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Shareholder Agreements in Closely Held Massachusetts Corporations

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Can fiduciary duties trump contractual rights of shareholders in closely held companies? Are shareholders of a subchapter-S corporation entitled to sell their shares to third parties, even when that sale would destroy the corporation's subchapter-S status? These are the questions addressed in the recent Superior Court decision *Merriam v. Demoulas Super Markets, Inc.*,¹ and lawyers who draft shareholder and employment agreements for closely held corporations should take note of the court's guidance.

Merriam marks yet another chapter in the ongoing infighting among Demoulas shareholders. The dispute centered on the shareholders' right to sell stock when that sale would cause the corporation to lose its favorable subchapter-S status. One Demoulas faction argued that fiduciary duties prohibited such a sale, even though nothing in the corporate charter prohibited it, citing to *A.W. Chesterton Company v. Chesterton*.² The would-be selling shareholders disagreed, arguing that their contractual right to sell company stock was not restricted by their fiduciary duties, citing to *Chokel v. Genzyme Corporation*.³

Merriam held that when shareholder conduct "falls clearly within the scope of" articulated contract rights, fiduciary duties do not restrict shareholders' exercise of their contract rights, but that fiduciary duties can serve as a check on shareholder conduct when shareholders act "in a manner inconsistent with the express terms of a shareholder agreement." In either situation, *Merriam* held that contracts between shareholders are subject to the implied covenant of good faith and fair dealing.

Although *Merriam* did resolve some of the underlying tension in Massachusetts law between fiduciary duties and contract rights,⁴ the court's renewed emphasis on the implied covenant of good faith and fair dealing creates murky waters for practitioners crafting contracts for closely held companies. Under Massachusetts law, that covenant requires that contracting parties remain faithful to the intended and agreed expectations of the contract; a breach is found where one party violates the reasonable expectations of another. When drafting contracts between shareholders of closely held companies, including corporate charters, employment agreements, or shareholder agreements, practitioners should take care to clearly establish the parties' rights and obligations, to unambiguously define any restrictions on those rights, and to expressly memorialize the parties' expectations. Failure to do so could result in interpretations of these contracts in which fiduciary duties trump contract rights and pave the way for claims for breach of the implied covenant of good faith and fair dealing which allege "reasonable expectations" of parties that were never intended.

If you have any questions or would like more information about this advisory, please contact the authors or your Mintz Levin attorney.

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Endnotes

- 1 *Merriam v. Demoulas Super Markets, Inc.*, Civ. A. No. 10-02681 (Mass. Super. Ct. Mar. 29, 2011) (Haggerty, J.).
- 2 *A.W. Chesterton Co., Inc. v. Chesterton*, 128 F.3d 1 (1st Cir. 1997).
- 3 *Chokel v. Genzyme Corp.*, 449 Mass. 272 (2007).
- 4 *Pointer* applied fiduciary duty principles, and not contract law, to the employment termination of a minority shareholder based on its finding that the employment contract permitted termination only upon a violation of the employment contract, and there was no finding of such a violation. *Pointer v. Castellani*, 455 Mass. 537 (2009). *Blank* applied the implied covenant of good faith and fair dealing, and not fiduciary duties, to the termination of a minority shareholder/employee because the employment contract permitted termination without cause. *Blank v. Chelmsford OB/GYN, P.C.*, 420 Mass. 404 (1995). *Merriam* reconciled these two seemingly inconsistent Supreme Judicial Court employment termination cases involving closely held corporations when it held that "fiduciary duties may still govern where shareholders act in a manner inconsistent with the express terms of a shareholder agreement [as in *Pointer*], but that courts will not entertain fiduciary claims where a shareholder's action falls clearly within the scope of an agreement [as in *Blank*]."

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