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Fiduciary Duties of Stockholders in Closely-Held Massachusetts Businesses

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One of the common questions we get from owners—particularly those in the minority—in family businesses and other closely-held entities is what their rights are when they believe they aren't being treated fairly by those who control the company.

Unlike other states, Massachusetts not only recognizes the special relationship between ownership and management in a closely-held corporation, but provides a heightened fiduciary obligation for the owners of such corporation to deal fairly with one another. This obligation is distinct from general duties to the corporation itself, such as the duty of an officer or director to act with reasonable prudence to achieve the best interests of the corporation. Note that this obligation is not unique to corporations, but also applies to LLCs.

Massachusetts courts have found that a closely-held corporation is one where (i) there are a small number of shareholders, (ii) there is generally no readily-available market to buy and sell the stock of the corporation, and (iii) there is substantial shareholder participation in the management, direction and operations of the corporation. Such corporations more resemble a partnership than a traditional corporate structure, and therefore some of the heightened obligations applicable to partners in a partnership are also applied to shareholders of closely-held corporations.

This unity of identity of shareholders and management provides an ideal arena for majority shareholders/management to impose their will on the minority and marginalize or freeze them out of having a say in the corporation. In such situations, a minority shareholder, who has no voting power or managerial authority to stop such actions, could be trapped with no recourse.

To protect minority shareholders, Massachusetts law imposes a duty on all shareholders in a closely-held corporation to treat each other with the utmost good faith and loyalty. This duty is higher than the standard duty that shareholders and directors of all corporations

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must adhere to. The only way for a shareholder to defeat a claim that he has not dealt with the other shareholders using the utmost good faith and loyalty is if he can demonstrate a legitimate business purpose for the conduct giving rise to the claim.

Although all actions of the shareholders in a closely-held Massachusetts corporation are subject to this heightened scrutiny, one of the most common types of claims raised by minority shareholders is when a majority shareholder wants to sell his stock back to the corporation. Because such a scenario would require the use of funds/assets from the corporation which may otherwise be available for distribution to the shareholders, including the minority shareholders, Massachusetts law steps in to protect the minority shareholders by requiring the corporation to also offer to purchase a pro rata amount of the minority shareholders' shares at the identical price that the majority shareholder would get. If the majority shareholders do not use their control of the corporation to make such an offer to the minority shareholders, there is a presumption that they have breached their duty of utmost good faith and loyalty to the minority shareholders.

The rationale for this requirement is that the majority should not be allowed to use their control of the corporation to obtain special advantages and benefits that are disproportionate from their share ownership. In other words, setting an unnaturally high price for the shares and using corporate funds (that the minority shareholders would otherwise be entitled to) to buy them.

On the other hand, a sale of shares by a majority shareholder to an independent third party does not necessarily give rise to a claim by other shareholders because typically corporate assets are not being used to pay for the stock and the price is presumably negotiated at arm's length by the buyer. Also, corporate constituent documentation such as the bylaws, charter or a shareholders' agreement can govern the mechanics, rights of other shareholders to make offers on the stock first, and even pricing of such sales.

So what is a majority owner of a Massachusetts closely-held corporation or LLC to do, given this heightened duty? The most practical advice is to always give full disclosure of corporate actions to other shareholders, particularly the minority holders. Think in terms of, and frame decisions in the best interests of, the company, which will often naturally then indirectly benefit those minority holders.

Disclaimer: This summary is provided for educational and information purposes only and is not legal advice. Any specific questions about these topics should be directed to attorney Arvid von Taube.