

# Termination for Cause, Office Romance and Unexpected Forgiveness in the Courts

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Consider the following: A male executive has a long-term, clandestine affair with a young female subordinate. The executive takes steps to conceal the affair, while at the same time using his position to advocate for his paramour's career advancement. Upon learning of the situation, his employer terminates his employment for "cause." Caught red-handed, the executive has no legal recourse, right? Not so fast.

In *Balles v. Babcock Power Inc.*, a recent case involving such an affair, the Massachusetts Supreme Judicial Court discussed whether such conduct constituted "**cause**" for termination and, if so, whether **correction** (or **cure**) was possible.

The Court's answers were unexpected – and forgiving.

## BACKGROUND

It was undisputed that Babcock Power Inc. terminated Eric Balles after learning of the affair. If the termination was for "cause," as defined in the stockholders agreement, the Company could repurchase Balles' stock for the nominal price of \$0.001 per share, and need not pay Balles any severance under his employment agreement. Thus, unsurprisingly, the Company took the position that the termination was for "cause." Balles filed suit, and the Company counter-sued.

The trial judge found for the Company on its breach of fiduciary duty (loyalty) claim and, on that basis, assessed against Balles an "equitable forfeiture" of past salary – that is, the salary he had been paid during the period of his disloyalty to the Company. In addition, the trial judge denied Balles any severance because of what the judge found to be Balles' material breach of his employment agreement. However, the trial judge held that, under the stockholders agreement, there was not "cause" for Balles' termination. The Company was ordered to return Balles' stock and to pay him past dividends.

The Company appealed and Massachusetts's highest court, the Supreme Judicial Court, granted direct appellate review.

## ANSWERS FROM THE COURT

The Supreme Judicial Court provided guidance in several areas of crucial importance to executives, including the following:

First, the Court discussed “**fraud**” as grounds for “cause.” As the parties had not supplied a definition of “fraud” in the agreements, the Court applied the common law definition and required, among other things, that the executive had done actual harm to the Company. The Court held that Balles’ efforts to advocate on behalf of his paramour – without disclosing their personal relationship – did not constitute “fraud” because, as the trial judge found, the paramour fully earned her salary and benefits by “her obvious verbal and managerial skills, intelligence, maturity, and motivation...”

Second, applying the common law again, the Court held that merely violating a Company policy does not constitute “**gross insubordination**.” “Gross insubordination,” in contrast to insubordination, “is generally defined as willful disregard of a direct order.” Balles never disobeyed a direct order and, therefore, his conduct did not constitute “gross insubordination.”

Third, when an agreement provides for **an opportunity to correct** one’s conduct (that is, to **cure**), a company cannot ignore this on the “narrow” theory of futility, such as that “cure” would be impossible because the harm was already done. As the Court pointed out, by asserting that cure requires the undoing of the wrong, rather than the remedying of its effects, the Company was reading the opportunity to correct out of the agreement, which it was not allowed to do. The Court rejected the Company’s argument “that the risk of a sexual harassment claim... was uncorrectable.” Rather, the Court pointed out that cure was possible, such as through the financial penalty (loss of severance) imposed by the trial judge. The Court went so far as to say that even if termination was required to protect the integrity of the Company’s personnel policies, the termination did not have to be “for cause.”

Fourth, “**the rights of stockholders** arising under contract...are governed solely by contract.” Thus, as a stockholder, Balles was entitled to his rights under the stockholder agreement – despite his breaching the duty of loyalty that he owed the Company as an employee.

## THE BOTTOM LINE

Here are two takeaways for executives: (1) first and foremost, drafting is king, so make sure you have an executive advocacy lawyer represent you in contract negotiation; and (2) even if you make a mistake, talk with your executive advocacy lawyer as soon as possible, as you may have legal protections of which you are unaware.

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