relied on an examination performed by inspectors hired by the awarding authority, the City of Boston.

The court ruled that, although the architect could have reasonably relied on an inspection of the work performed by its own assistants acting at its direction, it could not properly rely on an inspection performed by the city. By failing to inspect the work to determine if it was complete, as required by the construction contract, the architect “did not exercise his honest judgment in passing upon the question and in deciding that the work was completed on a certain date.” Therefore, the architect’s decision was not final and binding.

D. The Architect’s Decision Is Not Final if the Owner Interferes with that Decision

If the awarding authority interferes with the architect’s decision making, the resulting decision may not be final and binding. In Marsch v. Southern New England R.R. Corp., the defendants challenged the sufficiency of the plaintiff contractor’s causes of action, which were founded upon the allegation that the contractor had not been paid for all of its work. The construction contract appointed the engineer as “sole umpire” to decide questions arising under that contract, and it conditioned payment to the contractor on the issuance of a certificate by the engineer certifying that the contractor had performed the work for which payment was sought. The contract stated that the engineer’s certificate “shall be final and conclusive between the parties . . . and actual fraud only shall disqualify him [the engineer] from acting as aforesaid.”

The engineer did not issue the requisite certificate for all of the work for which the contractor had requested payment. Since the engineer’s decision to issue or not issue a certificate was final and binding in the absence of fraud, in order to challenge the engineer’s decision, it was not enough, the court stated, for the contractor to allege that it “has done and performed all acts and things which . . . he was required to do and perform.” Rather, to maintain its lawsuit, the contractor was required to allege “that the condition precedent [i.e., certification of the engineer] was performed or the want of that performance excused.”

The contractor alleged that the “engineer was prevented by the interference of the defendant [awarding authority] from giving a certificate.” Although the engineer was under the owner’s absolute control and direction, the court stated that such fact was not, by itself, a sufficient allegation “of bias, fraud or prejudice to show collusion and fraud and . . . not enough to require judicial inquiry.” Nevertheless, the court held that the contractor’s allegation of interference by the owner was sufficient to withstand the defendants’ challenge. Such an allegation “imports not alone undue influence, but also that the engineer yielded to that influence. If such should be the case, such action would be a fraud and would leave the provision for obtaining the certificate of no effect.”

E. The Architect’s Decision May Not Be Final if the Architect Fails to Object to the Contractor’s Means and Methods of Performing the Work

Unless its contract states otherwise, the contractor chooses the means and methods by which it will accomplish its work. Typically, neither the awarding authority nor its architect will interfere with that choice—and for good reason, because doing so may result in claims by the contractor. There may be instances, however, where

96. Hurley v. City of Boston, 244 Mass. 466, 471 (1923).
97. 244 Mass. 466 (1923).
98. Id. at 468. A payment bond in the amount of no less than 50 percent of the total contract price is required for all Massachusetts public construction projects estimated to cost more than $2,000 for municipalities and $5,000 for the commonwealth. See Mass. Gen. Laws ch. 149, § 29 (2006). This payment bond requirement is increased to 100 percent of the contract price for public building projects estimated to cost more than $100,000. See Mass. Gen. Laws ch. 149, §§ 44A and 44E (2006).
99. Hurley, 244 Mass. at 468.
100. Id.
101. Id. at 468, 471.
102. Id.
103. Id.
104. Id.
105. Id.
108. Id. at 490-91.
109. Id. at 489-90.
110. Id. at 490.
111. Id. at 494.
112. Id. at 490.
113. Id.
114. Id. at 494.
115. Id.
116. Id.
117. Id.
118. For examples of contractual provisions addressing the issue of control over means and methods of construction, see AIA General Conditions, ¶¶ 3.3.1 and 4.2.2, and EJCDC General Conditions, ¶¶ 6.01A and 9.09B.

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the failure to object to a contractor’s choice of means and methods will result in claims against the awarding authority.\textsuperscript{119} For example, in \textit{J.A. Sullivan Corporation v. Commonwealth,}\textsuperscript{120} the general contractor used the more expensive of two contractual methods of ledge excavation.\textsuperscript{121} The contract contained a separate unit price for each method of excavation, one more expensive than the other, but failed to indicate when and how the methods were to be used.\textsuperscript{122} During construction, the architect observed the ledge excavation but never objected to the contractor’s use of the more expensive method.\textsuperscript{123} Upon completion of the work, the contractor submitted to the architect a proposed change order based on the more expensive unit price.\textsuperscript{124} The architect rejected the proposed change order and recommended to the awarding authority, the Massachusetts Bureau of Building Construction, that the contractor be paid some lesser amount for the work, and the awarding authority followed that recommendation.\textsuperscript{125} Although the contractor accepted the lesser amount, it appealed the architect’s rejection of the proposed change order to the Executive Office for Administration and Finance, which denied the appeal six days later.\textsuperscript{126}

At trial, the commonwealth argued that the architect’s decision was final and binding and, therefore, not reviewable by the court.\textsuperscript{127} The superior court disagreed, holding that the controlling provision of the construction contract did not expressly state that the architect’s decisions would be final and binding.\textsuperscript{128} That provision, Article V, stated:

The designer [architect] shall decide all questions which may arise as to the conduct, quantity, quality, equality, acceptability, fitness and rate of progress of the several kinds of work and materials to be performed and furnished under the contract and shall decide all questions which may arise as to the interpretation of the plans, and specifications and as to the fulfillment of this contract on the part of the contractor.\textsuperscript{129}

\textsuperscript{119} J.A. Sullivan Corporation v. Commonwealth, 397 Mass. 789, 800-01 (1986) (contractor eligible for additional compensation for use of more expensive method of excavation because architect had failed to object to use of that method); Perini Corporation v. Massachusetts Port Authority, 2 Mass.App.Ct. 34, 44-45 (1974) (contractor eligible for additional compensation for certain drilling work because engineer had failed to object to that work).

\textsuperscript{120} 397 Mass. 789 (1986).

\textsuperscript{121} Id. at 798.

\textsuperscript{122} Id.

\textsuperscript{123} Id.

\textsuperscript{124} A “change order” is, generally, a written amendment to the construction contract reflecting the parties’ agreement regarding changes in the construction work and adjustments to the contract time or contract price. \textit{See AIA General Conditions, ¶ 7.2.1; EJCDC General Conditions, ¶ 1.01A(9).}

\textsuperscript{125} \textit{J.A. Sullivan Corp.}, 397 Mass. at 798-99.

\textsuperscript{126} Id. at 799.

\textsuperscript{127} Id.

\textsuperscript{128} Id. at 800. The commonwealth did not argue that the decisions of the Bureau of Building Construction and the Executive Office for Administration and Finance (concurring with the architect) were final and conclusive under “a provision in the contract that says ‘[t]he determination of the Bureau shall be final upon all questions of the amount and value of changes or method of submission and approval thereof.’” \textit{Id.} at 801-02. It raised that argument for the first time on appeal. Consequently, the SJC was “reluctant to conclude that the judge’s conclusion was ‘clearly erroneous’ because of the judge’s failure to take that provision into account.” \textit{Id.} at 802.

\textsuperscript{129} Id. at 799.

\textsuperscript{130} Id. at 800.

\textsuperscript{131} Id. (emphasis added).

\textsuperscript{132} Id.

\textsuperscript{133} Id. at 801.

\textsuperscript{134} Id. (citations omitted). In making this statement, the court appears to have rejected the trial court’s holding, \textit{id.} at 800, that the contract must expressly state that the architect’s decision will be final and binding for the decision to have such effect. Otherwise, the court’s statement appears contradictory, because if the contract must include such an express statement for the architect’s decision to be final and binding, and the contract here contained no such statement, it is unclear how the timing of the architect’s decision is relevant to the question of whether that decision is final and binding.
F. An Arbitrator May Be Bound by an Architect's Decisions

Where the contract requires the arbitration of disputes, the arbitrator, like a court, may have limited jurisdiction over the architect's decisions. In *G.L. Rugo & Sons, Inc. v. Town of Lexington*, the architect was responsible to do the following:

 decide all questions which may arise as to the quality, quantity, acceptability, fitness and rate of progress of the several kinds of work . . . and . . . all questions which may arise as to the interpretation of the plans and specifications . . . and his determination and decisions shall be final and conclusive.

Pursuant to that authority, the architect decided that certain disputed work was required by the contract and, therefore, did not constitute extra work.

After having performed the work as directed by the architect, the general contractor submitted the same question that had been decided by the architect to a panel of arbitrators pursuant to article 40 of the general conditions, which stated: "If any controversy arises under the contract . . . it shall be determined by arbitration. . . . In the event of any discrepancy between this [provision] and other provisions of the general conditions, the provisions of this article 40 shall govern." The panel of arbitrators ruled, however, that the architect's decision was final and binding, and that ruling was then filed with the superior court. On motion of the awarding authority, the Town of Lexington, the superior court entered judgment on the arbitrators' ruling, and the contractor appealed.

On appeal the general contractor argued that article 40 superseded the provision empowering the architect to make final and binding decisions. The SJC disagreed, stating:

 We perceive no discrepancy between the express grant of final authority to the architect . . . and the powers of the arbitrators. . . . Nothing in article 40 empowers the arbitrators to override the decisions of the architect on questions within the ambit of his authority. Upon submission only two issues were open to the arbitrators: (1) whether the architect acted within the scope of his powers, and (2) whether he was guilty of any fraud or bad faith in making his decisions.

Therefore, unless the provisions of the general conditions providing for arbitration expressly state otherwise, an arbitrator will likewise be bound by the limitation of judicial review codified in section 39J of chapter 30 of the General Laws.

G. The Architect's Decisions May Bind Subcontractors

Decisions by the architect may bind a subcontractor where the provisions of the construction contract, which authorize the architect to render final and binding decisions, are incorporated into the subcontract. In *Ostrow Electrical Co. v. J.J. Marshall & Sons, Inc.*, the plaintiff subcontractor disputed whether it, or another subcontractor, was responsible for certain electrical work. The dispute was submitted to the architect, who, as "the interpreter of the requirements of the Contract Documents," was required to "render interpretations necessary for the proper execution or progress of the work." To resolve the dispute, the architect interpreted conflicting language in the specifications, ultimately deciding that the plaintiff was responsible for the work.

The subcontractor sued the architect, general contractor and surety, arguing that the architect's decision was arbitrary and capricious. The superior court granted the subcontractor's motion for summary judgment on its claims against the contractor and surety, and an appeal ensued. The Appeals Court reversed, concluding that the architect's decision "was plausible and cannot be characterized as having no rational basis. The decision, therefore, was not arbitrary and capricious, and there was no error of law." Regarding the plaintiff's allegation that the architect had made "a new contract by interpreting ambiguities in the contract," the Appeals Court stated: "Contract terms are not changed when the architect decides in the course of a job what a specification means or whether one specification trumps another."

137. Id. at 749.
138. Id. at 747.
139. Id. at 748.
140. Id.
141. Id.
142. Id. at 751.
143. Id.
144. On public building projects estimated to cost more than $100,000, certain subcontractors, known as "filed sub-bidders," are required to execute a form of subcontract prescribed by statute, which binds the subcontractors to the general contractor to the same extent that the general contractor is bound to the awarding authority. *See Mass. Gen. Laws ch. 149, § 44F* (2006). For legal decisions involving subcontractor claims, see Hampden Cornice Works, Inc. v. Leo Spear Constr. Co., Inc., 348 Mass. 798, 798-99 (1965) (architect decides certain work to be responsibility of subcontractor); Salem Glass Co. v. Joseph Rugo, Inc., 343 Mass. 103, 104-05 (1961) (suggesting that decision of general contractor that subcontractor is responsible for certain work could be final and binding if subcontract gives general contractor authority to make such a decision and decision is reasonable); Farm-Rite Implement Co. v. Fenestra Inc., 340 Mass. 276, 278-79 (1960) (subcontractor agreed in subcontract to be bound to provision in general contract empowering architect to render final decisions on interpretations of specifications); Fred C. McClean Heating Supplies, Inc. v. Jefferson Constr. Co., 339 Mass. 336, 366-77 (1959) (decision of architect regarding scope of subcontractor's work not final because it was made long after commonwealth's acceptance of completed project); Derby Desk Co. v. Conners Bros. Constr. Co., 204 Mass. 461, 467 (1910) ("architect's decision as to the interpretation of the contract, made nearly a year after the date of the writ, should not be a condition precedent to the right of the plaintiff to bring suit"); Ostrow Elec. Co. v. J.J. Marshall & Sons, Inc., 59 Mass. App. Ct. 816, 819-22 (2003) (architect decides certain work to be responsibility of subcontractor); and, J.J. Finn Elec. Serv., Inc. v. P & H Gen. Contractors, Inc., 13 Mass.App.Ct. 973, 973 (1982) (engineer decides that certain work is not responsibility of subcontractor).
146. Id. at 817.
147. Id. at 819-20.
148. Id. at 817, 820-21.
149. Id.
150. Id.
151. Id. at 822.
152. Id. (quoting Fontaine Bros., Inc. v. City of Springfield, 35 Mass.App.Ct. 155, 159 (1993)).
Conclusion

The contract claims procedure is an important tool for allocating risk, managing construction costs, and resolving disputes arising out of a construction contract. Given the importance of the claims procedure, awarding authorities should draft that procedure carefully, using as a guide the legal principles discussed in this article, which can be summarized as follows:

(1) To avail itself of the remedies provided in the contract, a contractor must comply strictly with the terms of its contract, including the contract claims procedure;

(2) If the contractor fails to adhere to the requirements of the contract claims procedure, it will forfeit its claims, including any bad faith claim, unless it can prove that the awarding authority—through clear, decisive and unequivocal conduct—either (a) waived its right to reject the claim or (b) excused the contractor's noncompliance with the claims procedure;

(3) If the contractor complies with the contract claims procedure and the awarding authority arbitrarily rejects its claim, the contractor will not be eligible for damages greater than the relief provided in the contract for the claim, unless it can prove that the awarding authority acted in bad faith (i.e., a "true" breach of contract); and

(4) If the construction contract authorizes the project architect to make final and binding decisions on a contractor's claims, the architect's denial of a contractor's claim will be final and binding under section 39J of chapter 30 of the General Laws, and the contractor will be unable to obtain judicial review of that decision unless it can show that (a) it complied with the contract claims procedure and (b) the architect's decision was "made in bad faith, fraudulently, capriciously, or arbitrarily[, is unsupported by substantial evidence, or is based on error of law."\(^{153}\)

Shareholder Duties and Disputes in Closely-Held Corporations in Massachusetts

by Marc C. Laredo

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Over thirty years ago, the Supreme Judicial Court ("SJC") issued its landmark ruling in Donahue v. Rodd Electrotype Co. of New England, Inc.,1 in which it established standards for the governance of closely held corporations in Massachusetts and held that each shareholder in a closely-held corporation owes a fiduciary duty to the other shareholders.2 In the years since the Donahue decision, and in conformance with that landmark ruling, the Massachusetts courts have analyzed an array of issues involving the management and control of closely-held corporations.

This article first will review the Donahue ruling itself. It then will discuss significant developments in the Donahue doctrine, including: (a) the tension between running the corporation and protecting the interests of minority shareholders; (b) employment issues when a shareholder also is an employee; (c) the improper use of corporate opportunities; (d) the applicability of Donahue to non-Massachusetts corporations; (e) applying the Donahue rules to limited liability companies and limited liability partnerships; (f) drafting around the Donahue requirements; and (g) special issues for disputes involving professional services firms. Third, the article will provide an overview of available remedies, both by resort to the courts and through negotiation. Lastly, the article will note trends in the case law after Donahue and suggestions for further refinements in the balance between the needs of entities and the rights of individual shareholders.

I. The Donahue Ruling

Euphemia Donahue was the widow of Joseph Donahue, who had been employed by Rodd Electrotype Company of New England, Inc., starting out as a ”finisher” of electrotype plates and rising to “the positions of plant superintendent (1946) and corporate vice-president (1955),” although he “never participated in the ‘management’ aspect of the business.”3 Over time, Mr. Donahue bought stock in the company and, by 1955, was the owner of 20 percent of the company’s stock, with Harry Rodd owning the remaining 80 percent.4 During the ensuing years, Mr. Rodd gave some of his stock to his children and, in 1970, the corporation purchased the remaining stock that he owned.5 Mrs. Donahue learned of this purchase in 1971 and demanded that the company buy her stock on the same terms; the company refused, and a lawsuit was filed later that year.6 The superior court ruled in favor of the company and its officers and directors and, in a brief opinion, the Appeals Court affirmed.7 The SJC reversed the two lower courts, ruling that the company, Mr. Rodd, and its other individual officers and directors breached their fiduciary duties to Mrs. Donahue by not allowing her the opportunity to have the corporation buy her stock on the same terms that had been given to Mr. Rodd.8

The court then used this rather narrow internal dispute to provide a broad framework for the governance of “close corporations” in Massachusetts, dealing with the basics (formation, allocation of power, employment, stock purchase and sale) and then how operations, management and compensation can change over time.9 First, the

2. Id. at 593.
3. Id. at 581.
4. Id. at 581-82.
5. Id. at 582-83.
6. Mr. Donahue gave his wife joint ownership of his stock in 1962, they transferred five shares to their son in 1968 and, when Mr. Donahue died, Mrs. Donahue became the sole owner of the remaining shares. Id. at 583 n. 8, 584.
9. Id.
The court defined the term "close corporation," ruling that a corporation will be considered closely held when there are “(1) a small number of shareholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in the management, direction and operation of the corporation.”

Then came the heart of what would become the Donahue doctrine. Noting that “the close corporation bears striking resemblance to a partnership,” the court held that “[j]ust as in a partnership, the relationship among the stockholders must be one of trust, confidence, and absolute loyalty...” and the same standard applies to both large and small closely held entities. Building on the concepts of trust and fairness, the court recognized that while there were many advantages for using the corporate form, “it also supplies an opportunity for the majority stockholders to oppress or disadvantage minority stockholders.” In such cases, the oppressed minority shareholder has few remedies since “[h]e cannot easily reclain his capital, cannot readily sell his stock and cannot force a dissolution.” Thus, the court ruled, shareholders owe one another a strict fiduciary duty. Shareholders must act with “utmost good faith and loyalty.” “Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.” Furthermore, the court ruled that these rules applied not just to majority stockholders but to “all stockholders in close corporations.” In doing so, the court applied well-settled trust and partnership law to corporations which traditionally had been governed, for the most part, by statutory and contract law.

Having established the standards to be applied to shareholders in closely-held corporations, the court then addressed the issues of equal opportunities for all shareholders. Thus, if a shareholder who is a member of the group controlling the corporation has had his stock repurchased, the other shareholders must be given the same opportunity to have the same percentage of their shares repurchased at the same price. An effort by a shareholder to “issue stock in order to expand his holdings or to dilute holdings of other stockholders” is a similar breach of duty. Based on these rules, the court concluded that either Mr. Rodd had to return the money he had received (with interest) to the company, or Mrs. Donahue had the right to sell her stock to the company at the same price that Mr. Rodd had received (without interest).

II. Significant Developments in the Donahue Doctrine

A. Legitimate Business Interest and Other Basic Rules

In its first decision after issuing its broad pronouncements in Donahue, the SJC recognized that problems might be caused in the legitimate governance of closely held corporations by the “untempered application” of the Donahue standards. Thus began a series of appellate decisions over the next thirty years that have attempted to balance the rights of minority shareholders against the needs of controlling shareholders to run their businesses.

In Wilkes v. Springside Nursing Home, Inc., four men, including the plaintiff Wilkes, bought a building and began operating it as a nursing home through a corporation that they formed. Each of the four served as a director of the corporation, undertook responsibility for certain tasks associated with running the business, and eventually began to withdraw money regularly from the business. After a number of years, disagreements arose between Wilkes and one of the other shareholders. As a result, at directors’ and shareholders’ meetings in 1967, Wilkes was forced “out of active participation in the management and operation of the corporation” and the company “cut off all corporate payments to him.” Wilkes then filed suit for breach of fiduciary duty. The court ruled that

10. Id. at 586. This standard provides guidance regarding when a corporation will be considered closely held without establishing a rigid test. The standard also allows for a corporation’s status to change over time. A corporation that starts out as being closely held may change to a non-closely-held corporation as a result of events such as going public, having non-majority ownership, or having a large number of shareholders. Left unsaid by the court, but of significance, is the fact that most Massachusetts corporations, at least at their inception, fit the standards. Donahue is important to any practitioner dealing with businesses.

11. Id. at 586-87.
12. Id. at 588.
13. Id. at 591-92.
14. Id. at 593 & n. 18.
15. Id. at 593.
16. Id. at 594 (quoting Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928)).
17. Id. at 597 (emphasis added). While seeming to announce a bold new set of rules for closely-held corporations in Massachusetts, the court sought to link these rules to existing law by citing to a series of its prior cases and stating that “[a]pplication of this strict standard of duty to stockholders in close corporations is a natural outgrowth of the prior case law.” Id. at 595; see, e.g., Wilson v. Jennings, 344 Mass. 608, 614-15 (1962); Samia v. Cent. Oil Co. of Worcester, 339 Mass. 101, 112 (1959); Silversmith v. Sydeman, 305 Mass. 65, 68 (1940).
19. Id. at 598. The only exceptions, held the court, are if the articles of organization, the bylaws, or a shareholders’ agreement provide otherwise or the transaction is ratified by all other shareholders. Id. at 598 n. 24. (As discussed below, infra Part II. F., these exceptions have proven to be quite significant and demonstrate the flexibility and durability of the Donahue doctrine.)
20. Id. at 600 n. 25.
21. Id. at 603-04. In a concurring opinion, Justice Herbert P. Wilkins noted that he did not “join in any implication… that the rule concerning a close corporation’s purchase of a controlling stockholder’s shares applies to all operations of the corporation as they affect minority shareholders.” Id. at 604 (Wilkins, J., concurring). (As we shall see below, Justice Wilkins’ cautionary note was soon adopted by the court.)
23. While this article focuses primarily on the appellate decisions that have applied Donahue, a substantial body of law also has developed at the trial level since the launch of the business litigation session in the superior court. The topic also has been the subject of continuing education seminars. See, e.g., Litigating Closely-Held Corporation Disputes in Massachusetts, Boston Bar Ass’n Continuing Legal Education (Apr. 25, 2007) (the author was one of the panelists).
25. Id. at 844-45.
26. Id. at 845-46 & n. 8.
27. Id. at 846-47. In the interim, there had been some shift in the ownership of the corporation. Id. at 846.
28. Id. at 847.
29. Id. at 848.
the exclusion of Wilkes constituted a corporate “freeze out” and recognized that termination of employment can effectively prevent a minority shareholder from getting any return on his investment. 30 While recognizing the power that majority shareholders had, however, the court also expressed concern that the Donahue standards, applied literally, might be too stringent and inhibit legitimate management of the entity. 31 Thus, the court set some limits on the application of the Donahue doctrine and rules as to who bears the burden of proof concerning an alleged Donahue violation. In each case involving a challenge by a minority shareholder, the court must first ask “whether the controlling group can demonstrate a legitimate business purpose for its action.” 32 If the majority meets this initial test, then the burden shifts to the minority shareholder to show “that the same legitimate objective could have been achieved through an alternative course of action less harmful to the minority’s interest.” 33 The court “must weigh the legitimate business purpose, if any, against the practicability of a less harmful alternative.” 34 Here, there was no legitimate business purpose for the corporation’s action and, therefore, Wilkes was entitled to relief. 35

In cases following Donahue and Wilkes, the appellate courts have charted a basic series of rules concerning such issues as burden of proof, the duty of disclosure, problems that ensue when shareholders take on multiple roles in a corporation, and the principle that these rules apply to all shareholders of the entity. These rules generally follow logically from the basic premise that shareholders in a closely-held corporation owe an enhanced duty of fairness to one another.

Thus, in breach of fiduciary duty cases, the burden of proof is on the alleged wrongdoers, at least in the first instance, to justify their actions. A corporate insider whose transaction with the corporation is challenged “has the task of showing that the deal was not in breach of his fiduciary obligations toward directors, stockholders, and corporation.” 36 The director or shareholder must “prove that his or her actions were intrinsically fair, and did not result in harm to the corporation or partnership.” 37 Likewise, the burden is on the party whose action is challenged to show that its action had a legitimate business purpose. 38

The corporate insider is bound to make “full contemporaneous disclosure” of a transaction to the other directors and shareholders so they can review and approve it in order for the transaction to withstand a later challenge that it violated a duty owed to the other shareholders or to the corporation itself. 39 In O’Brien v. Pearson, 40 for example, the court ruled that a breach of fiduciary duty had occurred when the defendants unilaterally decided to change the enterprise’s objective without consulting the minority shareholder. 41 Self-dealing by a fiduciary may not be ratified by a corporation without full disclosure. 42 Moreover, the deference (more so in Delaware than in Massachusetts) given to corporate actions under the business judgment rule, namely that actions will not be subject to judicial scrutiny if they are an exercise of legitimate business judgment, “does not apply if the plaintiff can show self-dealing.” 43 For example, “[s]etting one’s own level of compensation, without corporate approval, is a form of self-dealing.”44 As such, it will be subjected to close scrutiny by the court. 45 Even silence alone can constitute a breach of a fiduciary duty. 46 Thus, a shareholder’s failure to disclose to his fellow shareholders the amount of rent payments he was receiving was a breach of his fiduciary duty. 47

Fiduciaries must be particularly careful when they assume multiple roles, such as when serving as “trustees of a trust [as well as] stockholders, directors, and officers of a close corporation involved in transactions in which they sit[and] on both sides and in which they ha[ve] a self-interest.” 48 As the Appeals Court observed, “[w]earing more than one hat —here, at least three— requires a fiduciary to be very nimble as well as most prudent. While the fiduciaries may purport to wear one hat at a particular moment, in truth all hats are worn together at all times.” 49

These rules apply to all shareholders, not just minority owners. 50 Even though a 50 percent shareholder, for example, can pursue the remedy of dissolution, he also can avail himself of the Donahue protections. 51

Thus, in Smith v. Atlantic Properties, Inc., 52 the court

30. Id. at 849-50.
31. Id. at 850-51.
32. Id. at 851.
33. Id. at 851-52.
34. Id. at 852.
35. Id. at 852-53.
41. Id. at 386. As discussed below, infra text accompanying notes 188-91, however, the remedy ordered by the court meant that the plaintiff gained little for his efforts.
45. Id. (stating that, while it was wrong not to get corporate approval for compensation, there was no breach of fiduciary duty where “actual amounts were well within the range of reasonable compensation”).
46. Puritan, 413 Mass. at 175-77.
47. Id. at 176-77.
49. Id.
51. Zimmerman, 402 Mass. at 658. Dissolution is discussed infra text accompanying notes 204-07.
applied Donahue to a minority shareholder who, through provisions in the entity’s articles of organization and bylaws, was able to veto certain corporation actions (in this case by voting against declaring a dividend which resulted in an adverse tax consequence to the entity). 53

At the same time that the courts have outlined the basic rules for shareholders to follow, they also have recognized that not every situation that may harm a shareholder constitutes a violation of the Donahue-Wilkes standards. For example, in a case involving the recapitalization of a publicly-held company that had the attributes of a closely held corporation, the recapitalization passed scrutiny because the minority shareholders failed to show that legitimate business purpose could have been reached with “less drastic alternatives.” 54 In Goode v. Ryan, 55 the court refused to order a corporation to repurchase a deceased shareholder’s stock. 56 There was nothing in the corporate documents or any agreement among the shareholders that required repurchase nor was the refusal to buy back the shares part of a freeze-out; “the plaintiff’s predicament… [was] merely one of the risks of ownership of stock in a close corporation.” 57 Thus, unlike Donahue, the corporation was not benefiting one shareholder while refusing to do the same for another. The entity was simply exercising its legitimate right not to undertake an activity that is was not obligated to do. In this regard, no Wilkes situation was presented because there was no harm to a minority interest. Rather, the court simply refused to create an affirmative right that the parties had not chosen to create. 58

Moreover, while a minority shareholder owed Donahue duties to the majority, the majority can legitimately “take its own interest into account” in deciding how to act. 59 Thus, “self-interest may be a proper motive for a stockholder’s actions, so long as that interest does not result in acts in derogation of the stockholder’s fiduciary duty.” 60 This right of “selfish ownership” extends “at least in part, to minority stockholders, although their interests are somewhat different in character.” 61 So a minority shareholder’s decision to vote against a merger was legitimate where it had not been given requested financial information and it had a reasonable suspicion that the proposed transaction “was based on unrealistic assumptions.” 62 Voting for the merger was not “a reasonable and practicable alternative.” 63

In In re Mi-Lor Corp., 64 the United States Court of Appeals for the First Circuit faced the question whether a release signed “by a close corporation and its directors and shareholders” barred a later claim of unjust enrichment. 65 In Mi-Lor Corp., all of the directors and shareholders of a closely held corporation, and the entity itself, entered into a global agreement which among themselves that included mutual releases. 66 Later, when the entity filed for bankruptcy, the creditor trustees brought claims on behalf of the entity against certain shareholders. 67 The court held that “where there is unanimous and fully informed shareholder approval in a close corporation,” even if all of them were “interested,” that was sufficient to uphold a release and no further showing of fairness was necessary. 68 The court further ruled “that Massachusetts would place the burden of showing the enforceability of a release on the corporate fiduciary who relies on that release to extinguish any recovery for the underlying breach.” 69

B. The Shareholder-Employee

Often in a closely-held corporation, the minority shareholder is an employee and the effort to harm him is to deprive him of employment. 70 In Merola v. Exergen, 71 the court was confronted with the problem of how to balance the competing principles of duties to fellow shareholders with the general right to terminate an at-will employee with or without cause. 72 Steven Merola, an employee who was not a founder of the company, purchased shares of stock in his employer, a closely-held corporation, when the company allowed its employees to make such stock purchases. 73 When Merola was terminated, he sued the company and its president and majority

53. Id. at 205-07.
56. Id. at 92.
57. Id. The court also noted that “the deceased shareholder…never held corporate office, or served on the board of directors or received any salary from Gloucester, and there is no indication that she or her estate was aggrieved by the absence of involvement in corporate management.” Id. at 91.
60. Id.
61. Id.
62. Id.
63. Id. at 22. One justice of the superior court has ruled that it was not a breach of a fiduciary duty for a shareholder to “plan and prepare for creation of a competing business” if he continues to carry out his commitments to “the original company. Data Cable Networks, Inc. v. Gogan, No. 05-02479, 2007 Mass. Super. LEXIS 178, at *5-6 (Mass. Super. Ct. June 8, 2007) (Gershengorn, J.). Once the shareholder was terminated (because the other shareholders had learned of his actions in creating a new entity) he was free to compete. Id. at *6-69.
64. 348 F.3d 294 (1st Cir. 2003).
66. In re Mi-Lor Corp., 348 F.3d 296, 298.
67. Id. The court commented that, in certain instances, “some claims of this sort may trigger a successful laches defense.” Id. at 300 n. 9. (No such defense was asserted in this instance).
68. Id. at 304. The court noted that Demoulas v. Demoulas Super Mkts., Inc., 424 Mass. 501 (1997), was ambiguous on this issue but concluded that its decision was the “wiser rule.” In re Mi-Lor Corp., 348 F.3d 303-04 & n. 13.
69. Id. at 306.
72. Id. at 463-66.
73. Id. at 462-63.
stockholder, Francesco Pompei, alleging that there was no legitimate business purpose for his termination and, therefore, it was a breach of fiduciary duty to fire him. The SJC ruled that:

[although there was no legitimate business purpose for the termination of the plaintiff, neither was the termination for the financial gain of Pompei or contrary to established public policy. Not every discharge of an at-will employee of a close corporation who happens to own stock in the corporation gives rise to a successful breach of fiduciary duty claim.]

Important factors in Merola were that (a) the employee got a fair price for his stock; (b) the employee did not help to form the company; (c) there was no expectation by any other employee-stockholders of continued employment with the company; (d) the value of the stock increased while the employee was employed; and (e) buying stock in the company was not a condition of employment. Furthermore, termination of employment pursuant to the terms of an employment contract is permissible and therefore, does not give rise to a Donahue inquiry.

In other cases, the courts also have balanced the issue of the rights of employers to freely terminate their employees (subject to certain limited exceptions) in at-will employment situations with the fiduciary duties owed to those same employees in their capacities as shareholders. For example, termination of an employee for participating in a shareholder derivative suit does not constitute a violation of public policy. But when a company terminated a shareholder-employee, thereby depriving him of a lifetime employment situation, triggering a stock redemption, and, by removing him from the company, denied him information relevant to the diversion of corporate assets, and, the day after the termination, had its employees sign a “confidentiality agreement” “whose only apparent purpose was to prevent these employees from disclosing to” the discharged employee what was going on at the company, the court entered a preliminary injunction ordering the employee reinstated to his position. It should be noted that an employee-shareholder who is wrongfully terminated cannot just sit back and wait for her rights to be vindicated; she still has an obligation to attempt to mitigate her damages.

The balance that must be struck between recognizing the rights of management to run the entity and protecting the minority shareholder from losing perhaps the only tangible benefit of stock ownership -- her job -- is difficult to achieve. In Wilkes and then in Merola, the court seems to have struck the appropriate balance, enhanced but not absolute protection for the shareholder who helps found or fund the company and diminished rights for the shareholder who receives stock incident to employment.

C. Diverting Corporate Opportunities

The rules concerning diversion of a corporate opportunity flow naturally from the general principles enunciated in Donahue, Wilkes and their progeny. A shareholder (like a corporate officer or director) breaches “his fiduciary duty by acquiring or diverting a corporate business opportunity for his personal profit….” Before diverting a corporate opportunity for his own use, a shareholder must fully disclose that opportunity to the corporation. As with other allegations of shareholder wrongdoing, full disclosure is the critical issue. In order to avoid later challenges, it is better to make the disclosure in writing and even better to get written consent for the action.

74. Id. at 461.
75. Id. at 466.
76. Id. at 465.
78. King, 418 Mass. at 583. In King, the court ruled that despite a statutory “right to participate in a derivative suit” termination of employment for such participation “did not violate any public policy.” Id. at 583. However, the termination was a breach of fiduciary duty owed to the employee under Donahue v. Rodd Electrotype Co. of New England, Inc., 367 Mass. 578 (1975), and Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842 (1976), even though the ultimate purchase of his stock was governed by a shareholders’ agreement. King, 418 Mass. at 585-87.
82. Wartski v. Bedford, 926 F.2d 11, 13 (1st Cir. 1991); Demoulas, 424 Mass. at 530-31; Dynan v. Fritz, 400 Mass. 230, 242-44 (1987); Energy Res. Corp. v. Porter, 14 Mass. App. Ct. 296, 302 (1982). Full disclosure in and of itself is not enough when the directors who decide whether to permit the pursuit of the opportunity are “self interested...” Demoulas, 424 Mass. at 531. In such cases “the burden is on those who benefit from the venture to prove that the decision was fair to the corporation.” Id.
83. See Wartski, 926 F.2d. at 19.
Whether there has been a breach of duty in diverting an opportunity depends on the particular facts of the situation.\(^84\) But it is a defense to a claim of usurping a corporate opportunity that the corporation would be unable to avail itself of that opportunity.\(^85\) Thus, in Energy Resources Corp. v. Porter,\(^86\) the Appeals Court held that in a “refusal to deal” defense, that is, the argument that there was no corporate opportunity if someone was refusing to transact business with the company, the refusal must be disclosed to the company along with a fair statement of the reason for the refusal.\(^87\) Only with full disclosure can a claim of diversion of a corporate opportunity be avoided.\(^88\) “The nondisclosure of a corporate opportunity is, in itself, unfair to a corporation and a breach of a fiduciary duty.”\(^89\) A director who usurps or diverts a corporate opportunity “is personally liable even where the profits or benefits accrue to a third party, whether or not it is under the control of the director.”\(^90\)

D. To Whom Do These Rules Apply? - Choice of Law Issues

While the Donahue standard applied to Massachusetts corporations, until the 1990s it was not clear how it applied to “foreign” corporations. This was a particularly important issue because Delaware is often the choice of forum for corporate lawyers looking to create a new entity. In Demoulas v. Demoulas Super Markets, Inc.,\(^91\) the corporation had been formed in Delaware but then merged into a new Massachusetts corporation.\(^92\) The SJC held that only one state’s laws should apply (even though some of the wrongdoing occurred while the entity was a Delaware corporation) and so it applied Massachusetts law.\(^93\) Four years later, in Harrison v. Netcentric Corp.,\(^94\) the court shifted course, rejecting any suggestion that it would adopt a functional approach to determining which state’s law applied, and holding that “the State of incorporation dictates the choice of law regarding the internal affairs of a corporation.”\(^95\) In reaching this conclusion, the court noted that “[t]o avoid the imposition of ‘conflicting demands,’ ‘only one State should have the authority to regulate a corporation’s internal affairs....’”\(^96\) The court reconciled its ruling in Demoulas by noting that the “case was an exceptional one, as it concerned a company that has changed its State of incorporation as well as conduct that spanned both periods....”\(^97\) Interestingly, the breach of fiduciary duty claim involved the company buying back the stock under a stock restriction agreement, which agreement provided that it would be governed by Massachusetts law. Yet, the court ruled that this choice of law provision did “not mean that the plaintiff’s breach of fiduciary duty claim must also be governed by the law of this State.”\(^98\)

There seems to be some element of unfairness in allowing an entity that, except for its state of incorporation, is based entirely in Massachusetts to be able to deprive its minority shareholders of the protections of Donahue. While, as discussed below, a well-crafted shareholders’ agreement can limit this inequity (and by the same token modify the Donahue duties for a Massachusetts entity), the fairer rule would be to look at least in some instances not just to the entity’s forum state but also to its principal place of business.

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84. Id. at 18; Puritan, 413 Mass. at 177 (where shareholder’s ownership of real estate predated his involvement with corporation, he was under no obligation to renew lease to corporation); compare Fronk v. Fowler, 71 Mass. App. Ct. 502, 507-10 (2000) (limited partnership “not a general purpose enterprise” but was rather “quite limited” and therefore no diversion of corporate opportunity).


86. 14 Mass. App. Ct. 296 (1982). Although not a Donahue case, its principles are applicable to the closely-held entity.

87. Id. at 300.

88. Id. at 300-02.

89. Demoulas v. Demoulas Super Mkts., Inc., 424 Mass. 501, 535 (1997). The records of the corporation, particularly minutes of meetings, may be very important in regard to determining whether disclosure was adequate. Id. at 539-40.

90. Id. at 544. Restitution is an appropriate remedy. Id. at 556.


92. Id. at 511.

93. Id.


95. Id. at 471.

96. Id. at 470.

97. Id. at 471.

98. Id. at 472 n. 10. If the entity in question is a Delaware corporation then careful analysis of Delaware law will be necessary. See Clemmer v. Cullinan, 62 Mass. App. Ct. 904 (2004) (rescript) (“Despite the sweeping dicta” in at least one Delaware case, “a cause of action for minority shareholder freeze-out” involving a Delaware corporation was allowed to survive a motion to dismiss under Rule 12(b)(6) of the Massachusetts Rules of Civil Procedure.).
E. The Applicability of Donahue to New Types of Legal Entities

Since Donahue was decided in 1975, the legislature has authorized two new types of legal entities: limited liability partnerships and limited liability companies. Although no Massachusetts appellate case has squarely addressed the issue, it appears that the Donahue principles will be equally applicable to these new types of entities. In Billings v. GTFM, LLC, for example, the court applied the rules relating to derivative actions brought by shareholders to members of a limited liability company. In so ruling, the court applied the word “member” in Rule 23.1 of the Massachusetts Rules of Civil Procedure to include members of limited liability companies even though the text of Rule 23.1 refers to “member” as a part of an “unincorporated association.”

The extension of Donahue and its progeny to these new entities seems logical. The Donahue principles are derived from general partnership law, so requiring members of limited liability partnerships to continue to abide by these duties while enjoying the primary benefit of a limited liability partnership, the ability to engage in business with others with at least some shield from personal liability, is reasonable. Likewise, since limited liability companies are designed to be a more flexible form of the corporate legal entity, it also is fair to require members of limited liability companies that share the attributes of closely-held corporations to follow the Donahue rules.

F. Shareholder and Other Agreements

Agreements among shareholders are enforceable. An agreement to purchase stock, for example, even if the price is less than market value, is enforceable if the agreement was entered into by all shareholders in advance. The validity of such agreements will be upheld absent any fraud, overreaching, undue influence, duress or mistake at the time the deceased entered into the agreement. Thus, “[q]uestions of good faith and loyalty do not arise when all the stockholders in advance enter into an agreement concerning termination of employment and for the purchase of stock of a withdrawing or deceased stockholder.” The crucial issue then is the circumstances and the disclosures at the time the agreement was negotiated, not what may subsequently appear fair in hindsight. The requirements of Donahue will have been met if the parties knew what they were doing at the time they entered into the agreement. What seems fair later on does not come into play.

Blank v. Chelmsford Ob-Gyn, P.C., is particularly instructive. There, the court ruled on a motion to dismiss that, where three individual shareholders had established a corporation and prepared and signed written employment agreements allowing the company to terminate employment on six-months notice (which, in turn, triggered a shareholder’s stock buy back agreement), the termination was valid and not a breach of fiduciary duty.

Absent such an agreement, one would have expected the court to readily conclude that there had been a Donahue violation. Indeed, termination of employment of a founder without cause is a classic example of a freeze-out. Yet, the existence of the employment agreement negated any potential Donahue breach. Certainly, a shareholder-employee in a closely held entity will need to be very careful about such agreements lest he essentially sign away the protections otherwise owed to him under Donahue standards.

While a discussion of the intricacies of drafting shareholder agreements (including tax ramifications which may be of critical importance) is beyond the scope of this article, some general comments are appropriate. Shareholder agreements should include, if possible, provisions on how to deal with death, disability and termination of employment (whether for cause, voluntary termination or by retirement). They also should include, where appropriate, protections for minority shareholders (such as imposing obligations for super-majority votes for certain events) while not unduly limiting the ability of the majority to run the enterprise. Counsel plays an important role in the creation of such agreements, although care must be taken to make it clear who the attorney does

100. 449 Mass. 281 (2007).
101. Id. at 289-90; Mass. R. Civ. P. 23.1.
102. Billings, 449 Mass. at 289-90. Rule 23.1 states, “[I]n a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association.…” Mass. R. Civ. P. 23.1.
109. Id. at 404-06.
(and does not) represent, to advise individual shareholders to seek independent counsel where appropriate, and to obtain informed consent regarding potential conflicts of interest. While even a well-crafted shareholders’ agreement will not stop the errant shareholder from usurping a corporate opportunity or wrongfully terminating a founding shareholder’s employment, it will, in many instances, help to avoid disputes in the first instance or provide guidance for their resolution when they do arise. There are also other contractual means to deal with the Donahue standards, including employment agreements and provisions in the articles of organization or bylaws.

G. Special Issues for Professional Services Firms

Disputes among shareholders of a professional firm present additional issues. While the Donahue standards certainly apply, they must be balanced with and, indeed, may at times be outweighed by the ethical rules governing the conduct of these professionals. So, for example, in the case of attorneys, the general prohibition against taking a corporate opportunity is balanced against the ethical concept that an attorney’s client has the right to choose her own counsel.110 A joint letter from both the firm and the departing attorney is the proper way to proceed.111 Whether similar considerations affect other professional corporations has not been addressed at the appellate level in Massachusetts.112 Counsel representing professionals in shareholder disputes in closely-held businesses must consult not only the general duties set forth in this article but also the applicable professional codes of ethics as well as any statutes that may affect that particular type of professional.

III. Remedies

A. Statutes of Limitations

In seeking legal recourse for an alleged wrongdoing, one of the first questions to ask is: is it timely?113 In cases involving shareholders in a closely-held corporation, the issue can be particularly difficult because the wrongdoing may have been going on for a long time and there may be a mix of contract and tort claims. Generally, the statute of limitations for tort claims is three years.114 The general statute of limitations for breach of contract claims is six years (although for contracts under seal it is extended to twenty years).115 Thus, a claim for breach of fiduciary duty is governed by the three-year statute of limitations.116

But determining the applicable statute of limitations is only the beginning of the analysis. In Demoulas, the court had to grapple with alleged wrongdoing that had occurred over many years.117 Recognizing that a shareholder’s derivative action was a tort claim subject to the three-year statute of limitations, the court had to consider whether actions that had occurred outside of the three-year window nevertheless could be maintained by virtue of General Laws chapter 260, section 12, the so-called “fraudulent concealment” exception to the statute of limitations.118 Relying on trust law concerning claims of breach of fiduciary duty by a trustee, the court held that the statute begins to run when a trustee “repudiates the trust and the beneficiary has actual knowledge of that repudiation.”119 The SJC ruled:

[when a defendant fraudulently conceals a cause of action from the knowledge of the plaintiff, the statute of limitations is tolled under . . . §12, for the period prior

110. See Meehan v. Shaughnessy, 404 Mass. 431-34 (1989)(discussing procedures to be followed regarding clients when lawyers leave a law firm); Lampert, Hasler & Rodman, P.C. v. Gallant, No. 03-1977 BLSS, 2005 Mass. Super. LEXIS 118, at *15-*16 (Mass. Super. Ct. Apr. 4, 2005) (Van Gestel, J.) (“There is a serious conflict in the law as established in Meehan between what lawyers may do when preparing for and planning to leave a law firm and the fiduciary duties that both Meehan and Donahue impose on partners in the law firm or shareholders in a closely held corporation.”).
111. Meehan, 404 Mass. at 442 n. 16. (A very different result might have ensued in a non-professional entity where the taking of customers could be deemed a breach of fiduciary duty).
112. But see Falmouth Ob-Gyn Assocs., Inc. v. Abisla, 417 Mass. 176, 179-81 (1994) (MASS. GEN. LAWS ch. 112, § 12X (2006) makes non-competition agreements among physicians unenforceable). A separate issue that is of particular concern to attorneys but beyond the scope of this article is multiple representation by an attorney of both the entity and some of its shareholders and breach of fiduciary duty claims that could be brought against the attorney. See Schaeffer v. Cohen, Rosenthal, Price, Mirkin, Jennings & Berg, P.C., 405 Mass. 506, 512-14 (1989) (declining to reach the issue while noting that “there is logic in the proposition that, even though counsel for a closely held corporation does not by virtue of that relationship alone have an attorney-client relationship with the individual shareholders, counsel nevertheless owes each shareholder a fiduciary duty”); Cacciola v. Nellhaus, 49 Mass. App. Ct. 746, 750-54 (2000) (breach of fiduciary claim against attorney survived motion to dismiss). A claim that an attorney improperly received funds for representing a shareholder’s interest is a derivative claim. Schaeffer, 405 Mass. at 513. Other states, of course, may have other statutes of limitations.
113. Of course, a statute of limitations is a defense, not an element of a case.
114. MASS. GEN. LAWS ch. 260, §2A (2006). Note that the statute of limitations for claims against trustees, guardians and conservators is two years and the statute for claims against executors or administrators is one year. MASS. GEN. LAWS ch. 260, §11 (2006). Claims against deceased persons generally must be brought within one year of death. MASS. GEN. LAWS ch. 197, §9 (2006). As with many statutes of limitations, there are exceptions to these rules that must be studied carefully.
116. See Shane v. Shane, 891 F.2d 976, 985 (1st Cir. 1989) (applying three-year statute of limitations and ruling that it was tolled due to evidence of fraudulent concealment and that claim was “inherently unknowable”); Sugarmann v. Sugarmann, 797 F.2d 3, 28-31 (1st Cir. 1986) (freeze-out was a tort for purposes of determining interest); Houle v. Low, 407 Mass, 810, 812-13 (1990) (claims against individual defendants were barred by the three-year statute where there was no fraudulent concealment or continuing tort and it was not inherently unknowable); Kirley v. Kirley, 25 Mass. App. Ct. 651, 652-53 (1988) (freeze-out claim governed by three-year statute of limitations). Careful pleading is in order if faced with an anticipated statute of limitations defense.
118. Id.
119. Id. at 518.
to the plaintiff’s discovery of the course of action. Where a fiduciary relationship exists, the failure adequately to disclose the facts that would give rise to knowledge of a cause of action constitutes fraudulent conduct and is the equivalent to fraudulent concealment for purposes of applying §12. 210

Applying “[a]n actual knowledge standard,” the court held that “a plaintiff need only show that the facts on which the cause of action is based were not disclosed to him by the fiduciary.” 211 It rejected the “reasonable diligence standard” used in most tort cases involving “the so-called discovery rule.” 212 Furthermore, the court ruled that in a derivative action, the statute of limitations does not begin to run “until knowledge is gained by those who have the power and responsibility to act on the corporation’s behalf and who are not themselves involved in the wrongdoing that is the basis for the cause of action.” 213 Thus, using the “adverse domination doctrine,” “the statute of limitations is tolled while a private plaintiff continues under the domination of the wrongdoer.” 214

Nearly a decade after deciding Demoulas, the SJC, in Aiello v. Aiello, 215 set some bright-line rules regarding the so-called “doctrine of adverse domination,” namely whether the domination of a board of directors by interested directors tolls the statute of limitations. 216 In Aiello, the plaintiff was a director and a shareholder of the corporation. 217 Thus, once she had actual knowledge of the wrongdoing, she could not avail herself of the adverse domination doctrine to further toll the statute. 218 As the court ruled:

we now adopt the “doctrine of adverse domination” as a form of equitable tolling in the Commonwealth. We also conclude that the complete domination test - - and not the disinterested majority test - - was appropriately chosen and applied by the judge in the circumstances of these cases. Under the former test, the statute of limitations is not tolled by reason of adverse domination unless the plaintiff can show the absence of any corporate director or shareholder who had actual knowledge of the alleged wrongdoing and the ability (and motivation) to sue the wrongdoers on behalf of the corporation or induce such a suit. 219

Before the issue of adverse domination is considered, however, plaintiff must have actual knowledge of the claim. 220 Only when an aggrieved shareholder has actual knowledge of the wrongdoing does the statute of limitations start to run (unless it is tolled by the “adverse domination rule”). 221 There are two reasons for the “adverse domination” rule: (a) it is not fair to have the statute of limitations bar a claim where the alleged wrongdoers will not let the corporation act, and (b) knowledge by wrongdoers of the claim should not be imputed to the corporation. 222 Under the Aiello court’s “complete domination” test, “only where a plaintiff can show that the culpable directors (or officers) completely or exclusively controlled the corporation” will the adverse domination doctrine apply. 223 In so ruling, the court rejected the “disinterested majority” test, which holds that, as long as a board of directors is controlled by wrongdoers (i.e., they are in the majority), the statute of limitations is tolled. 224

Statutes of limitations can be claim or even case dispositive in shareholder disputes. Yet, determining when the statute started to run may involve considerable discovery. The vigilant plaintiff’s counsel will need to carefully consider when a claim arose and, if some claims are barred, whether others will survive. Counsel for the defendant will need to plead the statute as an affirmative defense, if appropriate, and then engage in careful discovery to build support for the defense.

B. Direct versus Derivative Actions

One choice that a shareholder must make before bringing a case is whether the action is direct or derivative -- an action in her personal capacity or on behalf of the corporation -- or some combination of the two. The choice is significant since there are special rules for bringing derivative actions and the available remedies differ. In a direct action, the shareholder brings, and pays for, the suit in her individual capacity against other individual shareholders. In a derivative action,

120. Id. at 519. This holding follows logically from the court’s ruling in Puritan that a contract statute of limitations was tolled because of fraudulent concealment or failure to make full disclosure. Puritan Med. Ctr., Inc. v. Cashman, 413 Mass. 167, 175 (1992).
121. Demoulas, 424 Mass. at 519.
122. Id. at 520-21 & n. 26. The “reasonable diligence” standard provides that the statute starts to run “on the happening of an event likely to put the plaintiff on notice of facts giving rise to the cause of action.” Id. at 520.
123. Id. at 522-23.
124. Id. at 523.
126. Id. at 389-90; see Maggio v. Gerard Freezer & Ice Co., 824 F.2d 123, 130-31 (1st Cir. 1987) (plaintiff could not avail himself of arguments of “inherently unknowable” or “fraudulent concealment” to overcome statute of limitations defense where plaintiff had means to uncover facts that would have been basis for his claim).
128. Id. at 405-06.
in contrast, the shareholder sues on behalf of the corporation and may seek reimbursement of her legal fees from the corporation.

To bring a derivative action, one must follow the requirements of the Massachusetts business corporation statute (the “Business Corporation Act”), which went into effect in 2004, as well as Rule 23.1 of the Massachusetts Rules of Civil Procedure, which provides that:

the complaint shall be verified by oath and shall allege that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law from one who was a stockholder or member at such time.

Although an analysis of the specific requirements of the statute and Rule 23.1 is beyond the scope of this article, it is important to note that the statute has an explicit procedure for making demand on the corporation before an action is brought and careful attention must be paid to the requirements of the statute, including those that pertain to the review by independent directors or shareholder or independent persons and their ability to determine that such an action should not proceed.

In regard to remedies, in direct actions, damages are awarded to the wronged shareholder, while in derivative actions they belong to the corporation. The difference may be quite significant. For example, if a minority shareholder who owns 25 percent of a company’s stock claims that an owner of 75 percent of the company’s stock paid himself an excessive salary (a typical derivative claim), the money goes back to the corporation, not to the minority shareholder. If the funds are then distributed to the shareholders, the minority shareholder’s proportionate share is only one-quarter of the recovery. Another significant difference is in regard to attorneys’ fees. While a plaintiff in a derivative action can recover them, a plaintiff in an individual action probably cannot. The rationale for the differing rules is that a derivative action is really brought for the benefit of the corporation. In addition, the difference in the two rules mitigates the fact that a plaintiff in a derivative action may only have a limited personal benefit for her actions.

Donahue and some of its early progeny did not do much to distinguish between direct and derivative claims, preferring to simply right a wrong. Beginning with Bessette v. Bessette, however, the Massachusetts appellate courts began to draw sharp lines between the two types of actions. In Bessette, minority shareholders sued the individual majority shareholder, claiming that she had received “an excessive salary and payments on notes for which the corporation received no consideration.” The action was brought as an individual claim rather than a derivative action because the corporation had filed for bankruptcy and the bankruptcy trustee had not brought a claim on behalf of the corporation. The court distinguished Donahue, ruling that a direct action under Donahue could be brought only if “it would be difficult for the plaintiff... to establish breach of a fiduciary duty owed to the corporation...” Since the only breach was of the duty owed to the entity, the direct action failed.

In subsequent cases, the courts have attempted to refine the lines between direct and derivative actions. For example, the refusal of the majority of shareholders to offer equal opportunity for a stock repurchase to a minority shareholder is an individual claim. Individual claims also arise when there is an attempt to freeze out a minority shareholder through efforts to wrongfully withhold money due, deny employment in the corporation, or remove him as an officer or director.

Certain claims may only be brought by minority shareholders as derivative actions; that is, actions brought for the benefit of the corporation. Claims that a majority shareholder received an

137. The requirement that demand must be made in all cases is a change from prior case law which held that in certain cases demand was excused if it would be futile due to the alleged wrongdoer’s control of the entity, as was often the case in a closely-held corporation. Blake v. Friendly Ice Cream Corp., No. 03-0003, 2005 Mass. Super. LEXIS 694, at *13 (Mass. Super. Ct. July 26, 2005) (Agostini, J.) (“With the enactment of G.L. c.156D, §7.42, Massachusetts joined a growing number of so-called ‘universal demand’ states, whose derivative demand requirements permit no exception for futility.”). Even before the enactment of the statute, Massachusetts permitted corporations to form special litigation committees to determine whether the corporation should pursue a particular action. A case decided before the enactment of the new statute, Houle v. Low, 407 Mass. 806 (1982), held that if a special committee recommends that a corporation not pursue a claim, the decision of a special committee will be upheld, and the derivative action will be dismissed, if (1) “the committee was independent and unbiased” and (2) the committee’s decision was “reasonable and principled....” Id. at 826. How the courts interpret the requirements of the new statute remains to be seen.
138. See infra text accompanying notes 192-203.
139. Moreover, there is no right to a jury trial in a derivative action since it is a claim in equity. Demoulas v. Demoulas Super Mkt., Inc., 424 Mass. 501, 526-27 (1997).
140. Donahue v. Rodd Electrotype Co. of New England, Inc., 367 Mass. 578, 579 & n. 4 (1975). In Donahue, for example, the court noted that “[i]n form, the plaintiff’s bill of complaint presents, at least in part, a derivative action” while “seeking redress because of the alleged breaches of the fiduciary duty owed to her...” Id. at 579 n. 4 (emphasis in original). The court treated the case as a direct claim, stating that “[i]n this instance we prefer substance over form...” Id. at 579.
141. 385 Mass. 806 (1982).
142. Id. at 806.
143. Id. at 807 n. 2; see In re Mi-Lor Corp., 348 F.3d 294, 301 n. 11 (1st Cir. 2003) (citing Richard W. Southgate & Donald W. Glazer, Massachusetts Corporation Law & Practice §16.5(b) (2003 Supp.)).
144. Bessette, 385 Mass. at 809 (citations omitted).
145. Id. A derivative action may be brought not just by an actual shareholder but also by the beneficiary of a trust that owns such shares. Demoulas, 424 Mass. at 516-17. A trust did not have to be a party to such an action. Id.
146. Bessette, 385 Mass. at 808-09; Donahue, 367 Mass. at 593.
excessive distribution and salary are corporate claims and therefore need to be brought in a derivative action. Claims that funds were improperly diverted from the corporation are corporate claims. The prudent plaintiff will plead, if appropriate, both direct and derivative claims and follow the procedural requirements for both.

Of particular importance in a derivative action is the issue of standing. In Billings v. GTFM, LLC, the court allowed some creative lawyering to deprive a plaintiff of the ability to assert a derivative claim. Billings, a member of a limited liability company, brought a derivative action against the company. After the suit was filed, the company sold its assets and liabilities to another entity and then dissolved the company. Although as a member of a limited liability company, Billings had the right to maintain a derivative action, the court ruled that he lost that right once the entity was dissolved. The court held that only if there is “some misconduct such as fraud” will the member be able to continue to maintain his claim. The company had sold its assets to a new entity, which was owned by most of the members of the limited liability company. The court concluded that this transaction was proper “in order to solve a business problem, the need to remove Billings from the management and ownership of their venture.” The court stated that the trial “judge found that this was a rational business decision, taken in good faith based on legitimate concerns about Billings’ performance.” Since Billings did not argue that the transaction was fraudulent, he could not argue fraud on appeal. In addition, not only did the court rule that Billings had lost standing but it also allowed claims against him that had been assigned to the new company to continue to go forward.

The Billings ruling, while understandable in a purely legal sense, seems at odds with the general Donahue-Wilkes principles of fairness. In many of these types of cases there is a perceived need on the part of the majority to remove a dissenting shareholder from the business. It is the abuse of that right that Donahue, Wilkes and their progeny were designed to prevent. Now, under Billings, there is a vehicle available to majority shareholders to reach a result that might not otherwise seem to pass muster.

C. Rights to Information

Often in closely-held corporations, it is a lack of information that (a) can prevent a shareholder from knowing his rights or (b) in and of itself can be a breach of fiduciary duty. Relief for some of these problems can be found in the Business Corporation Act.

For example, a shareholder is entitled to a list of all shareholders in advance of a shareholders’ meeting. There also are procedures for shareholders meetings that may be relevant. In addition, the statute provides for a shareholder’s right to inspect various records of the corporation, including certain financial records. Both counsel for a minority shareholder and counsel for the company need to carefully consult the statute to determine what is legitimately subject to inspection and what may be properly withheld.

149. Sugarman v. Sugarman, 797 F.2d 3, 7-8 (lst Cir. 1986); Bessette, 385 Mass. at 809; Crowley, 30 Mass. App. Ct. at 756-59. “What is reasonable compensation for officers of a corporation is a question of fact...” Crowley, 30 Mass. App. Ct. at 756. The Crowley court noted that there was “manifest unfairness” for all of the income to be paid yearly for salaries leaving nothing for the shareholders. Id. at 758-59. The court added that “[i]t here is also the question whether Donahue’s higher standard is applicable in a derivative action.” Id. at 759 n. 10.


151. It is not always clear whether the Donahue standard applies to a derivative claim. Dyman v. Fritz, 400 Mass. 230, 243 (1987). “The two concepts tend to merge, however, when a shareholder’s alleged self-aggrandizement, if true, hurts both the corporation and the interests of the other stockholders.” Id.


153. Id. at 282. Billings also asserted direct claims “against his fellow members and managers of the company.” Id. at trial, those claims were decided “substantially in favor of the defendants.” Id.

154. Id. The transaction “had begun before the action was initiated...” Id. It is not clear whether this fact was considered by the court in reaching its decision. See Demoulas v. Demoulas Super Mkts., Inc., 424 Mass. 501, 511 n. 13, 512-13 (1997) (the merger of an existing corporation into a newly formed entity “did not extinguish the plaintiff’s right to bring a shareholder derivative suit for claims arising from occurrences during the first corporation’s existence” when he remained a shareholder in the new entity).

155. Id. at 291-94; compare Demoulas v. Demoulas Super Mkts., Inc., 424 Mass. 501, 511 n. 13, 512-13 (1997) (the merger of an existing corporation into a newly formed entity “did not extinguish the plaintiff’s right to bring a shareholder derivative suit for claims arising from occurrences during the first corporation’s existence” when he remained a shareholder in the new entity).

156. Billings, 449 Mass. at 292. In its ruling, the court cited to both a Massachusetts case, Mendelsohn v. Leather Mfg. Corp., 326 Mass. 226 (1950), and a Delaware case, Lewis v. Ward, 852 A. 2d 896 (Del. 2004). Billings, 449 Mass. at 290-94. Mendelsohn suggested that any type of fraud would suffice while Lewis “requires that the fraud be perpetuated ‘merely to eliminate derivative claims.’” Id. at 293 n. 25. The court left open the question of which rule applied. Id. In Kolancian v. Snowden, 532 F. Supp.2d 260 (D. Mass. 2008), the court applied Billings in ruling that since a merger was not undertaken ‘merely to eliminate derivative claims’” it was not fraudulent. Id. at 263 (citation omitted). According to Kolancian, the fraud must be “not only on the part of the acquired corporation, but also on the part of the surviving entity.” Id. (emphasis in original).


158. Id. at 294.

159. Id.

160. Id.

161. Id. at 295-96.


164. Id. § 7.20(b).


167. One could argue that in a Donahue situation, with all shareholders owning fiduciary duties, a minority shareholder should never be denied information. However, such a broad rule would seem to be at odds with post-Donahue cases such as Merola which recognized legitimate limits on these rights. Merola v. Exegen Corp, 423 Mass. 461, 465-66 (1996).
D. Damages, Equitable Relief and Attorneys’ Fees

Generally, many of the claims arising out of shareholder disputes in closely-held corporations are equitable, leaving the courts free to craft appropriate relief. A court has considerable discretion in fashioning remedies. For example, an award of damages may not be necessary if a lesser remedy is appropriate. In a derivative action, it is proper for those who profited from wrongdoing to have to repay the corporation those profits less what they invested personally in the new entities and less taxes that had been paid. Thus, in one appellate case, the remedy was to have the money be repaid by the wrongdoing shareholders to the entity and then a dividend issued to all shareholders (after consideration of the rights of creditors and claims by the Internal Revenue Service). In another case, the Appeals Court remanded for a further hearing in the superior court after which, if appropriate, it permitted the court to order the corporation to issue a dividend.

Interest also is an important consideration. In Demoulas, for example, an award of interest on cash distributions that had been made “was well within [the judge’s] power to frame the relief so as to avoid unjust enrichment.”

In certain instances, injunctive relief may be warranted. Thus, in Cain v. Cain, the court enjoined the wrongdoing shareholder from engaging in improper competitive activity.

Two recent cases have focused on the remedies available to an aggrieved shareholder and, in both decisions, the SJC has imposed limits on the relief that may be awarded. In Brodie v. Jordan, the SJC was faced with the question of whether a court could order a defendant to buy back “the plaintiff’s shares in the corporation at a price equal to her share of the corporation’s net assets, as valuated by a court-appointed expert, plus prejudgment interest” in the absence of any contract providing for such relief. The court ruled that such a remedy was improper.

Mary Brodie was the widow of Walter Brodie, a founder of Malden Centerless Grinding Co., Inc., a company that ran “a small machine shop.” After Mr. Brodie ceased being involved in the company’s regular operations, he and the other shareholders had disagreements and he asked to be bought out; the others refused. In the ensuing years after Mr. Brodie’s death, the other shareholders refused to provide Mrs. Brodie (as his heir) with relevant information about the company.

Relying on theory of “reasonable expectations,” the court ruled that while the Donahue duties to Mrs. Brodie had been breached, the remedy of a “forced buy-out” was improper. The proper remedy for a freeze-out is to restore [the minority shareholder] as nearly as possible to the position [s]he would have been in had there been no wrongdoing. The remedy should neither grant the minority a windfall nor excessively penalize the majority. While “c[ourts] have broad equitable powers to fashion remedies for breaches of fiduciary duty in a close corporation, . . . and their choice of a remedy is reviewed for abuse of discretion,” that right is not unfettered. Thus, a court’s order that a closely-held business buy out a minority shareholder, in the absence of anything requiring such a buy-out in the corporation’s articles of organization, bylaws or a shareholders’ agreement, will be upheld unless “clearly erroneous.”


169. See, e.g., Zimmerman, 402 Mass. at 660-62 (court properly ordered defendant shareholder to personally pay plaintiff fellow shareholder for value of latter’s business that had been “totally destroyed”).

170. Johnson v. Witkowski, 30 Mass. App. Ct. 697, 714-15 (1991) (company entitled to reimbursement only if consideration paid by it was “inherently unfair” and more than the assets were worth). One issue that courts face in awarding damages is how to value the stock of a closely-held business. In Bernier v. Bernier, 449 Mass. 774 (2007), a divorce case, the court provided significant guidance in this area, although a detailed discussion of the various methods is beyond the scope of this article. Id. at 781-93; see Leader v. Hycor, Inc., 395 Mass. 215, 224 (1985) (upholding use of so-called “Delaware block method” as one means of valuing company). The issue is important not only in cases involving disputes among shareholders but also in divorces where the parties are trying to value the business. Generally “valuation is a question of fact calling for the considered judgment of the trier of fact whose determination should not be disturbed unless clearly erroneous.” Leader, 395 Mass. at 223 (quoting Natural Gas Co. v. United States, 470 F.2d 1107, 1110 (8th Cir. 1973)); see Bernier, 449 Mass. at 785 (“Valuation of a business is a question of fact” and the judge’s decision will be upheld unless “clearly erroneous.”).


172. Id. at 766-68.
the appropriate remedy, “should, to the extent possible, restore to the minority shareholder those benefits which [he] reasonably expected, but has not received because of the fiduciary breach.” Such a remedy seeks to place the injured party in the same position as he would have been but for the breach.190

Unfortunately for the O'Brien plaintiff, the court held that his theory of lost profits was too speculative and that the only reasonable expectation that he had “would be involvement in the information sharing and decision-making….191 While the court remanded for a determination of damages, its ruling appears to make it difficult for the plaintiff to recover anything. Thus, while he achieved victory insofar as the court ruled that a fiduciary duty had been breached, the result may be hollow if there are no damages.

These two cases, while reaffirming the rules of Donahue, represent an obstacle for minority shareholders. After all, it is not enough to pursue a case simply to prove wrongdoing. To make it viable, there also must be a meaningful recovery. The Brodie and O'Brien plaintiffs may have “won,” but at what price and for what result?

Attorneys’ fees are not considered damages in a breach of fiduciary case.192 However, an award of attorneys’ fees as a separate element of recovery is appropriate for a successful shareholder in derivative actions.193 Under the Business Corporation Act, not only may a successful shareholder recover her attorney’s fees in a derivative action but the corporation can recover its attorneys’ fees from a plaintiff if the court “finds that the proceeding was commenced or maintained without reasonable cause or for an improper purpose.”194 Under the statute, the plaintiff may recover her attorneys’ fees if the court “finds that the proceeding has resulted in a substantial benefit to the corporation.”195 An award of attorneys’ fees appears to be discretionary given the use of the word “may” in the statute.196

The pre-Act cases may provide guidance as to when an award of attorneys’ fees is appropriate. Whether a defendant in a derivative action acted in good faith or bad faith is a factor a trial court may consider, “a finding of the defendant’s bad faith is not essential to a lawful award of counsel fees in such an action.”197 “The most important, but not dispositive, factor… is whether the plaintiffs have benefited the corporation in some way by the result obtained in the lawsuit.”198 Thus, where plaintiffs did not get any money for the corporation but “created… the opportunity to save corporate funds by identifying corporate misconduct” (even though the corporation chose “not to accept the benefits of the litigation”), an award of attorneys’ fees was appropriate.199 Furthermore, since the defendants’ counsel fees had been paid by the corporation, it was equitable for the plaintiffs also to have their fees paid by the corporation.200 The court specifically avoided the question of “whether intangible corporate benefits, such as raising the standards of fiduciary relationships (corporate therapeutics), could ever justify an award of attorneys’ fees in a stockholders’ derivative action.”201 Such fees are at the discretion of the court and it was not error for a court to decide not to award fees.202 But attorneys’ fees probably are not recoverable at all in individual actions.203

E. Dissolution of the Entity

In certain extreme instances, dissolution of the entity may be appropriate.204 Under the corporate dissolution statute, an action to dissolve a corporation may be brought in the superior court by any shareholder owning 40 percent or more of the shares of an entity if:

(i) the directors are deadlocked in the management of the corporate affairs, the shareholders are unable to break the deadlock, and irreparable injury to the corporation is threatened or being suffered; or


187. Id. at 872-73. The court, however, did leave open a number of other remedies to be considered on remand, including “the propriety of compelling the declaration of dividends.” Id. at 874.


189. Id. at 389.

190. Id. (quoting, in part, Brodie, 447 Mass. at 870-71).

191. Id.


195. Id. § 7.46(1).

196. Id. § 7.46.


198. Id.


200. Id. at 761.

201. Id. at 759 n. 4.
(ii) the shareholders are deadlocked in voting power and have failed, for a period that includes at least 2 consecutive annual meeting dates, to elect successors to directors whose terms have expired, or would have expired upon the election of their successors, and irreparable injury to the corporation is threatened or being suffered...205

Although there has been little case law on dissolution of a closely-held entity under the new statute, it has been the subject of at least one superior court opinion.206 In that case, the court was “relatively comfortable” with allowing the dissolution of a small entity with two 50 percent shareholders but deferred any “final decision” to allow the parties to attempt to reach a settlement and noted that:

Comment 2 to c. 156D, sec. 14.30, cautions that “involuntary dissolution should be available as a mechanism for resolving internal corporate disputes only in the case of true deadlock, and even then only when continuation of the deadlock will impose real and serious harm, and . . . significantly broader availability of this remedy in such circumstances invites gamesmanship in the negotiation of internal corporate disputes and makes the dissolution remedy available in circumstances in which nothing so extreme is required, or in the end, normally consummated.” Significantly, the Comment goes on to say: “The ‘irreparable injury’ requirements of both clauses of sec. 14.30(2) are more strongly worded than the ‘best interests of the shareholders’ requirement of BCL sec. 99, reflecting the strength of the belief that the availability (or potential availability) of dissolution to a disgruntled shareholder is rarely desirable, normally has material adverse effects on other constituencies (such as employees and vendors), and normally leads in the end to a buyout and not dissolution even after dissolution is entered.”207

While dissolution is an appropriate remedy in certain circumstances, it will not be granted lightly, particularly if other constituencies may be adversely affected.

F. Negotiated Resolutions

In any shareholders’ dispute, one of the starting points is the Business Corporation Act and the corporate documents and agreements: articles of organization, bylaws, employment agreements, shareholder agreements and corporate votes. As the courts have repeatedly held (and the Act now provides), these agreements are enforceable and can alter the fiduciary duties that might otherwise be owed. Even if these documents do not precisely address all of the issues at stake, they can be used as a guide to help counsel negotiate appropriate resolutions.208

Shareholder disputes in a closely-held business can be described as the business equivalent of a divorce. Family law practitioners can recount the tales of soon-to-be ex-spouses spending considerable energy and legal fees fighting over an item of little value. In the business dispute, the fights can lead to the destruction of the business itself.

Counsel involved in these cases can and should exercise creativity in helping parties resolve these cases. The appropriate resolution will vary depending on the type of business. For example, a professional services business such as a law or accounting firm will be relatively easy to divide between or among shareholders since the firms’ primary assets are clients or cases, both of which are very mobile. In such cases, the best agreements will allow the shareholders to work out a mechanism for retaining clients (subject to appropriate ethics rules), sharing or dividing staff, and dividing computers, furniture and other similar assets. Other types of businesses, such as companies that manufacture or sell a product, may be difficult if not impossible to divide. There, the best solution may be to facilitate a buy-out of a shareholder or to sell the entire business. Regardless of the form of resolution, whether a division of assets, a buyout or a sale, no one benefits (except perhaps the shareholder whose only goal is revenge or destruction) on the value of the business diminishing.

If the parties cannot agree, even with the assistance of counsel and other professional advisors, regarding how to proceed, then other forms of alternative dispute resolution, such as mediation, neutral valuator, arbitration or limited discovery are particularly appropriate. Of course, it will take the guidance of skilled counsel to help clients reach such results.

205. Id. §14.30(2).
207. Id., at *5-*6.
208. The Appeals Court has noted the benefit of such efforts, stating that “[i]t would obviously be appropriate, before a court-ordered solution is sought or imposed, for both sides to attempt to reach a sensible solution of any incipient impasse in the interests of all concerned after consideration of all relevant circumstances.” Smith v. Atlantic Props., Inc., 12 Mass. App. Ct. 201, 208-09 (1981); see also In re Mi-Lor, 348 F.3d 294, 308 (1st Cir. 2003) (“The underlying sum involved here is approximately $380,000, and considerable counsel fees have been spent to this point. We urge the parties to settle this case before the additional costs of further proceedings becomes a reality.”).
IV. Trends and Further Refinements

_Donahue_ is alive and well in the 21st century in Massachusetts, and it should be. Its fundamental holdings still form the basis for how owners of closely-held businesses must deal with one another. But its teachings are not unfettered - not every action that hurts a minority shareholder is unfair or oppressive. Nor are the remedies that a court may impose without limit. Still, the courts have broad latitude in fashioning just results. The Business Corporation Act also will be important as case law develops that interprets its provisions. Nevertheless, basic fairness remains the standard. Indeed, many shareholder disputes are inherently fact-intensive and the equities associated with each case often drive the result.

Lawyers for closely-held businesses and their shareholders, particularly those who advise them in their formation and ongoing operations, have a critical role to play in this regard. They must have a full understanding of the facts of each case as well as a knowledge of the _Donahue_ body of law in order to represent their clients effectively. Many of the disputes that have ended up in the courts since _Donahue_ could have been avoided, or their outcomes changed, with good advice. Of course, that presupposes that corporations and their shareholders consult with their attorneys when they form their businesses and then before they act, a course of conduct that unfortunately is often absent. Still, the prudent attorney can steer her client through the thicket of _Donahue_ law with carefully crafted agreements, having clients make full disclosure, and creative efforts to resolve disputes when they do arise.
Case & Statute Comments

Civil Law – Attorney–Client Privilege under Massachusetts Public Records Law


Introduction

In July of 2007, in Suffolk Construction Co. v. Division of Capital Asset Management, the Supreme Judicial Court (“SJC”) held that the state’s public records law does not require the disclosure of materials privileged by the attorney-client relationship within the government context. The SJC held that “confidential communications between public officers and employees and governmental entities and their legal counsel undertaken for the purpose of obtaining legal advice or assistance are protected under the normal rules of the attorney-client privilege.” Allowing the public records law to preclude the attorney-client privilege would, according to the SJC, severely inhibit the ability of government officials to obtain quality legal advice essential to the faithful discharge of their duties, place public entities at an unfair disadvantage vis-à-vis private parties with whom they transact business and for whom the attorney-client privilege is all but inviolable, and impede the public’s strong interest in the fair and effective administration of justice.

The holding in this case provides a greater degree of certainty regarding privilege afforded government entities and their attorneys by Massachusetts courts.

This case arose from a dispute over payments for construction work between the parties. In 2001, plaintiff, Suffolk Construction Co. Inc. (Suffolk) was designated general contractor for the historic restoration, renovation, and reconstruction of what is now known as the John Adams Court House, located in Boston’s Pemberton Square, by the defendant, Division of Capital Asset Management of the Commonwealth of Massachusetts (DCAM). As a result of DCAM’s allegedly inadequate project documentation, Suffolk found itself engaged in a fair amount of “extensive and unanticipated additional work.” In an attempt to remedy the situation, Suffolk presented DCAM with a number of “proposed change orders,” including Proposed Change Order (PCO) 704, which would increase payments to Suffolk. DCAM, upon consideration and with input from its consultants and architects, denied payment to Suffolk for PCO 704 in April of 2004.

Subsequent to DCAM’s refusal to submit to PCO 704, Suffolk served DCAM with two record requests pursuant to the Massachusetts public records law in October of 2004, seeking to “inspect and review all documents of every kind” related to the project, including “all documents between and among [the executive office for administration and finance] and/or DCAM, their counsel, agents, employees, consultants and/or counsel for other entities regarding this request.” In response, DCAM proffered a vast number of documents (according to DCAM, approximately half a million pages). However, DCAM withheld 189 documents, arguing that these documents were protected by the attorney-client privilege and submitted a privilege log to the court. Suffolk then filed a complaint for declaratory and injunctive relief and simultaneously moved for a preliminary injunction seeking similar relief in August of 2005. Four days later, Suffolk filed a complaint in superior court against DCAM alleging breach of contract and seeking damages as a result of the alleged unpaid work addressed in PCO 704. Judge Mitchell J. Sikora, Jr. of the superior court issued four rulings on this complaint on December 15, 2005. The court denied Suffolk the preliminary injunction “because the balance of irreparable harm in light of the merits favors the defendant DCAM, and because [an injunction] would alter, rather than preserve, the status quo.” Next, the court ordered DCAM to provide additional information in its privilege index in support of its claim to attorney-client privilege. The court also consolidated the actions filed by Suffolk in superior court. Lastly, the court reported the following question to the Appeals Court: “Do the provisions of the public

3. Id. at 450.
4. Id. at 446.
5. Id.
6. Id. at 446 n.5.
7. Id. at 446.
8. Id.
9. Id. at 447 (brackets in original).
12. Id.
13. Id.
17. Id. at 448.
records law, comprised of G.L. c. 66, § 10[,] and G.L. c. 4, § 7(26), preclude the protection of the attorney-client privilege from records made or received by any officer or employee of any agency of the Commonwealth.” The SJC granted both parties’ applications for direct appellate review, and acknowledged amicus briefs submitted by the Massachusetts Port Authority, the Boston Bar Association, and the City Solicitors and Town Counsel Association.19

Attorney-Client Privilege

Background of the Privilege

The attorney-client privilege attaches to “all confidential communications between a client and its attorney undertaken for the purpose of obtaining legal advice.”20 “Dating at least from the age of Shakespeare, the attorney-client privilege is the oldest of the privileges for confidential communications known to the common law.”21 The privilege is firmly established “as a critical component of the rule of law in our democratic society.”22 The lower court described the privilege as “ancient, powerful, and socially useful to the function of litigation as the mechanism for the peaceful resolution of disputes.”23

The United States Supreme Court has stated that the attorney-client privilege exists “to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice.”24 The policy behind the privilege is that “sound legal advice or advocacy” lies within the public interest, and that “such advice or advocacy depends upon the lawyer’s being fully informed by the client.”25

The SJC confirmed that “the attorney-client privilege is a fundamental component of the administration of justice.”26 Within Massachusetts, application of the attorney-client privilege is a matter of common law.”27 Commentary to the Massachusetts Rules of Professional Conduct provides insight into the general justification for attorney-client confidentiality: “[t]he lawyer is part of a judicial system charged with upholding the law. One of the lawyer’s functions is to advise clients so that they avoid any violation of the law in the proper exercise of their rights.”28 The comment also stresses that confidentiality “not only facilitates the full development of facts essential to proper representation of the client but also encourages people to seek early legal assistance.”29 Thus, the privilege enables the attorney-client relationship to be as effective as possible, thereby creating a more efficient and just judicial system.

Scope of the Privilege

The attorney-client privilege protects “all confidential communications between a client and its attorney undertaken for the purpose of obtaining legal advice.”30 The Supreme Court has held that the attorney-client privilege “only protects disclosure of communications; it does not protect disclosure of the underlying facts by those who communicated with the attorney.”31

To establish that the attorney-client privilege applies to a communication, the SJC has held that the party asserting the privilege carries the burden to demonstrate the following:

1. the “existence of the attorney-client relationship,”
2. that “the communications were received from a client during the course of the client’s search for legal advice from the attorney in his or her capacity as such,”
3. that “the communications were made in confidence,” and
4. that “the privilege as to these communications has not been waived.”32

Once attached, the privilege “protects all communications, whether they are written or oral.”33 Moreover, the privilege “lasts in perpetuity - it survives both the termination of the attorney-client relationship and even the death of the client.”34 The protections afforded by the attorney-client privilege can be lost if the client waives the privilege, and courts are frequently required to determine if inadvertent disclosure of a privileged document constitutes such a waiver.35 Massachusetts courts apply a “middle test” to determine whether inadvertent disclosure results in a waiver of the attorney-client privilege. “Where it can be shown … that reasonable precautionary steps were taken [to maintain confidentiality], the presumption will be that the disclosure was not voluntary and therefore unlikely that there has been a waiver.”36

Once the client has demonstrated that the document is privileged, Massachusetts courts then consider the totality of the circumstances in determining whether the client has met its burden of establishing that it took adequate precautions to maintain confidentiality. Specifically, the courts will consider:

18. Id. at 445.
19. Id. at 445 n.2.
20. Id. at 448.
21. Id. at 448-49 (quoting Upjohn Co. v. United States, 449 U.S. 383, 389 (1981)).
22. Id. at 456.
25. Id.
29. Id. at cmt. 2.
34. Id. at 31 (citing Hatton v. Robinson, 31 Mass. (14 Pick) 416, 421 (1834)).
36. Id. at 423.
The Attorney-Client Privilege in the Municipal and Public Law Context

On appeal, Suffolk argued unsuccessfially that “the application of the attorney-client privilege to the government and its lawyers is uncertain.”

The SJC concurred with DCAM, rather than Suffolk, finding it “well-established that communications between government agencies and agency counsel are protected by the privilege as long as they are made confidentially and for the purpose of obtaining legal advice for the agency.” The SJC explicitly held that “confidential communications between public officers and employees and governmental entities and their legal counsel undertaken for the purpose of obtaining legal advice or assistance are protected under the normal rules of the attorney-client privilege.”

In so holding, the SJC analyzed the policy of applying the privilege as a means to enable efficient and effective counsel for public officers and employees and governmental entities:

1. the reasonableness of precautions taken to prevent inadvertent disclosure;
2. the amount of time it took the producing party to recognize its error;
3. the scope of the production;
4. the extent of the inadvertent disclosure; and
5. the overriding interest of fairness and justice.

Public officials and employees must be cautious of waiving the attorney-client privilege as the privilege may be found to be waived when communications are dispersed outside the attorney-client relationship, even if the information remains within the public agency. The “burden is on the agency to demonstrate that confidentiality was expected in the handling of these communications, and that it was reasonably careful to keep this confidential information protected from general disclosure.”

The Attorney-Client Privilege and the Attorney Work Product Doctrine

In General Electric Co. v. Department of Environmental Protection, the SJC held that the commonwealth’s public records law did not contain an implied exemption for materials otherwise protected by the common-law “work product doctrine.” As a result, such records were discoverable pursuant to the public records law. However, in Suffolk Construction Co., the SJC found that the attorney-client privilege and the attorney work product doctrine “are readily differentiated.”

The work product doctrine protects documents prepared by a lawyer in anticipation of litigation. This doctrine offers protection of “written statements and mental impressions contained in the mind of the attorney,” while the attorney-client privilege exclusively protects confidential communications between the attorney and his or her client. The SJC noted that “[t]he distinctly different social value assigned to the two doctrines is reflected in the fact that the attorney-client privilege, which belongs to the client, is with rare exceptions inviolable, surviving even the client’s death.” Of course, work...
product protection is only limited to preparation for litigation, while the attorney-client privilege extends to all communications no matter the type of legal services provided to the client. Additionally, the work-product immunity can be challenged by a showing of need.\textsuperscript{49} Significantly, the lawyer holds the work product immunity, whereas the client exclusively controls the attorney-client privilege.\textsuperscript{50} In other words, while the attorney can waive the work product immunity, only the client may waive the attorney-client privilege. Furthermore, while the attorney-client privilege is absolute, the work product doctrine provides only a qualified immunity, which can be overcome upon a showing of need.\textsuperscript{51} For example,

\begin{quote}
[w]here relevant and non-privileged facts remain hidden in an attorney's file and where production of those facts is essential to the preparation of one's case, discovery may properly be had. Such written statements and documents might, under certain circumstances, be admissible in evidence or give clues as to the existence or location of relevant facts. Or they might be useful for purposes of impeachment or corroboration. And production might be justified where the witnesses are no longer available or can be reached only with difficulty.\textsuperscript{52}
\end{quote}

In those cases in which counsel may be compelled to disclose work product, the opposing party bears the burden of "establish[ing] adequate reasons to justify production through a subpoena or court order."\textsuperscript{53} The tension lies in preserving the attorney-client privilege and the work-product doctrine and the public interest in open government as expressed through the public record law.

**Public Records Law and the Attorney-Client Privilege**

The heart of the issue in *Suffolk Construction Co.* was whether the Massachusetts public records law precluded application of the attorney-client privilege in the public context.\textsuperscript{54} The SJC did not address attorney-client privilege in *General Electric Co.*, but held that under the public records law, documents of a governmental entity are not privileged by the work product doctrine and are thus subject to disclosure.\textsuperscript{55}

Ultimately, the SJC held in *Suffolk Construction Co.* that the Massachusetts public records law does not require disclosure of confidential communications between a governmental entity and its attorney.\textsuperscript{56} In making this determination, the SJC considered the history and the intent of both the public records law within Massachusetts and the long-standing recognition of the attorney-client privilege. The SJC also took care to distinguish its conclusion in *Suffolk Construction Co.* from its holding in *General Electric Co.*

The SJC in *Suffolk Construction Co.* acknowledged that the public records law is in place because:

\begin{quote}
'the public has an interest in knowing whether public servants are carrying out their duties in an efficient and law abiding manner,' and that 'great access to information about the actions of public officers and institutions is increasingly . . . an essential ingredient of public confidence in government.'\textsuperscript{57}
\end{quote}

Providing access to governmental records serves to realize "the paramount right of the public to know."\textsuperscript{58}

The public records law in Massachusetts defines the term "public records" as follows:

\begin{quote}
all books, papers, maps, photographs, recorded tapes, financial statements, statistical tabulations, or other documentary materials or data, regardless of physical form or characteristics, made or received by any officer or employee of any agency, executive office, department, board, commission, bureau, division or authority of the commonwealth, or of any political subdivision thereof, or of any authority established by the general court to serve a public purpose . . .
\end{quote}

Pursuant to the statute, a presumption arises that any such public record should be accessible to the public and thus subject to disclosure.\textsuperscript{59} The presumption can be overcome by the governmental entity seeking to protect the record from disclosure by demonstrating that the materials fall within a specific statutory exemption.\textsuperscript{60}

\textsuperscript{49} Id. at 457 (citing Hickman v. Taylor, 329 U.S. 495, 511-12 (1947)).
\textsuperscript{50} In re Grand Jury Proceedings, 604 F.2d 798, 801 (3rd Cir. 1979).
\textsuperscript{51} Brief of the Defendant/Appellee at 22, Suffolk Constr. Co. v. Div. of Capital Asset Mgmt., No. SJC 09733 (2007) (citing Admiral Insurance Co. v. U.S. District Ct. for the District of Arizona, 881 F.2d 1486, 1494 (9th Cir. 1989) (holding the attorney work product doctrine can be “overcome by a showing of need for the materials in question”)).
\textsuperscript{52} Taylor, 329 U.S. at 511.
\textsuperscript{53} Id. at 512.
\textsuperscript{54} Suffolk Constr. Co., 449 Mass. 444.
\textsuperscript{56} Suffolk Constr. Co., 449 Mass. at 461.
\textsuperscript{57} Id. at 453 (quoting New Bedford Standard-Times Publ. Co. v. Clerk of the 3d Dist. Ct. of Bristol, 377 Mass. 404, 417 (1979) and Attorney General v. Collector of Lynn, 377 Mass. 151, 158 (1979)).
\textsuperscript{58} Brief of the Plaintiff/Appellant at 11, Suffolk Constr. Co. v. Div. of Capital Asset Mgmt., No. SJC 09733 (2007).
\textsuperscript{59} MASS. GEN. LAWS ch.4, §7, clause 26 (Supp. 2007).
\textsuperscript{60} MASS. GEN. LAWS ch. 66, § 10(c) (2006).
\textsuperscript{61} Id.
Neither the work product doctrine nor the attorney-client privilege is an enumerated exemption within the statute. In *General Electric Co.*, the SJC stated that, “[b]ecause of the [public record law’s] presumption in favor of disclosure, we have said that the statutory exemptions must be strictly and narrowly construed.” Moreover, “the plain language of the statute manifests a legislative intent to provide broad public access to government documents subject to limited exceptions” and, because the legislature explicitly rejected an exemption protecting public attorney work product, the SJC declined to recognize an exception for the work product doctrine and held that public attorney work product was subject to disclosure via the public records law. In reaching its decision the SJC considered the deliberative process exemption.

**The Deliberative Process Exemption**

Suffolk also argued that the attorney-client privilege is sufficiently protected by statutory exemption (d), known as the deliberative process exemption, which states that “inter-agency or intra-agency memoranda or letters relating to policy positions being developed by the agency” are not subject to disclosure pursuant to the public records law. The SJC found the deliberative process exemption to be a “sub-species of [the] work-product privilege that covers documents reflecting advisory opinions, recommendations and deliberations comprising part of a process by which governmental decisions and policies are formulated.” The purpose of the deliberative process exemption “is to foster independent discussions between those responsible for a governmental decision in order to secure the quality of the decision.”

Maintaining that exemption (d) would be sufficient for DCAM’s purposes, Suffolk contended that:

> the scope of exemption (d) includes the protections sought by DCAM in connection with its implied privilege. The Court need not go further than the explicit language of the statute to ensure the governments’ ability to shelter its decision making process, including the seeking of legal advice, from scrutiny until it is completed.

According to Suffolk, the government’s interest in applying privilege and shielding documents from disclosure should be dependent only upon completion of the “decision making process.” Otherwise, the application of the attorney-client privilege would “create an incentive to bring lawyers into even more decisions so that the decisions might be shielded from public review in perpetuity.” To support its argument, Suffolk stated that, in attaching the traditional attorney-client privilege to the public context, the SJC would, in effect, be “plac[ing] a shroud of secrecy over government decision-making.”

In response, DCAM contended that exemption (d) “has a scope and purpose that are distinct from, and in no way a substitute for, the attorney-client privilege.” DCAM argued that the exemption (d) is an improper replacement for privilege, because the exemption shields all documents, rather than those communications between counsel and client in the legal context, and because of the temporal aspect of the exemption discussed above. DCAM argued that the exemption would “not meaningfully address [the] purpose” of the privilege which is to foster “candid disclosure of facts and opinions between agency officials and their legal counsel.” Furthermore, DCAM maintained that public interest is not hindered but rather furthered by application of the attorney-client privilege in the public context:

> Governments must not only follow the laws, but are under additional constitutional and ethical obligations to their citizens. The privilege helps ensure that conversations between municipal officials and attorneys will be honest and complete. In so doing, it encourages and facilitates the fulfillment of those obligations.

The Massachusetts Port Authority argued in its *amicus* brief that the attorney-client privilege should attach in the public context because public entities are faced routinely with legal questions every bit as complex as - and in many cases substantively indistinguishable from - those faced by private entities. . . . To deprive such public entities of the attorney-client privilege enjoyed by their private counterparts would place them at a significant disadvantage in their interactions with the private sector. It would prevent public entities . . . from receiving the same quality of legal advice and legal services as private entities.

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64. Id. at 802.

65. Id. at 802-03.

66. Id. at 807.

67. Mass. Gen. Laws ch.4, §7, clause 26 (d) (Supp. 2007) (with the exception of “reasonably completed factual studies or reports,” which are subject to disclosure).


71. Id. at 32 (emphasis added).

72. Id. at 28.


74. Id. at 45-46.

75. Id. at 46.

76. Id. at 23-24, (quoting Ross v. City of Memphis, 423 F.3d 596, 602 (6th Cir. 2005)).

77. Brief of Massachusetts Port Authority as Amicus Curiae at 13-14, Suffolk Construction Co. v. Div. of Capital Asset Mgmt., No. SJC 09733.
The SJC was unconvinced by Suffolk’s arguments, finding instead that “Suffolk has offered nothing other than speculation to support its claim that our holding would open the door to actions of bad faith, or that courts and opposing counsel lack the tools to probe claims of attorney-client privilege.” Ultimately, the SJC determined that, because of the distinction between the work product doctrine and the attorney-client privilege, *General Electric Co.* did not control in this case, and the “deliberative process” exemption, which could extend to protect attorney work product to a certain degree, was not intended to truncate the attorney-client privilege. To interpret *General Electric Co.* and the public records law to do so would “upend[] the common law and fundamentally make[] no sense.”

The SJC, in its analysis, looked to legislative intent of the public records law, but ultimately determined that “[n]othing in the language or history of the public records law, or in our prior decisions, leads us to conclude that the Legislature intended the public records law to abrogate the privilege for those subject to the statute.” Rather, the SJC concluded, “[i]f the Legislature intended to divest government officials and entities subject to the public records law of a privilege as basic and important as the attorney-client privilege, it would have made that intention unmistakably clear.”

**Federal Precedents**

The federal Freedom of Information Act (FOIA), upon which the Massachusetts public records statute is modeled, provides guidance on the implications of this case. The United States Supreme Court has interpreted FOIA since 1975 as containing an exemption for documents protected by the attorney-client privilege. Other federal courts have offered guidance as well on the interplay between FOIA and the attorney-client privilege.

The United States District Court for the District of Columbia has held that the attorney-client privilege covers interagency memoranda which contain the agency counsel’s “legal conclusions and reasoning.” But that court has also held that counsel’s memorandum that was “merely inserted in counsel’s internal file” and never communicated or sent to the client is not protected under the attorney-client privilege.

Additionally, the federal courts can provide further guidance as to the SJC’s emphasis that state entities provide a detailed index of documents withheld by the state entity based on a claimed privilege. Federal courts frequently require the government entity to provide a “Vaughn” index, which provides an extensive “description of the requested material or information, and the agency’s reason for withholding each document or portion of a document.”

**Conclusion**

Massachusetts lawyers have been uncertain for many years whether documents otherwise protected by the attorney-client privilege were nonetheless subject to disclosure under the Massachusetts public records statute, and the matter has been disputed by a long line of supervisors of public records and an equally long line of attorneys general. This case resolves the issue in a manner designed to encourage candid exchanges between government officials and their government attorneys.

Elissa Flynn-Poppey

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79. *Id.* at 457.
80. *Id.* at 458.
81. *Id.* at 446.
82. *Id.* at 461.
88. Carpenter v. U.S. Dep’t of Justice, 470 F. 3d. 434, 442 (1st Cir. 2006). Generally, a Vaughn index provides a broad description of the requested material or information, and the agency’s reason for withholding each document or portion of a document. See Vaughn v. Rosen, 484 F.2d 820 (D.C. Cir. 1973); see also Church of Scientology Int’l v. U.S. Dep’t of Justice, 30 F.3d 224 (1st Cir. 1994).
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