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THE BALANCE OF POWER BETWEEN MAJORITY OWNERS AND MINORITY INVESTORS IN TEXAS PRIVATE COMPANIES: IS SOMEONE'S OX BEING GORED BY TEXAS LAW, AND IF SO, WHOSE

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A. INTRODUCTION—WHOSE OX IS BEING GORED—ARE MAJORITY OWNERS IN PRIVATE TEXAS COMPANIES TRULY UNDER ATTACK

This article does two things. First, it provides an overview and update of Texas law regarding the rights and duties of majority owners and minority investors in private Texas companies. Second, it considers and evaluates arguments by some majority shareholders of privately-held Texas companies that Texas law is unduly favoring minority investors.[1] This article therefore reviews recent cases presenting claims by minority shareholders that were successful in the trial courts, as well as the efforts by majority shareholders, and those aligned with them to overturn jury verdicts and resulting judgments for minority shareholders.

We did not attempt to conduct a statistical analysis of case filings for this paper, but the anecdotal evidence indicates that the number of state court lawsuits that minority investors are filings against the majority owners of Texas private companies has grown significantly over the last decade. Whether there is now a "glut" of litigation by minority owners can be debated, but a number of factors are causing increased filings by minority investors. These factors include government regulations causing more companies to refrain from going public, the troubled economy and the ready access to capital outside the public markets. As these claims by minority investors have begun reaching the appellate courts, the majority owners have responded with a number of different arguments and defenses. This article evaluates four primary contentions that majority owners are making in response to claims by minority investors.

Contention No. 1: Texas law does not permit trial courts to exercise any equitable remedies for oppression other than ordering liquidation or the appointment of a receiver.

Contention No. 2: Texas law is so vague that courts must enact new standards to define what constitutes acceptable conduct by majority owners.

Contention No. 3: Minority investors who sign Buy-Sell Agreements are bound by the terms of those agreements regardless of any later oppressive conduct by majority owners.

Contention No. 4: Even if oppression is found, the remedy must be so narrowly tailored that it rarely, if ever, will authorize a buyout.

The majority owners' arguments have had some success to date at the appellate level, which confirms that, contrary to protestations from majority owners and some commentators, Texas law is taking a balanced and measured approach to disputes arising between majority owners and minority investors. Stated another way, Texas has not become a hotbed of claims by minority investors making it perilous for private business owners to operate in this state. Far from it.

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[1] It can be argued that at least some majority owners are encouraging "judicial activism" by urging courts to "legislate from the bench" and overturn jury verdicts against their self-interest. What constitutes judicial activism, however, is the subject of multiple law review articles and is beyond the scope of this paper. Within conservative political circles, judicial activism is: "the term used to define judges acting as lawmakers. In 1803, the U.S. Supreme Court defined its role as accurately defining what the law is. This means that judges act as interpreters of the law, if and when the law, or its application, is confusing. In recent years, judges have left this traditional understanding of judicial review and have begun legislating from the bench." American Policy Roundtable, Feb-March 2014.

To the extent that some majority owners of private companies have become overwrought about decisions that have favored minority owners, their concerns seem overblown, this discussion is intended to provide a reality check to contentions that Texas law is out of balance and is unduly favoring the interests of minority investors. Many minority shareholders find it difficult to get to or prevail at trial on oppression claims for several reasons, including the following: the sizable expense of maintaining a legal challenge to a well-funded and committed defendant; the difficulty of securing all documents necessary to demonstrate the majority owner's oppressive conduct; the challenge of surviving summary judgment when presented with a detailed business judgment defense; and the wisely-counseled majority owner who takes steps to remedy his oppressive conduct after the lawsuit is filed.

B. THE CLOSELY HELD (PRIVATE) CORPORATION

Most majority owners of private Texas companies have not yet amassed great wealth from their private company ownership. Yet, in terms of the balance of power and financial resources, majority owners who own and control privately held Texas firms typically have both much greater power (control) and deeper pockets than minority investors, who may have acquired their interest through sweat equity, gift or inheritance. Given the imbalance of power within Texas private companies, we attempt in this paper to evaluate whether Texas statutes and case law have become biased against majority owners of Texas private companies. Stated more succinctly, is Texas law out of whack in providing windfalls for minority investors.

The starting point of this discussion is to appreciate that majority owners of private companies wield power they can exploit their control in a manner that is abusive to the minority investors. Texas law therefore seeks to strike a balance between, on the one hand, giving control to the majority owner, who has the biggest stake and almost always, the largest capital investment in the business with, on the other hand, protecting the rights of the minority investor, who is also a co-owner holding a minority ownership interest in the company.

The "minority shareholder oppression" scenario arises uniquely in the context of the private company. An investor in a large, public corporation can certainly conclude that management engaged in "bad acts" that are unfavorable to him as a minority owner of the business. The public company investor has a ready exit available, however, because he has the right to sell his shares immediately in the open market.[2] A shareholder in a private company lacks this option because, in most cases, there is no market for the shares of a private company. Moreover, in many private companies, a shareholder's agreement imposes restrictions on the stock's sale or transfer by the minority shareholder. The non-marketable nature of an investment in a private company makes it possible for controlling shareholders to "squeeze out" the minority shareholder from management and daily operations of the company, while also "freezing out" the minority owner's ability to cash out on or realize other monetary benefits from his investment.

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[2] The minority shareholder in a public company may also have a variety of state and federal securities claims to pursue, but these claims are beyond the scope of this article.

By definition, a minority shareholder, minority member of an LLC and limited partner lacks control over the business. In the corporate context, shareholders elect the board of directors, which gives the majority shareholder the right through control of the board to, among other things: (i) select the officers, (ii) set officer compensation, (iii) determine whether the company will issue any dividends and, if so, (iv) how much of a dividend to issue to the minority owners. In the LLC context, the majority members have the power to appoint the managers and achieve the same results described above. The majority shareholder(s) or LLC member(s) can deny the minority owner the right to participate in the management of the business, and the right to share in the financial success of the business on a current basis (*i.e.,* the denial of dividends).

In a limited partnership, the operational control belongs to the general partner, and the limited partners are not generally active in the business, although the limited partnership act does allow limited partners some leeway, including the ability to consult with (and advise) general partners and to also call, attend and participate in meetings with both the limited and the general partners. TEX. BUS. ORG. CODE § 153.103.

In most cases, the successful functioning of a closely held corporation, LLC or limited partnership depends on a cooperative relationship of trust that exists among the owners of the business and the belief that they will each share in the company's financial success. When the majority owners abuse their control over the company, trust ends and problems follow.

C. REVIEW OF THE CLAIM FOR MINORITY SHAREHOLDER OPPRESSION UNDER TEXAS STATUES AND CASE AUTHORITIES

The best legal advice that a potential minority investor may receive before investing (or accepting) an ownership interest in a business is – "get a corporate prenup." This is a shorthand reference to a recommendation that the minority investor seek to negotiate – upfront – a stockholder (or LLC member) agreement that protects the investor's rights during the operation of the business and also when the minority investor decides that the time has come to exit from the company. A corporate prenup entered into by the minority owner and the majority owners of the business generally includes provisions that deal with all of the following issues: (i) capital contributions, (ii) dilution rights, (iii) rights of redemption to secure a buyout and (iv) the procedure for determining the value of the investor's minority held ownership interest.

Minority investors who did not obtain a redemption agreement at the time they acquired their stock or LLC units are not necessarily out of luck if they want to obtain a redemption of their ownership interest in the business. Under the right set of facts demonstrating oppressive conduct by the majority owners, Texas law permits minority investors to file suit to obtain a court-ordered buyout of their interest. Pursuing that legal path is certain, however, to be far more contentious and also subject to more uncertainty than if they had secured a contract that gave them the right to enforce the terms of a stock buyback.

The primary cause of action available to minority investors who contend that they have been mistreated by the majority owners is the claim for minority shareholder oppression. This claim and the equitable remedies it authorizes was recognized by Texas courts more than 25 years ago (and exists in other jurisdictions), but the contours of the claim continue to develop in

several recent cases.[3] The origins of the oppression claim (and statute) date back to the 1950's, but the Texas Supreme Court heard oral argument in February 2013 in a shareholder oppression case in which the trial court awarded a mandatory buyout of the minority ownership interest. *See Ritchie v. Rupe*, 339 S.W.3d 275 (Tex. App.—Dallas 2011, pet. granted).

1. The Oppression Statute and Equitable Remedies in Texas

The starting point for the assertion of an oppression claim is found in Texas statutes. The Texas Legislature enacted several statutes in 1955 to address "illegal, oppressive, or fraudulent" actions by controlling shareholders in closely-held corporations.[4] The oppression statute is now found in Section 11.404 of the Texas Business Organizations Code. Notably, Section 11.404 provides, in certain circumstances, that an oppressed minority shareholder has a statutory right to obtain relief from the majority shareholder's oppressive conduct. *See* TEX. BUS. ORG. CODE § 11.404. This statute also authorizes a Texas trial court to appoint a receiver, or to order that the company be liquidated when there is a showing of "illegal, oppressive or fraudulent" conduct by the "**governing persons**" of the business entity. *Id.* § 11.404(a)(1)(C) (emphasis added).

The two remedies of court-ordered receiverships and liquidation authorized by this Texas statute, however, are generally viewed as unduly harsh to the parties by trial judges. Courts view these two remedies as draconian and are therefore loathe to apply them. When a private company is able to continue functioning – and particularly when the company is profitable – it is rarely viewed as a business ripe for the appointment of a receiver, or appropriate for a court-ordered liquidation putting the company out of business. In sum, despite the hand-wringing by on behalf of some majority owners, Texas cases do not reflect that majority owners of private companies have any objective basis on which to fear their companies will be dissolved or become subject to a receivership merely because a conflict arises with a minority owner.

Before appointing a receiver, the applicable Texas statute requires a trial court to consider whether "all other available legal and equitable remedies . . . are inadequate." *Id.* at § 11.404(b)(3). This particular provision in the statute is quite important, because it not only authorizes the court's use of its equitable powers, it actually requires the trial court to consider the extent to which an "equitable" remedy can be crafted that will address the minority investor's complaints about mistreatment by the majority owner. These remedies include court-ordered buyouts of the minority owner's interest in the company and an award of a mandatory dividend to be shared by the minority shareholder, as well as the issuance of a preliminary injunction to preserve the status quo (and the company's existing management) until a trial can be held on the merits of the minority shareholder's claims.

[3] *Davis v. Sheerin*, 754 S.W.2d 375, 377-80 (Tex. App.—Houston [1st Dist.] 1988, writ denied).

[4] The original oppression statute was codified in Articles 7.05 and 7.06 of the Texas Business Corporations Act and, as discussed above, it is currently found in section 11.404 of the Texas Business Organizations Code.

2. Minority Shareholder Oppression As Defined by Texas Courts

In light of the understandable reluctance of Texas trial courts to order that companies be dissolved or to appoint receivers to rehabilitate or dissolve companies, Texas case law has developed to provide additional remedies to minority shareholders upon proof that the majority shareholders engaged in oppressive conduct. The shareholder oppression claim is based on tort, but there is no single set of actions by the majority owners that constitute oppression. In the seminal case of *Davis v. Sheerin*, the court held that:

> Oppressive conduct has been described as an expansive term that is used to cover a multitude of situations dealing with improper conduct, and **a narrow definition would be inappropriate** . . . . Courts may determine, according to the facts of the particular case, whether the acts complained of serve to frustrate the legitimate expectations of minority shareholders, or whether the acts are of such severity as to warrant the requested relief.

754 S.W.2d at 382-383 (emphasis added).[5] The judicial definition of the oppression claim from *Davis v. Sheerin* is set forth below and allows minority owners to succeed on the cause of action by presenting facts supporting either of two prongs for the claim:

(1) majority shareholder's conduct that substantially defeats the minority's expectations that, objectively viewed, were both reasonable under the circumstances and central to the minority shareholder's decision to join the venture; or

(2) burdensome, harsh and wrongful conduct; a lack of probity and fair dealing in the company's affairs to the prejudice of some members; or a visible departure from the standards of fair dealing and a violation of fair play on which each shareholder is entitled to rely.[6]

This two-part test for oppression relies on language from Articles 7.05 and 7.06 of the Texas Business Corporations Act (now Section 11.404 of the Texas Business Organizations Code discussed above). *Davis* adopted the doctrine of minority shareholder oppression and held that the statute authorizes court-ordered equitable remedies. In *Davis*, the appellate court upheld a jury verdict of oppressive conduct, based on: (i) findings of a conspiracy by the majority shareholders to deprive the plaintiff of his ownership interest in the corporation, (ii) findings that the majority shareholders wasted corporate funds and received dividends that were withheld from the plaintiff, and (iii) undisputed evidence that the plaintiff would be denied any future voice in the corporation's management.

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[5] The *Davis* court crafted a court-ordered buy-out of the plaintiff's stock at fair value, as an acceptable "less harsh" remedy to the statutorily authorized liquidation, available to the court under its "general equity powers" when "oppressive conduct" had occurred. *Id*. at 378, 380, 382-83.

[6] *Davis*, 754 S.W.2d at 381-82; *see also Gimpel v. Bolstein*, 477 N.Y.S.2d 1014, 1017-18 (N.Y. Sup. 1984).

For more than two decades, Texas appellate courts have consistently looked to and upheld the holding of *Davis* in defining shareholder oppression and considering the equitable remedies that are available to the trial court under Section 11.404, of the Texas Business Organizations Code. A review of Texas law since the opinion in *Davis* was issued reflects that more than 25 reported decisions in 11 of the 14 Texas appellate districts have upheld minority shareholder oppression as a viable cause of action under Texas law and no appellate decision has ever rejected the existence or validity of the claim.[7] Federal courts also recognize this claim under Texas law.[8]

3. The Origins of Oppression Claims in Texas

In developing the two-part test, the *Davis* court cited and relied on the Texas Supreme Court's holding in *Patton v. Nicholas*, which first examined the shareholder oppression claim (and related statutes) in 1955.[9] When the Texas Supreme Court issued *Patton*, the Texas Legislature was enacting Articles 7.05 and 7.06 of the Texas Business Corporations Act (now Section 11.404 of the Texas Business Organizations Code) to address oppressive or fraudulent actions by controlling shareholders in closely-held corporations.

The *Patton* case involved the Machinery Sales & Supply Company in Dallas. The company's owner hired two employees in 1940 and later gave them both a 20% ownership interest. From 1940 to 1945, the company generated revenues of more than $1 million with annual net profits of more than $100,000. The minority shareholders also received "relatively frequent and substantial" dividends until disputes arose among the owners—and the two minority shareholders left the company in December 1945. In the following five years (1946-

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[7] *See, e.g.*, *Redmon v. Griffith,* 202 S.W.3d 225, 234-35 (Tex. App.—Tyler 2006, pet. denied) (holding that individual minority shareholders had standing to sue majority shareholders for shareholder oppression); *Hoggett v. Brown,* 971 S.W.2d 472, 488 n.13 (Tex. App.—Houston [14th Dist.] 1997, pet. denied) (recognizing various theories of shareholder oppression as claims by individual shareholders against the oppressive majority shareholder); *Davis,* 754 S.W.2d at 382-83 (noting oppression demonstrated by acts of the oppressive majority shareholder, against whom the individual shareholder plaintiff's claims were proper); *Willis v. Bydalek,* 997 S.W.2d 798, 801 (Tex. App.—Houston [1st Dist.] 1999, pet. denied) (permitting shareholder oppression claim by 49% minority shareholder against majority shareholder, but finding that minority shareholder failed to demonstrate oppressive conduct).

[8] *See Bulacher v. Enowa, LLC*, No. 3:10-CV-156, 2010 WL 1135958, at *2 (N.D. Tex., Mar. 23, 2010) (Lynn, J.) (citing *Davis* and holding: "Texas courts take a broad view of the application of oppressive conduct to a closely-held corporation . . . [and] the facts alleged by [the minority shareholder] are sufficient to state a claim for shareholder oppression under Texas law"); *In re Rosenbaum*, No. 09-4023, 2010 WL 1856344, at *7 (Bankr. E.D. Tex. May 7, 2010) (citing *Davis* and holding that "[w]ith respect to [plaintiff's] claim for minority shareholder oppression, there is no set standard for determining whether shareholder oppression has occurred. Rather, the Court must examine the facts as a whole and determine whether the corporation's conduct has deprived a minority shareholder of the shareholder's reasonable expectations as an equity holder of the corporation"); *see also In re Mandel*, No. 10-40219, 2011 WL 4599969, at *23-24 (Bankr. E.D. Tex. Sept. 30, 2011).

[9] *Patton v. Nicholas*, 279 S.W.2d 848, 855-57 (Tex. 1955). The *Patton* Court highlighted the "new and elaborate" statute that oppression by majority shareholders and commented "that its approach to this type of [oppression] case is one of 'rehabilitation' in preference to dissolution and liquidation." *Id.* at 854 (citing Articles 7.05-09 of the Texas Business Corporations Act).

1950), the company generated similar revenues (more than $1 million), but after the minority shareholders left the company the company's books showed a sharp drop in profits and no further dividends were paid to the minority owners.

The minority shareholders in *Patton* therefore brought suit for an accounting and seeking liquidation of the company. At trial, multiple witnesses testified that the majority shareholders withheld dividends so the minority shareholders "don't make a penny out of this business." The trial court ordered liquidation and the court of appeals agreed that the company should be liquidated. The *Patton* Court viewed liquidation as an "extreme" remedy, but concluded that the majority shareholder's "malicious suppression of dividends is a wrong akin to a breach of trust, for which the courts will afford a remedy." Rather than liquidating a profitable company, the *Patton* Court ordered the corporation (and its controlling majority shareholder) to pay a reasonable dividend "at the earliest practicable date," as well as in future years.

4. Minority Shareholder Oppression Returns to the Texas Supreme Court—More Than 55 Years Later

The Texas Supreme Court had not addressed the shareholder oppression claim (or statute) since *Patton* in 1955, or more recently, since *Davis v. Sheerin* was decided in 1988. Almost six decades after *Patton*, however, the Texas Supreme Court granted review of a shareholder oppression case. In February 2013, the Texas Supreme Court heard oral argument in *Ritchie v. Rupe*, 339 S.W.3d 275 (Tex. App.—Dallas 2011, pet. granted). In *Ritchie*, the minority shareholder sought to sell her shares to a third party, but the third party requested the opportunity to meet with the majority owners before purchasing her minority interest, which is typical in a due diligence process. The majority shareholders refused to meet with—or provide information to—the potential buyers of her stock. Left with no ability to sell her shares to a third party, the minority shareholder filed an oppression suit claiming oppression.

The jury findings supported an oppression determination, and the trial court ordered the majority owners to buy the minority shareholder's stock at a "fair value" of more than $7 million. The Dallas Court of Appeals then determined that the majority shareholders' conduct was oppressive under ***both tests*** set forth in *Davis* because: (1) the company's policies constructively prohibited the minority shareholder from selling her shares "would substantially defeat the shareholder's general reasonable expectation of being able to market her unrestricted stock;" and (2) the majority shareholders (and directors) departed from the "standards of fair dealing" by refusing to meet with prospective purchasers of the minority shareholder's stock.

The Dallas appellate court did remand the case, in part, holding that the trial court had erred in instructing the jury regarding the manner in which to determine the value of the minority interest. The jury had been instructed not to consider discounts that are typically applied to the valuation of a minority interest for lack of marketability and control. On remand, the jury was therefore instructed to consider the extent to which those discounts should apply to the value of the minority interest when it was going to be purchased by a third party.

In *Rupe*, The Texas Supreme Court was presented with a case focused on the standard that applies to minority shareholder oppression and the oral argument was notably active as all Justices asked pointed questions. The Court did not provide signs that would allow its holding to

predicted with confidence, but we do not expect the Court to overturn the shareholder oppression doctrine. First and foremost, unlike other states, Texas has a statue that applies to provide minority owners with relief when the "**governing persons**" engage in "illegal, oppressive or fraudulent." *Id.* § 11.404(a)(1)(C) (emphasis added).

Second, a holding that overturns *Davis v. Sheerin* would also upend more than 25 years of case law that has consistently followed the *Davis* holding. To the extent that the Court concludes, however, that the legal standards governing oppression are vague and need more definition, the Court may refine the standards that currently apply to oppression claims.

5. Other Recent Shareholder Oppression Cases in Texas Courts

The *Rupe* case is hardly an isolated instance as a number of Texas courts have issued opinions relating to minority shareholder disputes. Two recent cases from the Dallas Court of Appeals (reviewing trial court and jury findings); one case from the Houston Court of Appeals (legal questions on summary judgment) are reviewed below.

a. Recent Cases from the Dallas Court of Appeals

In the last two years, different panels from the Dallas Court of Appeals have issued conflicting opinions regarding the standards that apply to shareholder oppression claims.

Ritchie v. Rupe. The Dallas Court of Appeals first construed the claim for shareholder oppression in March 2011 in *Ritchie v. Rupe*, 339 S.W.3d 275 (Tex. App.—Dallas 2011, pet. granted). In *Ritchie*, the Dallas appellate court affirmed the trial court's judgment and court-ordered buyout of the minority shareholder, Ann Rupe based on a series of oppressive acts that culminated in the majority owners' refusal to meet with any of at least five groups interested in buying her stock.

Ann Rupe inherited stock (approximately 17% of the company) in 2002 after her husband died. Soon after, Ms. Rupe contacted the Company's president about selling the shares and ultimately hired a retired capital fund manager in 2004 to help sell her stock to third parties. But the majority owners (three owners controlling 73% of the stock) informed Ms. Rupe in February 2006 that they (and the company) would not meet with potential buyers due to apparent concerns about potential securities liability. With no ability to sell her stock, Ms. Rupe filed suit in July 2006 and after a multi-week jury trial obtained a finding of both shareholder oppression ***and*** breach of fiduciary duty that resulted in a judgment ordering the Company to buy her stock at "fair value" (*i.e.* without discounts) for $7.3 million.

On appeal, the Dallas Court of Appeals affirmed the shareholder oppression finding, but remanded for the trial court to consider including discounts on the value of Ms. Rupe's stock based on lack of marketability and control because she held a minority stake. Although the *Rupe* court and the majority owners framed the case on appeal as a "failure to meet" issue, Judge Moseley also recognized that the trial court found additional oppressive acts that included all of the following actions by the majority owners: (a) causing the company to withhold corporate books and records from Ms. Rupe; (b) making redemption offers to Ms. Rupe that were not in accordance with the Company's policy; (d) making Ms. Rupe a conditional offer to be on the

board of directors but only if she agreed to forgo legal action against another Company shareholder; and (d) causing the company to pay personal expenses of one of the majority owners. *Id.* at 283 n.9; *but see id.* at 297 n. 39 (explaining company had no contractual obligation to repurchase the stock).

In June 2011, the majority owners filed a Petition for Review in the Texas Supreme Court and the Court granted review of the case and held oral arguments in February 2013. The majority owners' position was that the Texas statute was limited to a single remedy of a receivership. For that reason, the majority owners suggested that no equitable remedy existed for the trial court to order a buyout. The Justices were openly skeptical of the suggestion that the "sole remedy" available was receivership when the statute uses the word "oppressive" conduct and refers to equitable remedies.

While not discussed in the appellate opinion in *Rupe*, the minority owner's counsel pressed two themes to the Supreme Court. First, the facts surrounding the "failure to meet" issue was just one of many oppressive acts such as making low-ball offers, corporate waste, or putting restrictions on any board seat appointment. Second, the minority owner's counsel explained that the Company's alleged concerns about committing securities violations in a meeting with prospective buyers was overblown because a confidentiality agreement was in place with each of the potential purchasers of Ms. Rupe's stock. All prospective buyers had to sign this confidentiality agreement before they could obtain any company documents. Thus, the company had all the protections it needed because it also required the recipients of the documents to disclaim reliance on the company (and board's) statements. Finally, the prospective purchaser (and the minority shareholder) were required to indemnify the company. In other words, the majority owners apparent justification for refusing to meet with the buyers (potential claims for securities violations) had already been addressed.

Finally, *Rupe* is also the first Texas case that addresses how a trial court should value a minority investor's stock. Based on the jury's findings, the trial court in *Rupe* ordered the company to pay $7.3 million to redeem Ms. Rupe's stock. But this figure represented the stock's "enterprise value." The Dallas Court of Appeals determined that Ms. Rupe's position as a minority owner (with lack of control) meant that the shares should be valued at "fair value" that would include a "minority discount" (for lack of control) and a "marketability discount" (for lack of marketability. Thus, *Rupe* found that the trial court abused its discretion by ordering a valuation at "enterprise value" (*i.e.* $7.3 million) and should be done instead at "fair value" = approximately 30% less than enterprise value. At the same time, many legal commentators have argued that "minority and marketability discounts have no place in shareholder oppression disputes." *See* Douglas K. Moll, *Shareholder Oppression and "Fair Value,"* 54 Duke L.J. 293, 318 (2004). The primary difference in *Rupe* is that the minority owner was trying to market her stock while other cases—like *Cardiac Perfusion*—involve a minority owner being forced to sell its shares due to oppressive conduct and the valuation does not include any discount. *See also Feldman v. Kim*, No. 14-11-00184, 2012 WL 1449726 (Tex. App.—Houston [14th Dist.] Apr. 24, 2012, no pet.).

Cardiac Perfusion. In July 2012, the Dallas Court of Appeals affirmed the jury's verdict and concluded that the majority shareholder engaged in oppression. The Court upheld the

equitable remedy awarding a redemption of the minority's shares at fair value (*i.e.* excluding discounts for lack of control). *See Cardiac Perfusion Servs., Inc. v. Hughes*, 380 S.W.3d 198 (Tex. App.—Dallas 2012, pet. filed).

The dispute in *Cardiac Perfusion* arose out of a majority owner's decision to fire his employee and then attempt to redeem his minority (10%) ownership interest by paying him a heavily discounted "book value" of $77,674 for his stock. From 1991 until 2006, the two owners helped their medical practice grow and prosper into a profitable company. Along the way, however, the majority owner was taking out significant cash for himself and his family. When the majority owner fired the minority owner in August 2006, he also filed claims against the minority owner (the day after firing him) alleging breach of fiduciary duty and tortious interference with contract. The majority owner's lawsuit sought to trigger a provision in the company's buy-sell agreement enabling him to purchase the minority's stock for $77,674—its discounted book value as of the end of 2005. This value was substantially lower than a "fair value" price that would have excluded application of a minority discount for lack of control.

The minority owner fought back. In several counterclaims, the minority owner alleged that the majority owner was "oppressing [him] as the minority shareholder" and had used the company "to pursue [his] self-interests" or for "his own personal gain." The majority owner also refused to turn over the company's books and records for review by the minority owner.

At trial, the minority owner presented evidence and expert testimony that the majority owner had engaged in a number of improper actions in running the company, including: (a) having the company pay more than $325,000 to the majority owner's college-age children as "salary" for meaningless work; (b) paying himself grossly excessive compensation of $775,000 per year when compensation data for peer companies show a reasonable salary was less than $275,000; and (c) seeking reimbursement of more than $64,000 in credit card bills that were not legitimate business expenses. After hearing nine witnesses, the jury in *Cardiac Perfusion* found that the majority owner had: (a) suppressed payment of profit distributions; (b) paid himself excessive compensation; (c) made improper payments to family members; (d) improperly paid his personal expenses from company funds; (e) wrongfully exploited his control of the company to lower the overall value of the minority owner's stock; and (f) failed to permit the minority owner to examine and make copies of the company's books and records.

Rather than the $77,674 valuation (offered by the majority owner), the jury determined that the book value of the stock (after accounting for improper payments and excessive salary) would be $300,000 for the minority owner's 10% ownership interest.

The Dallas Court of Appeals affirmed the jury's findings and upheld the jury's oppression judgment. At the Dallas appellate court (and before the Texas Supreme Court), the majority owner's primary argument is that the buyout should be $77,674—not $300,000 awarded by the jury—because the minority owner's oppression claims conflict with the company's Buy-Sell Agreement. In effect, the majority owner is seeking to force the minority owner to accept a discounted buyout under the Buy-Sell Agreement—in disregard of his wrongful, oppressive conduct and the equitable remedies provided by the Texas statute. The majority owner argues that the lower courts are "rewriting" the contract to permit an equitable claim to proceed.

The majority owner's argument misses the point by giving short shrift to Texas statutes. As noted earlier, in Section 11.404(b) of the Texas Business Organizations Code, the Texas legislature has directed trial courts to consider whether "all other available legal and equitable remedies . . . are inadequate." *Id.* at § 11.404(b)(3). This statute therefore grants trial courts the power to, among other things, order a redemption of a minority owner's stock for fair value. The Dallas Court of Appeals did not rewrite any contract, it merely exercised its authority to follow the mandates of the Texas Legislature.

Second, and just as importantly, the equitable remedy of a buyout valued the company in light of: (a) the jury's finding of oppression; and (b) what the company would be worth absent the excess salary, payments to family members, and improper use of corporate funds. The court's rationale was that the majority cannot improperly drain cash from the company for his personal benefit after the contract was entered into and then decide to value the minority owner's stock based on the diminished cash the he left in the company. This "heads I win, tails you lose" inequitable argument was rejected by the appellate court because it would effectively deprive the minority owner from ever receiving the benefit of his bargain in the Buy-Sell Agreement.

In February 2013, the majority shareholder filed a petition for review with the Texas Supreme Court in Case No. 13-0014.

Argo Data. In August 2012, the Dallas Court of Appeals reversed a trial court (and extensive jury findings) supporting a court-ordered one-time dividend of $85 million from the company's large stash of retained earnings. The trial court had awarded the dividend to be split between the majority (53%) and minority (47%) owners. *See Argo Data Resource Corp. v. Shagrithaya*, 380 S.W.3d 249 (Tex. App. —Dallas 2012, pet. filed).

In *Argo Data*, the trial court's judgment was based on the results of a six-week trial in which the jury found the majority shareholder, Martin, had (1) wrongfully suppressed payment of dividends from a $140 million cash hoard of retained earnings as part of a "freeze out" scheme; (2) committed fraud by giving false information to the minority shareholder and failing to disclose the earnings were being secretly accumulated as part of the freeze out scheme; and (3) unilaterally slashed the minority shareholder's compensation by 70% without board approval during a year of record profits; (4) obstructed potential opportunities for the minority shareholder to sell his shares to third parties; and (5) wrongfully used corporate funds for personal and family use (*i.e.*, travel expenses; family expenses; condominium purchase).

Notwithstanding a long record of misconduct by the majority owner, the Dallas Court of Appeals in *Argo Data* concluded that the minority shareholder had not been oppressed. The jury had found that Martin had committed 11 separate "predicate acts" of misconduct, which caused the trial court to hold that Shagrithaya had been oppressed. Yet, the *Argo Data* appellate panel held there was no oppression principally based on the expectations test, which required the minority owner to show that his objectively reasonable expectations at the time he joined the company had been substantially defeated by the majority owner's actions.

The court of appeals rejected the majority owner's expectations, as found by the jury, as unreasonable. More specifically, the appellate court found that:

- It was not reasonable for the minority owner to expect to receive compensation equal to the majority owner despite having received virtually equal compensation for 25 years.
- The majority owner's unilateral imposition of a 70% annual pay cut on the minority owner had no impact on his expectations as a shareholder because his compensation relates only to his status as an employee not as a shareholder
- The minority owner had received his pro rata share of $25 million in dividends that had been issued by the end of 2008 (more than a year after the lawsuit was filed)
- There was no evidence the value of the minority owner's shares declined in value during the time the jury found that the majority owner was suppressing dividends
- After audits were conducted and after the lawsuit was filed, the majority owner repaid the company more than the total amount he had improperly taken out for personal use

The activism in which this panel of the Dallas Court of Appeals in *Argo Data* engaged to achieve a prescribed result is notable for several reasons. First, the appellate court ignores—repeatedly—that it based its decision on actions the majority owner took <u>long after</u> the minority owner filed his lawsuit. When the majority owner declared a $25 million dividend, his agreement to issue back pay to the minority owner and his restitution of hundreds of thousands of dollars in improper personal expenses all took place <u>long after</u> the lawsuit was filed, and close to the time of trial. Thus, the appellate court tacitly adopted a "no harm, no foul" standard that allows majority owners to wait to be sued, wait for trial to be set and then take remedial actions at the 11th hour that will pull the rug out from and fully eliminate the minority shareholder's claim for oppression.

Second, the appellate court also adopted a judicial fiction in denying a practical reality. As noted above, the *Argo Data* panel concluded that the minority owner had not been harmed because his shares had not declined in value during the time the jury found he was being defrauded by the majority owner. The jury found that the majority owner had indeed defrauded his co-founder and longtime business partner by secretly engaging in a scheme to stockpile the company's earnings under false pretenses. That is, the majority owner represented to the minority owner—in writing—that the company's profits were being retained for business purposes, when in fact, the majority owner was accumulating them as part of a secret freeze out scheme to get rid of the minority owner. The appellate court does not discount the jury finding, but instead condones the fraud by stating that retaining earnings to buy out a minority owner is not improper – **without acknowledging that Martin concealed his actual purpose and that corporate directors are not entitled to deceive their fellow board members.** Rather than attempting to determine the appropriate remedy for the majority owner's fraud, however, the appellate court held that the minority owner was not harmed by the fact that his ownership interest was not diversified because his ARGO shares continued to appreciate in value while Martin's fraud was ongoing. The fiction with this position, of course, is that the minority owner has no right to access or monetize the value of any of his shares once the majority owner's fraud was revealed. By contrast, if his ownership had been diversified, the assets would have actually been made available to him. The essence of equity is to prevent the majority owner, the party

who engaged in fraud, from profiting from his conduct, but the appellate court turned the tables on the minority owner. Indeed, the appellate court chastised the minority owner for engaging in speculation because he failed to meet an impossible burden – proving how the facts would have changed if he had not been defrauded by the majority owner.

In late 2012, the minority shareholder filed a petition for review with the Texas Supreme Court. The Court asked for briefing from all parties in the case, but it has not yet accepted it for oral argument.

b. Recent Case from Houston Court of Appeals

Another significant minority owner case from the Houston Court of Appeals did not involve a review of lengthy jury trials like in *Cardiac Perfusion* and *Argo Data*, but it presented similar factual claims with slightly different legal issues.

Devon Energy. In March 2012, the Houston Court of Appeals imposed a formal fiduciary duty on a sole majority member (and sole manager) of a closely-held oil and gas company in the context of a redemption of shares owned by a minority member. *See Allen v. Devon Energy Holdings, LLC*, 367 S.W.3d 355 (Tex. App.—Houston [1st Dist.] 2012, pet. granted, judgm't vacated w.r.m.). The decision in *Devon Energy* provides important guidance for majority (or controlling) owners when providing information to minority members as part of a "buyout" or purchase of their ownership interest. The crux of the *Devon Energy* case concerned fiduciary duties in a Texas LLC, however, both the trial and appeals court dismissed the oppression claim by noting: "[the] conduct alleged . . . is not the typical wrongdoing in shareholder oppression cases: [the plaintiff] was not a terminated employee; [the minority member] was not denied access to company books or records; and there was no allegation that [the controlling member] wrongfully withheld dividends, wasted corporate funds, paid himself excessive compensation, or locked [the minority member] out of the corporate offices." Given the absence of those facts (similar to *Cardiac Perfusion* and *Argo Data* above), the court in *Devon Energy* focused on whether a majority member might owe fiduciary duties in the context of a redemption or sale.

The dispute in *Devon Energy* arose when the majority member offered to purchase the minority shareholders' stock at $1.13 million per 1% ownership interest. This offer came in November 2003 and the majority member provided a valuation and certain representations to the minority members (*i.e.* future projects for the oil company would be "non-economic" and that he would spend less time with the company). The deal did not close until eight months later in June 2004 where the minority member received $8 million for the entirety of his ownership interest. But two years later, the company sold for over $1 billion dollars and the minority member's stock would have been worth $160 million.

The LLC's minority member filed suit alleging, among other things, that representations made in the November 2003 letter were fraudulent and that the majority had a fiduciary duty to disclose material changes (*i.e.* significant technological advances and lease purchases) that occurred in the eight months between the "offer" and the ultimate "redemption." The *Devon Energy* court addressed other issues, but agreed with the minority member that the November 2003 representations could support a fraudulent inducement claim **and** that the majority

shareholder owed a specific fiduciary duty to the minority shareholder (in the context of the redemption). In late 2012, with a petition for review pending in the Texas Supreme Court, the parties settled the lawsuit and the Houston Court of Appeals' opinion continues to provide guidance on fiduciary duties in a closely-held company in Texas.

6. Review of Majority Shareholder Contentions

Contention No. 1: Texas law does not permit trial courts to exercise any equitable remedies for oppression other than ordering liquidation or the appointment of a receiver.

Fact Check: This contention was squarely rejected in *Rupe,* which pointed to the plain language of the statute requiring a trial court to consider whether "all other available legal and equitable remedies . . . are inadequate." *Id.* at § 11.404(b)(3). The statute clearly authorizes trial court to impose and apply equitable remedies short of liquidation or receivership.

Contention No. 2: Texas law is so vague that courts must enact new standards to define what constitutes acceptable conduct by majority owners.

Fact Check: This contention is an "eye" of the beholder argument making it difficult to refute or support. Section 11.404 does not define oppression or prescribe specific equitable remedies that courts should apply. Yet, Texas statutes do not define "negligence" and both courts and juries readily grasp the reasonable man standard. In *Rupe,* the majority owner claimed that it would be subject to securities law violation claims if it met with a potential third party buyer of the interest held by the minority investor, and on appeal seeks a more stringent application of the business judgment. The *Rupe* court deal with this issue in thoughtful terms: "As discussed below, there are several means by which the corporation can protect itself from litigation short of a flat refusal to meet with potential buyers . . . balancing the minority shareholder's general reasonable expectations against the corporation's need to exercise business judgment to these facts, we cannot conclude the corporation's desire to avoid any possibility of litigation outweighed Ann's general reasonable expectation of marketing the Stock. Bottom line: the Supreme Court may feel compelled to add more definition to the claim for shareholder oppression, but majority owners have not shown that there is a compelling need for it.

Contention No. 3: Minority investors who sign Buy-Sell Agreements are bound by the terms of those agreements regardless of any later oppressive conduct by majority owners.

Fact Check: This contention is the "tails I win, heads you lose" approach to application of the contract at issue. The majority owners are seeking to leave the minority with a right but no remedy, which is the antithesis of a court acting with equity and is therefore disfavored by Texas law. *See*, *e.g.*, *BankOne v. Stewart*, 967 S.W.2d 419, 455 (Tex. App.—Houston [14th Dist.] 1998, pet. denied); *Conn v. Hagan*, 55 S.W. 323, 325 (Tex. 1900). A majority owner cannot harp on sanctity of contract if it engages in conduct after the contract is entered into that utterly destroys the basis of the bargain on which the contract was made. Equity will and should provide a remedy in those circumstances.

Contention No. 4: Even if oppression is found, the remedy must be so narrowly tailored that it rarely, if ever, will authorize a buyout.

Fact Check: This contention by majority owners has been described as the "punishment must fit the crime" in applying the equitable remedy. In practical effect, however, this approach disregards equity. Under this scenario, whenever majority owners are found to have misappropriated company funds for their personal use, grossly overpaid themselves, and issued disproportionate dividends to themselves, the only remedy is to return the funds to the company and thereby return them to their own control. This is not a remedy, it is a license to engage in self-dealing. This approach, however, was effectively sanctioned by the *Argo Data* court, which held that the minority shareholder was not harmed when the majority owner was found to have misused company funds, but returned them to the company long after the lawsuit was filed.

D. EXAMPLES OF OPPRESSIVE CONDUCT

One classic example of an oppression claim by the majority shareholder is the "freeze-out" or "squeeze out" scheme. A freeze out describes a pattern of behavior by the majority shareholder that is characterized by terminating the minority shareholder's employment without cause, removing the minority shareholder from the board or from all aspects of management, refusing to provide financial information to the minority, and refusing to declare dividends – all of which culminates in an offer from the majority shareholder to buy out the minority shareholder at an unfairly low price. Under this scheme, the majority shareholder freezes the minority owner out of the business and leaves no tangible financial benefit for his/her ownership interest.

To establish a claim for oppression, the minority shareholder typically will prove that the majority shareholder engaged in actions of the types listed below, which is not an exhaustive list:

- Terminating the minority shareholder's employment without cause;
- Removing the minority shareholder from the board of directors;
- Removing the minority shareholder from management;
- Refusing to declare dividends when the company is profitable;
- Denying the minority shareholder access to information,
- Siphoning off earnings to the majority shareholder through *de facto* dividends or excessive compensation;
- Entering into favorable contracts with affiliates of the majority shareholder;
- Engaging in recapitalizations or mergers designed to dilute or eliminate the minority shareholder's interest;
- Usurping corporate opportunities;
- Using corporate assets for personal benefit; and/or
- Making loans to family members.

Not every example of the conduct listed above rises to the level of minority shareholder oppression. For example, terminating the employment of a minority shareholder who is also an employee at-will does not automatically translate into a valid oppression claim. The threshold question of whether minority shareholder oppression has taken place is generally decided by the court after the jury determines that all or some of these acts, or related oppressive conduct, took

place. The *Davis* court held that "[a]lthough whether certain acts were performed is a question of fact, the determination of whether these acts constitute oppressive conduct is usually a question of law for the court."[10]

Similarly, the First District Court of Appeals in Houston – one decade after its decision in *Davis* – placed limitations on shareholder oppression claims in *Willis v. Bydalek*.[11] In *Willis*, the corporation operated a nightclub that had never earned a profit. Even though the majority shareholder removed the plaintiff from management, the court in *Willis* did not find that there was sufficient evidence to support a finding of oppression—despite the jury's finding of a wrongful lock-out and that majority had not misused corporate funds. Further, the jury did not find that the majority had suppressed dividends because the company was never profitable and dividends were never distributed to any shareholders – either minority or majority.[12]

The court declined to view these acts as oppressive, and determined that the firing of the minority investor was not oppression, because he was an at-will employee without an employment contract.[13] The *Willis* decision set some boundaries on the shareholder oppression claim recognized in *Davis*, and stressed that "[c]ourts must exercise caution in determining what shows oppressive conduct."[14]

E. APPLICATION OF TEXAS BUSINESS ORGANIZATIONS CODE TO LIMITED PARTNERSHIP AND LIMITED LIABILITY COMPANY OPPRESSION CLAIMS

Before the effective date of the Texas Business Organizations Code,[15] limited partners facing oppression had to look to Section 8.02 of the Texas Revised Limited Partnership Act, and LLC members in a similar situation had to look to Article 2.02 of the Texas Limited Liability Act. Now both can look to the same statute – Section 11.314 of the Texas Business Organizations Code.

Section 11.314 is titled "Involuntary Winding Up and Termination of Partnership or Limited Liability Company" and provides a remedy similar to those in the former TBCA, upon which *Davis* was, in part, based. Section 11.314 allows for the judicial winding up and termination of a limited partnership upon application by a partner or member if the following standards are met:

> (1) a partner in the partnership if the court determines that: (A) the economic purpose of the partnership is likely to be unreasonably frustrated or (B)

[10] 754 S.W.2d at 380.

[11] 997 S.W.2d 798 (Tex. App.—Houston [1st Dist.] 1999, pet. denied).

[12] *Id.* at 802.

[13] *Id.*

[14] *Id.* at 801 (citing *McCauley v. Tom McCauley & Son, Inc.*, 724 P.2d 232, 237 (N.M. 1986)).

[15] The effective date of the Business Organizations Code is September 1, 2009.

another partner has engaged in conduct relating to the partnership's business that makes it not reasonably practicable to carry on the business in partnership with that partner; or

(2) an owner of the partnership or limited liability company if the court determines that it is not reasonably practicable to carry on the entity's business in conformity with its governing documents.

The theory behind the limited partnership portion of this provision – that a court can dissolve a partnership when relations between the partners renders it impractical for the partnership to conduct business – was applied by an Illinois Appellate Court to compel dissolution of a partnership.[16] In *Susman v. Venture*, the general partners had a dispute with Susman, a limited partner, over the sale of the partnership assets. The general partners later removed Susman's name from the tax records and refused to provide him with any information. These acts were considered sufficient to justify judicial dissolution as a remedy for the aggrieved minority.

While the LLC portion of Section 11.314 has yet to be tested in Texas, it seems safe to predict that, upon proof of sufficient, valid evidence, the court would order liquidation. The members of an LLC, therefore, would likely be entitled to the same remedies as a minority shareholder upon a showing that the majority, controlling members engaged in oppressive conduct.

F. APPLICATION OF THE BUSINESS JUDGMENT RULE – AS APPROPRIATE

The "less harsh" non-dissolution remedies set forth in *Davis* are equitable in nature, and therefore, they are not prescribed by statute. Before *Davis*, however, Texas courts had been reluctant to issue rulings that impacted the relationships among shareholders or partners and the entities in which they had invested. Courts gave great deference to company officers and directors under the "business judgment rule."[17] The long-standing existence of the business judgment rule led courts to adopt a hands-off approach to the business conduct of officers and directors under the common law rule that they "shall not be held liable for an honest mistake of judgment if he [they] acted with due care, in good faith, and in furtherance of a rational business purpose."[18]

While *Davis* did not seek to overturn the business judgment rule, the Texas minority shareholder oppression doctrine contains elements that conflict with the rule to some extent. In considering claims by minority shareholders alleging oppression, Texas courts have begun to scrutinize with less deference the actions of majority owners to determine whether they engaged in "burdensome, harsh, and wrongful conduct"[19] and to assess whether the majority owners'

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[16] *Susman v. Venture*, 114 Ill. App. 3d 668, 675 (Ill. App. Ct. 1982).

[17] *Cates v. Sparkman,* 11 S.W. 846, 849 (Tex. 1889).

[18] *FDIC v. Wheat*, 970 F.2d 124, 130-31 (5th Cir. 1992).

[19] *Davis v. Sheerin*, 754 S.W.2d 375, 377-80 (Tex. App.—Houston [1st Dist.] 1988, writ denied).

actions have thwarted the "reasonable expectations"[20] of the minority shareholders. The Fifth Circuit Court of Appeals, in *Hollis v. Hill,*[21] closely examined the application of the business judgment rule in a case where a controlling shareholder was clearly oppressing a frozen-out minority. The court stated that:

> [i]n the context of a closely held corporation, many classic business judgment decisions can also have a substantial and adverse affect on the 'minority's' interest as shareholder. Close corporations present unique opportunities for abuse because the expectations of shareholders in closely held corporations are usually different from those of shareholders in public corporations.[22]

The *Hollis* court affirmed the lower court's decision that required a buy-out of the minority's shares, based upon a finding of breach of fiduciary duty and oppressive conduct by the majority.

Interestingly, in response to *Hollis*, in the *Rupe* case, the Dallas appellate court quoted from *Hollis*, but then hearkened back to *Davis v. Sheerin,* and stated as follows:

> In deciding whether conduct rises to the level of oppression, courts must exercise caution, balancing the minority shareholder's reasonable expectations against the corporation's need to exercise its business judgment and run its business efficiently. *See Willis*, 997 S.W.2d at 801 (recognizing that "a corporation's officers and directors are still afforded a rather broad latitude in conducting corporate affairs"). However, as the *Davis* court observed, "Courts take an especially broad view of the application of oppressive conduct to a closely[ ]held corporation, where oppression may more easily be found." *Davis*, 754 S.W.2d at 381.

Id.

G. CLAIM FOR BREACH OF FIDUCIARY DUTIES

Minority investors in closely held companies have another avenue available to challenge the actions of majority/controlling owners. To the extent the majority shareholder or the general partner breaches his fiduciary duties, those acts give rise to a separate tort claim. At issue is whether a claim for breach of fiduciary duty can be brought as a direct action by the minority shareholder or limited partner, or whether this claim must be brought as a derivative action by the investor on behalf of (and in the name of) the entity.

The longstanding general rule in Texas is that corporate officers and directors owe fiduciary duties solely to the entity itself, not to its individual shareholders.[23] Shareholders were

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[20] *Id.*

[21] *Hollis v. Hill*, 232 F.3d 460 (5th Cir. 2000).

[22] *Id.* at 467.

[23] *See Hoggett v. Brown*, 971 S.W.2d 472, 488 (Tex. App.—Houston [14th Dist.] 1997, pet. denied).

therefore without standing to enforce those duties, except through the vehicle of a derivative lawsuit that was filed on behalf of the corporation.[24]

Closely held companies present a different scenario, however, as borne out by cases that focus on this corporate setting. Although the cases repeatedly affirm that a majority shareholder does not owe a fiduciary duty to other shareholders as a matter of law, a number of Texas cases have held that a fiduciary duty may arise in the closely held company context in which the "shareholders operate more as partners than in strict compliance with the corporate form."[25] When courts hold this duty runs directly from the majority shareholder to the minority shareholders, they allow the breach of fiduciary duty claim to be asserted by the minority shareholder in a direct action.[26]

Private, closely held companies can constitute an exception to the foregoing general rule, and when courts hold that majority owners owe fiduciary duties directly to the minority shareholders, the breach of those duties give rise to a judicial finding of oppression. In *Duncan v. Lichtenberger*,[27] the Fort Worth Court of Appeals awarded damages to two minority shareholders who had never received compensation as officers or dividends as shareholders. The court noted that "[t]he breach of a fiduciary duty is the type of wrong for which the courts of this State will afford a remedy."[28]

Dating back over 50 years, the Texas Supreme Court held that the failure of a majority shareholder to declare dividends constituted fraud and an abuse of his controlling position.[29] In *Patton v. Nicholas*, the Court affirmed the jury's verdict, observing that "the malicious suppression of dividends is a wrong akin to a breach of trust, for which the courts will afford a remedy."[30] The *Patton* court issued an injunction requiring the corporation to pay a reasonable dividend "at the earliest practical date," as well as in future years.[31]

In the partnership context, the Tyler Court of Appeals upheld a claim of oppression based upon a breach of fiduciary duties, even though the plaintiff was not a partner (and therefore lacked standing to assert a claim for breach of fiduciary duties).[32] The *Cleaver* court noted, however, that fiduciary duties would have to be weighed for a court to properly assess the policy

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[24] *Faour v. Faour*, 789 S.W.2d 620, 621-22 (Tex. App.—Texarkana 1990, writ denied).

[25] *Willis v. Donnelly*, 118 S.W.3d 10, 31-32 (Tex. App.—Houston [14th Dist.] 2003), *rev'd on other grounds*, 199 S.W.3d 262 (Tex. 2006).

[26] *Id.* at 34-35; *Joseph v. Koshy*, No. 01-98-01432-CV, 2000 WL 124685, at *4 (Tex. App.—Houston [1st Dist.] Feb. 3, 2000, no pet).

[27] 671 S.W.2d 948 (Tex. App.—Fort Worth 1984, writ ref'd n.r.e.).

[28] *Id.* at 950.

[29] *Patton v. Nicholas*, 279 S.W.2d 848 (Tex. 1955).

[30] *Id.* at 854.

[31] *Id.* at 849.

[32] *Cleaver v. Cleaver*, 935 S.W.2d 491 (Tex. App.—Tyler 1996, no writ).

of the managing partner that was subject to challenge, *i.e.*, retaining earnings rather than declaring distributions.[33]

H. REVIEW OF SHAREHOLDER DERIVATIVE CLAIMS

In light of the frequent holdings by Texas cases that majority shareholders owe fiduciary duties to the company rather than to other shareholders, claims for breach of fiduciary duty have often been filed as derivative actions for the benefit of the company. Shareholder derivative actions are governed by statute.[34]

The problem for majority shareholders in pursuing derivative actions is that they may require adherence to multiple procedural hurdles, including: (1) the shareholder must have had an ownership interest in the company at the time of the alleged wrong and at the time the suit was filed, (2) the shareholder must be able to show that he can fairly and adequately represent the company in the derivative action, and (3) the shareholder must make a demand on the company to take action on the claim and have the company refuse to do so before the shareholder files a lawsuit.[35] The shareholder's failure to comply with these procedural hurdles can result in a dismissal of the derivative lawsuit.

Importantly, under the Texas Business Organizations Code, the majority of the procedural requirements that exist for shareholders in a derivative action are eliminated for a closely held company.[36] Further, the statute also provides that "[i]f justice requires . . . a derivative proceeding brought by a shareholder of a closely held corporation may be treated by a court as a direct action brought by the shareholder for his own benefit."[37]

Based on this statute, a minority shareholder in a closely held company can file the lawsuit on his own behalf directly against the majority shareholder for breaches of fiduciary duty without having to comply with the procedural requirements that accompany derivative actions. In these derivative actions, however, the minority shareholder still needs to name the company as a nominal defendant and the action must still proceed in the name of the company, but the court has the authority to permit the recovery in the action to go directly to the minority shareholder.

Whether or not a limited partner in Texas has a direct action against the general partner for breaches of fiduciary duties when the company has been harmed rather than the limited partner directly remains an open question. Some states, such as Florida, apply a "separate and distinct" injury test to corporations and partnerships. Under this test, to pursue a direct action, the minority owner must establish that he suffered an injury separate and distinct from the other owners. Limited partners are not directly injured when they are damaged only to the extent of

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[33] *Id.* at 495-96.

[34] *See* TEX. BUS. ORG. CODE § 21.551, et seq.

[35] *See* TEX. BUS. ORG. CODE § 21.552-553 .

[36] *Id.* § 21.563.

[37] *Id.*

their proportionate interest in the partnership.[38] Therefore, a limited partner faces a risk of dismissal in bringing a claim against the general partner for breach of fiduciary duties if the injuries were sustained by the limited partnership itself rather than by the limited partner individually.

One key advantage that does exist for a shareholder who files a derivative action under Texas law is the plaintiff's right under the statute to recover his legal fees and litigation costs "if the court finds that the proceeding brought by the shareholder has resulted in a substantial benefit to the domestic or foreign corporation."[39]

I. REMEDIES FOR MINORITY SHAREHOLDER OPPRESSION

The harshest remedy for shareholder oppression is liquidation of the corporation as authorized by Texas statute. *See* TEX. BUS. ORG. CODE § 11.404 (Vernon's 2011). Texas courts, however, have taken heed of the legislature's admonition that before liquidating a company or appointing a receiver to liquidate the business, trial courts must consider whether "all other available legal and equitable remedies . . . are inadequate." *Id.* at § 11.404(b)(3). As discussed above, *Davis v. Sheerin* and numerous later opinions have reasoned that they are empowered to impose equitable remedies to provide an outcome less drastic than dissolution or receivership.[40] Courts have discretion to tailor the equitable remedy to the fit the specific facts.[41]

Given the harshness of the dissolution/receivership remedy, in particular, the more common remedy for shareholder oppression is a court-ordered buyout of the minority shareholder's interest by the majority shareholder(s).[42] Texas courts order buyouts under their general equitable powers as a remedy less harsh than dissolution, but courts also have the power to impose equitable remedies that include reinstatement of the minority shareholder to the board or require the mandatory issuance of dividends.

J. ISSUES REGARDING THE BUYOUT REMEDY

One of the most critical issues that arises in a case presenting a claim for minority shareholder oppression is in which a court-ordered buyout is requested is the standard of value to be applied to the minority ownership interest, *i.e.,* should the shares be valued at "fair value" or

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[38] *See Litman v. Prudential-Bache Properties, Inc.*, 611 A.2d 12, 16 (Del. Ch. 1992).

[39] *See* TEX. BUS. ORG. CODE § 21.561; *see also O'Neill v. Church's Fried Chicken, Inc.*, 910 F.2d 263, 267 (5th Cir. 1990); *Basralian v. Hatfield*, No. 07-96-0326-CV, 1998 WL 40415, at *1 (Tex. App.—Amarillo Feb. 2, 1998, no pet.); *Bayoud v. Bayoud*, 797 S.W.2d 304, 307 (Tex. App.—Dallas 1990, writ denied).

[40] *Davis*, 754 S.W.2d at 380; *Duncan*, 671 S.W.2d at 953; *Redmon*, 202 S.W.3d at 235; *Gibney v. Culver*, No. 13-06-112-CV, 2008 WL 1822767, at *17 (Tex. App.—Corpus Christi Apr. 24, 2008, pet. denied.).

[41] *Davis*, 754 S.W.2d at 380.

[42] *Lund v. Krass Snow & Schmutter, P.C.*, 879 N.Y.S.2d 127, 128 (N.Y.A.D. 1 Dept. 2009) (affirming trial court judgment ordering buyout of minority shareholder Court of appeals affirmed judgment awarding plaintiff a buyout plus post-judgment interest).

"fair market value."[43] The decision on valuation standards is ultimately one for the trial court, because the issue of whether the majority shareholders actually oppressed the minority owner is a question of law, which the trial court will decide based on factual disputes resolved by the jury. Further, once the trial court concludes that the majority has engaged in oppressive conduct, the trial court has considerable discretion to apply an appropriate equitable remedy. The equitable relief the trial court decides to award to the minority shareholder may then be overturned on appeal only for an abuse of discretion.

After oppression has been found, the valuation battle between the parties is the extent to which the court will apply discounts to the valuation of the minority shareholder's stock. These discounts are based on the lack of marketability of the stock in a private company and that lack of control that the minority is able to exert in the operations of the business. The fundamental distinction is between "Fair Value" or "Enterprise Value" where no discounts apply to the minority interest or "Fair Market Value" where these discounts apply in full force. The fair market value of the minority interest is "the price at which property would change hands between a willing buyer and a willing seller when neither party is under an obligation to act."[44] A fair market value will usually substantially discount the minority interest in a close corporation for lack of marketability and lack of control.[45]

Before the Dallas Court of Appeals' *Rupe* opinion in March 2011, many courts declined to include a lack of control discount in the context of a court-ordered buyout, because it would "deprive minority shareholders of their proportionate interest in a going concern,"[46] and would undermine the remedial goal of protecting "minority shareholders from being forced to sell at unfair values imposed by those dominating the corporation while allowing the majority to proceed with its desired corporate action."[47] The lack of marketability discount, however, has been viewed as more debatable and courts would consider adjusting the valuation to reflect the fact that shares in a close corporation lack liquidity.[48] Thus, majority shareholders will argue strenuously to apply discounts and use the fair market value standard to determine the value of the minority shareholder's interest. By contrast, minority shareholders seek buyouts of their interest at fair value, a valuation with no discounts in which the minority shareholder receives a full share of the entire enterprise value based on the percentage of ownership.[49]

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[43] *See generally* Douglas K. Moll, *Shareholder Oppression and "Fair Value": Of Discounts, Dates, and Dastardly Deeds in the Close Corporation*, 54 DUKE L.J. 293 (Nov. 2004); *Balsamides v. Protameen Chems., Inc.*, 734 A.2d 721, 734-35 (N.J. 1999).

[44] *Pueblo Bancorporation v. Lindoe, Inc.*, 63 P.3d 353, 362 (Colo. 2003).

[45] *See* DOUGLAS K. MOLL & ROBERT A. RAGAZZO, THE LAW OF CLOSELY HELD CORPORATIONS § 8.02[B][3] (2009).

[46] *In re Friedman*, 661 N.E.2d 972, 976-77 (N.Y. 1995).

[47] *Id.*; *see also Balsamides*, 734 A.2d at 734-35.

[48] *Pueblo Bancorporation*, 63 P.3d at 357 n.2; *Advanced Commc'n Design, Inc. v. Follett*, 615 N.W.2d 285, 291 (Minn. 2000).

[49] *See generally* Douglas K. Moll, *Shareholder Oppression and "Fair Value": Of Discounts, Dates, and Dastardly Deeds in the Close Corporation*, 54 DUKE L.J. 293 (Nov. 2004).

The *Rupe* decision was the first reported Texas case to require fair market discounts to be applied to the valuation of the minority shareholder's stock interest. While *Rupe* upheld the trial court's finding that the minority shareholder had been oppressed by the majority shareholders, the court overturned an award of more than $7 million – as determined by the jury – for the minority shareholder's stock interest. On remand, *Rupe* required the jury, on retrial, to apply discounts for lack of control and lack of marketability in valuing the minority shareholder's stock interest in the company. As noted earlier, *Rupe* has now been argued to the Texas Supreme Court with a decision expected later this year or in the first part of 2014.

In *Rupe,* the appellate court held that minority (or fair market value) discounts must be applied by the jury when the minority stockholder complains that the majority shareholders blocked the sales of the minority's stock to a third party. The *Rupe* court held as follows:

> We conclude that a buyout is an available remedy for shareholder oppression under Texas law and that, under the circumstances, appellants' conduct in refusing to meet—or allow RIC management to meet—with prospective purchasers constituted oppressive conduct as to Ann. We also conclude that the trial court did not abuse its discretion in ordering appellants to cause RIC to buy the Stock as an equitable remedy for this oppressive conduct. To this extent, we overrule appellants' first issue. As a result, we need not consider whether the trial court erred in concluding that appellants' other conduct—standing alone or in conjunction with their conduct as a whole—was oppressive.[50]

The appellate court in *Rupe* also favorably cited commentary by Professor Doug Moll, who has written extensively regarding minority shareholder oppression claims.[51] Prof. Moll, in turn, has expressed the view that trial courts should adopt a flexible approach in construing minority shareholder oppression claims and fashioning remedies for oppressed minority shareholders.[52]

As an alternative to a court-imposed equitable buyout award, some states offer the majority shareholder the option to buy the minority owner's shares. For example, California permits the corporation or the shareholder with more than 50% to avoid dissolution by buying the dissenter's stock for "fair value."[53] If the parties cannot agree on fair value, the court can order evidence submitted to a panel of three disinterested appraisers selected by the Court. The Court then enters a decree based on its review of and affirmation of the valuation of the appraisers. The decree gives the corporation, or, if it declines, the majority shareholder, the right to avoid dissolution by purchasing the minority's shares for the price stated in the decree.[54]

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[50] 339 S.W.3d at 299.

[51] *Id.* at 291 nn. 24-25, 27-29, 299 n. 42 (citing Moll publications).

[52] *See*, *e.g.*, Douglas Moll, *Majority Rule Isn't What It Used It Used To Be: Shareholder Oppression In Texas Close Corporations*, 63 TEX. B.J. 434 (2000).

[53] CAL. CORP. CODE § 2000 (West 2010).

[54] *Id.*.

K. OTHER NON-BUYOUT REMEDIES THAT MAY BE AVAILABLE TO MINORITY SHAREHOLDERS

There are many potential remedies other than dissolution and buyouts, although they are the ones that are most commonly discussed. Some states seek to encourage creative judicial resolution of shareholder oppression claims by codifying equitable options. For example, South Carolina's statute includes nine separate equitable options other than a buyout or dissolution.[55] Illinois's statutes identify eleven alternatives.[56] California simply instructs its courts to do equity.[57] In states lacking specific statutory authority, courts have nonetheless picked up the mantle of equitable creativity in addressing shareholder oppression.

The list of potential other remedies for shareholder oppression include at least the following:

- Altering or setting aside an action of the corporation, its shareholders or directors;
- Cancelling a provision in the articles of incorporation or by-laws;
- Ordering payment of dividends;
- Appointing a custodian to manage the business;
- Appointing an individual to be an officer or director, or a provisional officer/director;
- Removing a director or officer from office;
- Ordering an accounting;
- Awarding damages;
- Reinstating the minority as an employee;
- Requiring repayment of sums wrongly siphoned from the corporation;
- Limiting the salary of the majority or defining certain amounts of compensation as a constructive dividend;
- Ordering issued stock to be cancelled or redeemed; and/or
- Permitting the minority to purchase additional share.[58]

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[55] S.C. CODE 33-18-410 (West 2010).

[56] 805 ILL. COMP. STAT. 5/12.56 (West 2010).

[57] CAL. CORP. CODE § 1804 (West 2010) ("After hearing the court may decree a winding up and dissolution of the corporation if cause therefore is shown or, with or without winding up and dissolution, may make such orders and decrees and issue such injunctions in the case as justice and equity require.").

[58] *See, e.g.*, *Brodie v. Jordan*, 857 N.E.2d 1076, 1082 (Mass. 2006) (discussing prospective injunctive relief to allow minority to participate in the business, including reinstatement of employment and/or back pay); *Hirsch v. Cahn Elec. Co.*, 694 So. 2d 636, 643 (La. Ct. App. 1997) (ordering return of $200,000 in excessive compensation and payment of a dividend); *Brenner v. Berkowitz*, 634 A.2d 1019, 1033 (N.J. 1993) (discussing alternatives to dissolution); *Balvik v. Sylvester*, 411 N.W.2d 383, 388-89 (N.D. 1987) (same); *Masinter v. Webco Co.*, 262 S.E.2d 433, 441 & n.12 (W. Va. 1980) (same); *Baker v. Comm. Body Builders, Inc.*, 507 P.2d 387, 395-96 (Or. 1973) (same); *see also* 805 ILL. COMP. STAT. 5/12.56 (West 2010); S.C. CODE 33-18-410 (West 2010); the Model Statutory Close Corporation Supplement (1993).

L. LOOKING AT THE PAST WITH AN EYE TOWARD THE FUTURE

Despite the anecdotal increase in case filings alleging shareholder oppression claims, there is no avalanche of oppression cases that are being tried and even fewer in which the minority owner prevails at trial. There are three cases currently pending in some form before the Supreme Court, but in one of those, the minority shareholder's judgment was overturned by the Dallas Court of Appeals. This is not a rosy picture for minority shareholders under any set of circumstances and concerns by business owners that they are under siege in how they operate their businesses based on uncertain or hostile Texas law smack of the claims by the wealthy 1% discussed at the outset of this article who claim they should be viewed as victims.

With respect to *Rupe, Cardiac Perfusion and Argo Data,* the ball is in the Supreme Court's hands to determine the legal standards that apply going forward to the minority shareholder oppression claim. Business owners, minority investors and counsel await the Court's decision first in *Rupe,* which is expected soon because it was argued to the Court in February 2013. While majority owners may be hopeful that the Court will invalidate the claim for shareholder oppression or eliminate the buyout remedy, but this result seems highly unlikely.

First, as discussed, Section 11.404 of the Texas Business Organizations Code provides an oppression remedy to aggrieved minority shareholders under appropriate circumstances. This statute expressly authorizes Texas trial courts to appoint a receiver, or to order that the company be liquidated when there is a showing of "illegal, oppressive or fraudulent" conduct by the "governing persons" of the business entity. *Id.* § 11.404(a)(1)(C).

Second, another reason to doubt that Supreme Court will give unfettered discretion to majority owners in operating private companies is the strong public perception that corporate leaders of both public and private companies have run amok in past years. This is particularly so in Texas where claims regarding the Stanford *Ponzi* scheme continue to be litigated and the corruption of Enron's senior management has not been forgotten. The distress over misconduct by corporate officers, and the devastating results caused to their companies and shareholders, led to the passage of Sarbanes-Oxley (SOX). SOX has been in place for more than 10 years, but as the Stanford case shows, the corruption factor remains. The Texas Supreme Court will likely be reluctant to abandon a claim that has served Texas reasonably well in the private company context. Moreover, the oppression claim is based on a statute that has not been amended in 50 years and on fiduciary duties that reflect bedrock common law principles.

Third, and finally, a rejection of the oppression doctrine by the Court would jettison more than 25 years of appellate decisions (more than two dozen at this point) consistently validating the claim upheld in *Davis v. Sheerin*. Many astute appellate judges have studied this claim and concluded that shareholder oppression is a claim well-placed in Texas law. We expect the Supreme Court to be unwilling to abandon the precedential value of these numerous appellate decisions. If the Court concludes that the oppression doctrine is ambiguous in its present form, however, the Court may devote its efforts to refining the standards that apply to the rights of minority investors and the corresponding duties of majority owners.