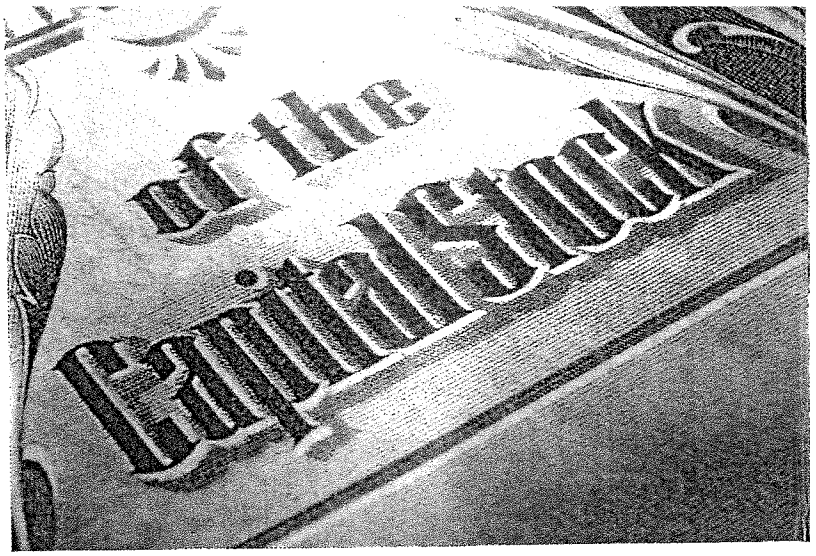
What CPAs Need to Know About Shareholder Duties in Closely-Held Corporations in Massachusetts



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As key business advisors, CPAs need to understand the rights and obligations that shareholders of closely-held businesses in Massachusetts owe to one another. CPAs also play a critical role in helping shareholders craft agreements and resolve disagreements among themselves. This article will provide an overview of the legal framework in which closely-held corporations in Massachusetts function, including the definition of a closely-held corporation, the general rules that govern the shareholders of these entities, the importance of careful planning to avoid disputes among shareholders, and available remedies when disputes do arise.

A Massachusetts 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." *Donahue v. Rodd Electrotype Co. of New England, Inc.*, 367 Mass. 578 (1975). Thus, where three friends join together to form a new Massachusetts entity, with all of them planning to be in the business, the company will be a closely-held corporation. In contrast, a company in which non-active investors own the majority of the company's stock will not be considered closely-held. Massachusetts has a well-developed body of law, which governs the operation of these closely-held entities.

The Duties of Shareholders

The shareholders in closely-held corporations are like partners, owing their fellow shareholders fiduciary duties of good faith, loyalty and fairness. These duties apply not only to majority shareholders but to minority shareholders as well. Recognizing that the fiduciary duties that shareholders owe to one another must be balanced with the corporation's need to govern itself, Massachusetts courts have tempered these strict obligations so that they do not unduly limit the corporation's ability to function. For example, if a minority shareholder challenges a corporate act, the first question is whether the act had a legitimate business purpose. If it did, then the shareholder challenging the action has to show that this purpose could have been achieved in a manner that was less harmful to the minority shareholder. If the act passes both tests — legitimate business purpose and no less harmful alternative — then it will pass muster even if it harms the shareholder.

Employees who are also shareholders pose special issues for closely-held corporations. In most closely-held entities, the shareholders also work for the company. Indeed, the salaries and benefits that they draw may be the prime benefit that they have from their ownership in the entity. For shareholder-employees, efforts to deprive them of employment, unless those efforts have a legitimate business purpose that cannot be achieved by other means, can be breaches of fiduciary duties. However, if the employee is not a founder of the company, but only has bought (or been granted) stock as part of his normal employment, he or she generally will be treated like any other employee and will not be accorded the special consideration otherwise given to shareholder-employees. *Merola v. Exergen Corp.*, 423 Mass. 461 (1996).

Shareholders in closely-held businesses must be very careful not to improperly divert corporate opportunities or assume multiple roles in an improper fashion. In such situations, full disclosure is critical. One shareholder, for example, may be an employee, while owning a company that does business with the corporation and the real estate where the corporation is located. In such cases, the shareholder at the very least must make full and complete disclosure of actions that could benefit him personally to the potential detriment of the corporation or his fellow shareholders.

All shareholders in Massachusetts corporations have the right, pursuant to statute, to some information about the company. Shareholders in closely-held corporations probably are entitled to additional information beyond the information to which shareholders of all types of corporations are entitled, although exactly how much additional information will depend on the particular situation. In any event, providing information, like making disclosures, can alleviate potential problems.

The Importance of Planning

Agreements among shareholders are enforceable and can alter the duties that shareholders might otherwise owe to one another. For example, shareholders commonly agree on how to buy out one another in the event of death, disability, retirement or deadlock. Absent such agreements, however, there may be no mechanism for a shareholder to sell his or her stock, leaving a corporation with a shareholder who no longer is contributing to the company (as most shareholders do in closely-held entities) and the shareholder having no means of getting any value for his or her stock. These disputes can become even more pronounced as stock passes to later generations.

Careful planning is critical, both to avoid disputes in the first instance and to help resolve them when they do arise. CPAs can play a key role in this regard, encouraging newly-created businesses to craft shareholder agreements at the inception of the corporation and providing valuable guidance as to both the tax and business implications of any such agreements.

Disputes Among Shareholders

Despite the best planning, or more often in the absence of planning, disputes do arise among shareholders of closely-held corporations. Those disputes take two forms: direct claims that one shareholder may have against another, and derivative claims which belong to the corporation but are brought through a shareholder because the corporation refuses to act (the boundaries between these two types of actions can become blurred). Examples of direct claims are when the other shareholders act to deprive a shareholder employment with the corporation or remove him or her as a corporate director. A derivative claim might be that the corporation paid excessive compensation to a shareholder employee and the employee is acting on behalf of the company in bringing it.

Assuming that there is a viable claim, then the question arises as to how to remedy the wrong. One remedy is an award of damages. Another is through equitable relief, such as the restoration of one's employment. It is important to note, however, that there are limits on such equitable relief. For example, a court cannot order that a shareholder be bought out. Also of significance is whether a successful shareholder can recover his or her attorneys' fees. Such recoveries are permitted for derivative claims but not for direct claims. Finally, in certain instances, a shareholder can seek to dissolve the entity. Unless otherwise provided in the company's articles of organization or by-laws or in a shareholders' agreement, dissolution is governed by statute.

Oftentimes, disputes are foreseeable. Even if a particular dispute is not foreseeable, the possibility of disputes should be anticipated. When are the parties most likely to be reasonable about resolving differences? At the beginning of a relationship, when they are filled with hope and expectation, or after disputes have arisen, rancor and distrust have set in, and the parties are barely communicating?

Finally, when disputes do arise in the course of the corporation's history, there are tremendous benefits to a negotiated resolution instead of a court battle. The CPA, who often has been intimately involved with the shareholders and who has perhaps the greatest knowledge about the company's finances, needs to be closely involved with this process, helping the parties understand the value of the entity and the financial and tax implications of any settlement.

CPAs have a critical role in closely-held businesses. Working with legal counsel, they can form an effective team to help the company and its shareholders avoid problems in the first instance and resolve them when they do arise.

Marc Laredo, Esq., is a partner in the Boston law firm of Laredo & Smith LLP, where he concentrates his practice in the areas of business litigation and general business law. He has represented clients in a wide array of business disputes, including shareholder disputes in closely-held corporations. Laredo also is counsel to a number of closely-held businesses, advising them on the initial formation and maintenance of the business entity, contract and employment issues, and general legal matters. Laredo is a graduate of Cornell University and the University of Pennsylvania Law School.