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CORPORATE LAW—CLASH OF THE CONCEPTS: WHEN FIDUCIARY DUTIES OVERCOME SHAREHOLDER AGREEMENTS IN CLOSELY HELD CORPORATIONS—SELMARK ASSOCs., INC. V. EHRLICH, 5 N.E.3D 923 (MASS. 2014).

In Massachusetts, shareholders in closely held ("close") corporations owe fiduciary duties to the corporation and to each other, and the relationship among the shareholders of a close corporation "must be one of trust, confidence and absolute loyalty if the enterprise is to succeed." However, shareholders’ rights and obligations under an agreement regarding the close corporation are applied to contract law, and not by fiduciary principles that would usually govern. In Selmark Associates, Inc. v. Ehrlich, the Supreme Judicial Court of Massachusetts ("SJC") held that Selmark still owed Evan Ehrlich fiduciary duties, even where shareholder agreements existed, because the employment agreement had expired, and therefore the contract did not completely govern Ehrlich’s rights as a shareholder.

Selmark Associates, Inc. (Selmark) and Marathon Sales, Ltd. (Marathon) are both closely held corporations from Massachusetts, and in September of 2001, Evan Ehrlich entered into a number of written agreements that, among other things, provided for the gradual sale of Marathon to Selmark and Ehrlich. Although Ehrlich’s employment

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1 See Donahue v. Rodd Electrotype Co. of New England, Inc., 328 N.E.2d 505, 505-512 (Mass. 1975) (creating “Donahue test”). A "closely held" corporation is "typified by: (1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in the management, direction and operations of the corporation." Id. at 511; see Elmaleh v. Barlow, No. 042644H, 2005 WL 2373851, at *5-7 (Mass. Super. Ct. July 7, 2005) (applying Donahue test). The court in Donahue ultimately determined that the entity at issue was a close corporation, which fiduciary duties applied to shareholders in close corporations, and a breach of fiduciary duties occurred. See Donahue, 328 N.E.2d at 519-521; see also John W. Marshall, Closely Held Conflicts, BOARD OF BAR OVERSEES, OFFICE OF THE LEGAL COUNSEL (July 2003), available at http://www.mass.gov/obcbbo/closely_held.htm (discussing conflicts that arise in closely held corporations).


3 5 N.E.3d 923 (Mass. 2014).

4 See Selmark, 5 N.E.3d at 927.

5 Id. at 927 (discussing shareholder agreements each company agreed on). There were a total of four contracts: a stipulated stock purchase and redemption agreement, a conversion agreement, an employment agreement and a stock agreement. Id. The employment agreement stipulated that Ehrlich could be fired without cause. Id. at 928. Additionally, the employment agreement stated
agreement expired in 2002, he continued to work for Marathon until Selmark fired him without cause in 2007. After his termination, Ehrlich had yet to cash in his Marathon stock, and remained a minority shareholder of the company. After his termination from Marathon, Ehrlich began working at a competing firm, where he solicited business from Marathon customers.

In 2008, Selmark and Marathon filed a complaint alleging that Ehrlich breached his fiduciary duties to Marathon by soliciting and acquiring Marathon principals at his new job. In response, Ehrlich asserted thirteen counterclaims, which included a claim of breach of fiduciary duties by Selmark, Marathon, and Elofson. In 2011, the jury found that Ehrlich breached his fiduciary duties to Selmark, and that Selmark and Elofson breached their contract and fiduciary duties to Ehrlich as well. After the judgment was entered in October 2011, both parties
filed motions for a judgment notwithstanding the verdict, among other motions, but all were denied. In January 2012, both parties cross-appaled, and the SJC granted Ehrlich’s application for direct appellate review.

In 1975, the Supreme Judicial Court delivered its landmark decision in Donahue v. Rodd Electrotype Co. of New England, Inc., holding that shareholders in close corporations owe fiduciary duties to the other shareholders in the corporation. In Donahue, the court looked to the

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strong similarities of closely held corporations and partnerships, and determined that shareholders in close corporations are similar to partners in that they owe a duty of good faith and fairness to each other. Additionally, the court determined that fiduciary duties should be applied to shareholders in close corporations, because of the few remedies that oppressed shareholders in close corporations have.

In contrast, in *Chokel v. Genzyme Corp.*, the SJC held that when the rights of shareholders are provided by agreements between the shareholders, these rights are to be determined by contract law. In

shareholder competing with his corporation in the Hagshenas case, at least three other typical factual situations can be identified as violations of the heightened fiduciary duty owed by shareholders in closely held corporations, or at least in those that are 'close corporations':

1. Unequal (disproportionate) treatment. Relief may be obtained when a shareholder is shown to be deprived, by action taken by other shareholders, of his or her proportionate share of the financial benefits generated by the corporation.

2. Frustration of reasonable expectations. Relief may be obtained when it is shown that the reasonable expectations of a shareholder with respect to his or her involvement in the corporation have been blocked by action taken by other shareholders.

3. Freeze out/squeeze out. Relief may be obtained when it is shown that there is overbearing, heavy handed conduct to literally force a particular shareholder out of the corporation, by coercing the shareholder to sell his or her shares (usually at a disadvantageous price) or by barring the shareholder's participation in the corporation without a sale of shares.

*Id.* at 252.

15 See *Donahue*, 328 N.E.2d at 516 (noting shareholders rely on trust and confidence which makes fiduciary duties applicable).

16 See *id.* at 513 (noting vulnerability of minority shareholders in close corporations). The court explained that fiduciary duties apply because of trust and confidence relied upon by each shareholder. See *id.* at 515. Additionally, the resemblance of close corporations to partnerships supports the court's application of fiduciary duties to close corporations. See *id.; see also* Note, *Freezing Out Minority Shareholders*, 74 HARV. L. REV. 1630, 1641-42 (1961) (discussing minority shareholder freeze-outs). Equitable relief is generally more suitable in close corporations in contrast to remedies for minority shareholders in public corporations. See Note, *supra*, at 1641. One reason for the difference of relief given to minority shareholders in close corporations and public corporations is because a minority shareholder in close corporations tends to own a greater proportion of shares than a minority shareholder in a public corporation, and is typically more involved in the corporation as a director or officer as well. See *id.* The absence of a market for shares in close corporations causes difficulties and little options for an oppressed minority shareholder. See *id.*

17 867 N.E.2d 325 (Mass. 2007).

18 *Chokel*, 867 N.E.2d at 330-31 (discussing application of fiduciary duties with articles of organization). The SJC held that the procedure for exchanging stocks fell exactly within the contract, and any obligations the directors owed to Chokel must be consistent with the terms provided for in the corporations articles of incorporation. See *id.* The scope of fiduciary duties “is only as broad as the contract that governs the particular relationship[,] the covenant does not supply terms that the parties were free to negotiate, but did not, nor does it create rights and duties
Chokel, the court held that where the procedure for exchanging shares was directly expressed in the contract, any obligations of the directors were to be determined strictly by the terms agreed to in the articles. Like in *Merriam v. Demoulas Super Markets, Inc.*, the *Selmark* court stated, “when the challenged conduct at issue in a case is clearly contemplated by the terms of the parties’ written agreements, we have declined to find liability for breach of fiduciary duty.”

*Selmark* applies *King v. Driscoll* and *Blank v. Chelmsford Ob/Gyn, P.C.*, where the SJC held that if a director’s actions fall completely within the agreement(s), then fiduciary principles do not apply. However, a contract between shareholders and directors does not “completely relieve” them of their fiduciary duties. Therefore, in order for rights and obligations provided by contract between shareholders to be not otherwise provided for in the contract.” *Id.* at 329 (internal quotation marks and citation omitted).

19 See id. at 331 (discussing applicability of fiduciary duties in this instance). The court ultimately held that the procedure in question fell “squarely within the contract,” and any obligations owed were limited by the terms contractually agreed to. *See id.* “Under Massachusetts’ law, a corporation’s articles of organization form a contract between the corporation and its shareholders.” *Id.* at 329.


21 See *Selmark Assoc., Inc. v. Ehrlich*, 5 N.E.3d 923, 933 (Mass. 2014) (discussing application of fiduciary duties to contracts). “Although a shareholder in a close corporation always owes a fiduciary duty to fellow shareholders, good faith compliance with the terms of an agreement entered into by the shareholders satisfies that fiduciary duty.” *Merriam*, 985 N.E.2d at 395 (“A claim for breach of fiduciary duty may arise only where the agreement does not entirely govern the shareholder’s actions.”).


24 *Blank*, 649 N.E.2d at 1105 (articulating implied covenant of good faith and fair dealing between parties to a contract). The court also noted that employment contracts contain this implied covenant of good faith and fair dealing, and a termination not made in good faith may constitute a breach of the contract. *See id.* at 1105-06 (“[T]he fact that a stockholder has entered into employment agreement or fact that stockholders execute valid stock purchase agreement does not relieve stockholders of high fiduciary duty owed to one another in all their mutual dealings.”); *see also* Evangelista v. Holland, 537 N.E.2d 589, 593 (Mass. 1989) (citing *Donahue* in consideration of breach of shareholder agreement). “Questions of good faith and loyalty do not arise when all the stockholders in advance enter into an agreement for the purchase of stock of a withdrawing or deceased stockholder.” *Evangelista*, 537 N.E.2d at 593.

25 See *King*, 638 N.E.2d at 586 (holding that employment agreement entered into replaced shareholders’ fiduciary duties); *see also Blank*, 649 N.E.2d at 1106 (discussing terms of employment agreement in application to shareholder’s termination). The court held that the termination of the shareholder was valid, as the other shareholders strictly abided by the employment agreement, which provided for the other shareholder’s termination without cause. *See Blank*, 649 N.E.2d at 1106 (noting plaintiff received six-months’ notice as provided in employment agreement).
supplemented by fiduciary duties, the contracts must not “entirely govern” the parties’ rights and obligations at issue.26 The SJC again looked to the Donahue precedent, focusing on “the relationship among shareholders in a close corporation.”27

In Selmark Associates., Inc. v. Ehrlich, the SJC determined that although Ehrlich and Marathon had three effective shareholder agreements, these agreements did not cover Ehrlich’s employment sufficient enough to supersede the fiduciary duties imposed on shareholders in a close corporation.28 Selmark considered the Blank precedent and distinguished it from Blank, because unlike in Blank, the expired employment agreement here was no longer in force.29 Pointing to King and Merriam, the court reiterated the premise that the mere existence of a contract does not absolutely release shareholders from their fiduciary duties, and that the agreements must sufficiently dictate the rights and obligations at issue.30 Accordingly, since there was no effective agreement governing Ehrlich’s employment at the time Ehrlich was fired, the SJC held that Selmark’s termination of Ehrlich was controlled by fiduciary principles.31 Lastly, the court looked to consider whether Selmark actually had a genuine reason for firing Ehrlich, and ultimately found that Selmark did not have a valid basis for Ehrlich’s termination.32

In Selmark, the SJC rightfully ensured that the issue at hand was sufficiently provided for by contract, before automatically applying contract law because of the existence of agreements between the parties.33 Although previous decisions have held that shareholder agreements might replace fiduciary duties, the court held that the matter at issue must be sufficiently addressed in the agreements in order to replace the

26 See Blank, 649 N.E.2d at 1105-06.
27 See id. at 1105 (noting resemblance of close corporations and partnerships). The court explained that shareholders’ relationships “must be one of trust, confidence, and absolute loyalty if the enterprise is to succeed.” Id.
28 See Selmark Assoc., Inc. v. Ehrlich, 5 N.E.3d 923, 934 (Mass. 2014) (holding that fiduciary duties still applied as result of no operative employment agreement).
29 See id. (comparing applicability of fiduciary duties to shareholder agreements in Blank).
30 See id. (stating that agreement must “entirely govern” parties’ rights and obligations).
31 See id. (noting applicability of fiduciary duties).
32 See id. at 935 (concluding that Selmark did not have “cause” for firing Ehrlich). The court found that “[t]here was no evidence of poor performance—Ehrlich was consistently the second highest producer of commission revenue in the company—or of an inability to get along with others.” Id. Also, the court determined that Selmark did not have a “legitimate business purpose for his termination.” Id. (citing O’Brien v. Pearson, 868 N.E.2d 118 (Mass. 2007)). Selmark could have “sought less harmful alternatives before resorting to termination.” Id.
33 See Selmark, 5 N.E.3d at 934 (ensuring agreed upon terms existed in written agreement before applying common law contract principles to agreement).
shareholders’ fiduciary duties.\textsuperscript{34} This decision by the SJC now provides minority shareholders in close corporations more security, in that majority shareholders must be much more cautious in situations where it appears that a “freeze out” of the minority shareholder has occurred or is impending.\textsuperscript{35} Minority shareholders in close corporations are particularly more susceptible to freeze outs compared to those in other types of entities because there is no ready market for their shares.\textsuperscript{36} Thus, when issues may arise within the corporation, minority shareholders’ options are limited.\textsuperscript{37}

The general notion that fiduciary duties apply to shareholders will undoubtedly see further evolution in the future, and therefore attorneys must stay afloat on the continued development of the law regarding close corporations.\textsuperscript{38} Even more specifically, courts will again be asked to address conflicts that arise regarding fiduciary duties when a shareholder enters into specific contractual provisions governing his/her rights and obligations.\textsuperscript{39} In representing injured shareholders, future litigators must make sure to direct the court’s attention closely to the relationship of the agreements and the issue in dispute. Since roughly 90% of companies in the U.S. are close corporations, litigation regarding shareholders in these corporations will not be going away any time soon.\textsuperscript{40} Since it is generally suggested that shareholders in close corporations have shareholder and

\textsuperscript{34} See id. (requiring matter to be well developed in shareholder agreement to supersede fiduciary duties). “Because Blank is inapplicable, and general fiduciary principles apply, Selmark’s argument that the breach of fiduciary duty claim fails as a matter of law must itself fail, and the trial judge did not err in denying Selmark’s motion for judgment n.o.v. Our standard for reviewing a motion for judgment n.o.v. is whether, anywhere in the evidence, from whatever source derived, any combination of circumstances could be found from which a reasonable inference could be drawn in favor of the [other party].” Id. at 934-35 (internal quotation marks omitted); see supra notes 20-25 (discussing how previous decisions treatment of employment agreements impact on fiduciary duties).

\textsuperscript{35} Selmark, 5 N.E.3d at 932-33 (noting “[f]reeze-outs can occur when a minority shareholder is deprived of employment”).

\textsuperscript{36} See supra note 14 (summarizing law of applying fiduciary duties to shareholders in close corporations).

\textsuperscript{37} See supra note 14.

\textsuperscript{38} See Vliet & Snider, supra note 14, at 248 (“The shareholder-fiduciary rule is by no means a finished or perfect concept...”). Judicial and legislative action will be needed in the future, in order to further evolve and improve the approach to these fiduciary duty issues. See id. at 264.

\textsuperscript{39} See Blank v. Chelmsford Ob/Gyn, P.C., 649 N.E.2d 1102, 1105-6 (1995); see also Appellant’s Brief, supra note 6, at *1 (“[Court was] once again asked to address questions that recurrently arise when a claimed conflict exists between general notions of fiduciary duty and specific contractual provisions governing shareholder rights in close corporations.”).

employment agreements even before incorporation, it is almost inevitable that issues regarding these agreements will arise in the future.\footnote{See Marshall, supra note 1 (discussing continuing legal issues involving closely held corporations and fiduciary duties of shareholders); see also Brent Nicholson, The Fiduciary Duty Of Close Corporation Shareholders: A Call For Legislation, 30 Am. Bus. L.J. 513, 533 (1992) (endorsing and promoting written shareholder agreements). “A shareholder agreement permits the parties to write their own rules about dividend policy, employment, management, shareholder use of corporate assets, dissolution, and other matters.” See Nicholson, supra, at 532.}

Furthermore, as issues regarding fiduciary duties and shareholder agreements continue to occur in closely held corporations, it is also likely that these issues will arise in the very similar type of entity—the LLC.\footnote{See Douglas K. Moll, Minority Oppression & The Limited Liability Company: Learning (Or Not) From Close Corporation History, 40 Wake Forest L. Rev. 883, 895 (2005) (analyzing minority shareholder oppression in close corporations and LLCs). “[T]he problem of oppression is ‘portable’ to the LLC context, as the LLC shares certain core features of the close corporation.” See id. at 896.} The SJC has already held that members of LLCs owe fiduciary duties to each other, and therefore litigation regarding the relationship between fiduciary duties and agreements between the LLC and members will likely come to fruition as well.\footnote{See Mass. Gen. Laws ch. 156C, § 63(b) (2012) (stating members may limit their fiduciary duties by contract); see also Pointer v. Castellani, 918 N.E.2d 805, 816-17 (Mass. 2009) (holding other members of LLC violated their fiduciary duties toward president-member). The SJC concluded that where the president-member of LLC owning forty-three percent of business was subject to a freeze-out by two members collectively owning fifty-one percent, the two members violated their fiduciary duties in relation to their employment agreement. See Pointer, 918 N.E.2d at 814-16 (noting secret hiring of replacement for then president-member before attempts at resolution prior to termination); see also One to One Interactive, LLC v. Landrith, 920 N.E.2d 303, 306-7 (Mass. App. Ct. 2010) (holding breach of fiduciary duties by members in LLC); 1 F. Hodges 0’Neal & Robert B. Thompson, Close Corp and LLCs: Law And Practice § 5:1 (Rev. 3d ed.) (discussing operating agreements in LLCs). The reach of operating agreements is broader than those in close corporations. See 1 O’Neal & Thompson, supra.} As guidance for future litigators representing either shareholders, close corporations, or LLCs and its members, they all must urge the court to focus on the instrumentality of the terms and matter in dispute, in conjunction with the agreement(s) all together.\footnote{See Selmark Assocs., Inc. v. Ehrlich, 5 N.E.3d 923, 934 (Mass. 2014).} Attorneys must consider whether the matter in dispute is amply considered in the agreements enough to supplant the fiduciary duties that each shareholder owes to each other.\footnote{See id. (holding “terms of a contract must clearly and expressly indicate a departure from those obligations”). The court held that although there were brief references to the expired employment agreement in the three valid shareholder agreements, it was not enough to hold the agreements operative regarding Ehrlich’s employment. See id. (“[N]one of the three agreements contains terms that address in any way Ehrlich’s employment rights upon expiration of his Marathon employment agreement before conversion of his Marathon stock.”); see also Donahue v. Rodd Electrotype Co. of New England, Inc., 328 N.E.2d 505, 516 (Mass. 1975) (stipulating that the agreements must be used to meet their express purpose.”).} It will be helpful to see an opinion.


\footnote{See Douglas K. Moll, Minority Oppression & The Limited Liability Company: Learning (Or Not) From Close Corporation History, 40 Wake Forest L. Rev. 883, 895 (2005) (analyzing minority shareholder oppression in close corporations and LLCs). “[T]he problem of oppression is ‘portable’ to the LLC context, as the LLC shares certain core features of the close corporation.” See id. at 896.}

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by a Massachusetts appellate court that gives perhaps a more precise illustration of what the Massachusetts legal and business realm must focus on when determining the status and legitimacy of shareholder agreements in regard to certain matters that may otherwise be governed by fiduciary duty principles.

In *Selmark Associates, Inc. v. Ehrlich*, the SJC set forth that although there may be shareholder agreements between the shareholders, there must be an examination of these agreements in determining whether or not fiduciary duty principles still apply to the shareholders’ rights and obligations. The court demonstrated that it is important to look at the agreements closely and to determine whether there is a sufficient relationship between the matter in dispute and the shareholder agreements. In light of these cases, we now know that neither closely held corporations nor majority shareholders can contract away fiduciary obligations – even when they think that contract law protects them – if the contracts do not entirely govern the parties’ rights and obligations. Both the legal and business world can look forward to future decisions by Massachusetts courts that hopefully dictate with precision what shareholders in close corporations can expect with regard to their shareholder agreements and potential applicable fiduciary duties.

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