Presented:
2012 SECURITIES REGULATION AND BUSINESS LAW CONFERENCE
February 10, 2012
Dallas, TX

CLAIMS FOR OPPRESSION BY MINORITY SHAREHOLDERS IN PRIVATE COMPANIES UNDER TEXAS AND DELAWARE LAW: A PLAINTIFF'S PERSPECTIVE

Ladd A. Hirsch

James D. Sheppard

Author contact information:
Ladd A. Hirsch
James D. Sheppard
Diamond McCarthy LLP
1201 Elm Street, 34th Floor
Dallas, TX 75270

LHirsch@diamondmccarthy.com
214-389-5323
JSheppard@diamondmccarthy.com
214-389-5347

TABLE OF CONTENTS

TABLE OF AUTHORITIES

A. INTRODUCTION

A favorite Willie Nelson song cautions mothers not to let their babies grow up to be cowboys. If Willie had been asked to offer guidance to mothers of investors in private Texas companies, however, he might have changed his lyrics to, "Mamas don't let your babies grow up to be minority shareholders without a redemption agreement." This version of Willie's song would likely be a dud on country radio, but it is sage advice.

An investor who buys a minority ownership stake in a private Texas company without an exit strategy in place is likely to be "locked in" to (and unable to dispose of) his investment in the business long after he desires to sell. Unless the minority investor obtains a redemption agreement (or some other contractual right to exit the business) at the time he buys his stock, he lacks the right to choose the point at which he can later "monetize" his investment. In most cases, there is no market for a minority shareholder's stock in a private company. Further in the absence of a redemption agreement with the company or other shareholders, the company and the other shareholders have no obligation to buy the minority shareholder's stock for any price. This leaves the minority shareholder with no option to dispose of his shares and hoping for a liquidity event such as a sale of the business, a merger, or an Initial Public Offering (IPO).

This article focuses on conflicts among minority and majority owners of privately-held Texas companies. While litigation is on the rise in this area, the spate of claims by minority shareholders is only now reaching the appellate courts and there are not yet an extensive number of appellate decisions dealing with these issues. As Texas courts start to grapple with claims by minority shareholders, however, they are reexamining the rights and duties of majority owners of private companies.

In this troubled economy, claims and lawsuits by minority shareholders, limited partners and LLC members in private Texas companies appear to be increasing. Although this article does not include a statistical analysis of this perceived trend, the common sense explanation is that a down economy eliminates, or sharply reduces, the prospect for minority owners in private companies to cash out.[1] As a result, many investors/owners in private businesses have become frustrated by the structural and economic inability to monetize their investments. In the wake of this frustration, and after concluding that their rights have been violated by majority owners who abused their control of the business to operate the company in a manner that is hostile to and oppressive of the minority owners, these minority investors are turning to the courts.[2]

[1] The dearth of IPO filings in the early 2000's has not persisted. In late 2004, Barron's reported that this year had been a "tour de force" for new stock issues and that 205 stocks went public during 2004 raising a total of $41 billion. This compares with 73 stocks that went public in 2003 and a peak of 864 that went public during 1996. Among the IPO's of 2004 were Google, Texas Roadhouse restaurants and NavTeq, which was 41% owned by Phillips Electronics. IPO filings were down slightly in 2005 from 2004, but still greatly outpaced the number of offerings in 2003.

[2] For the purposes of this article, the assumption is made that the minority owner does not have a shareholder's agreement or any other contractual right that would force a buyout of his or its interest by the majority owners for the fair value of that interest.

From a plaintiff's perspective, the good news is that all hope is not lost for minority investors who do not obtain a redemption agreement before they invest in a private company in Texas. Texas courts have recognized that minority shareholders in private companies do have "exit rights" if they can establish that they were "oppressed" by the conduct of the majority shareholder(s). In these limited circumstances, minority shareholders may be able to secure a court-ordered remedy that provides them with value for their ownership interest in the company.

B. THE CLOSELY HELD (PRIVATE) CORPORATION

The "minority shareholder oppression" scenario arises uniquely in the context of the private company, including the close corporation. An investor in a large, publicly-held corporation can certainly feel oppressed, *i.e.*, that his investment goals are being thwarted by the management's operation of the company or that management has engaged in "bad acts." The public company investor has a ready exit available, however, because his shares may be readily sold in the open market.[3] As previously noted, a shareholder in a closely held company lacks this option, because typically there is no market for the shares of a private company. Moreover, in many close corporations, a shareholder's agreement includes 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 the company's management and daily operations, while also "freezing out" the minority owner's ability to cash out on or realize other monetary benefits from his or its investment.

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 (Vernon's 2010).

In most cases, the successful functioning of a closely held corporation, LLC or limited partnership depends on the relationship of trust that exists among the owners of the business and the way in which they run the company and share in its financial success. When the majority owners abuse their power and control over the company, trust ends and problems follow.

[3] 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.

C. CLAIM FOR MINORITY SHAREHOLDER OPPRESSION UNDER TEXAS LAW

When minority shareholders in private Texas companies conclude that the controlling, majority shareholders have exploited their power to deny the minority the right to share in the company's financial returns, the minority shareholders may bring a claim for shareholder oppression. The claim for minority shareholder oppression and resulting equitable remedies was judicially recognized by Texas courts more than 20 years ago (and also exists in other jurisdictions), but the contours of the claim continue to develop in case law.[4]

The starting point for the assertion of an oppression claim is found in Texas statutes. In limited circumstances, 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 (Vernon's 2011). This statute 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."

These statutory remedies of court-ordered receiverships and liquidation, however, are often viewed as unduly harsh to the parties, and these draconian remedies are therefore largely disfavored by trial courts. When a private company is able to continue functioning – and particularly when the company is profitable – it is rarely viewed as a company that is ripe for the appointment of a receiver, or appropriate for a court-ordered liquidation. Instead, a court is far more likely to issue a preliminary injunction that will 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.

Due to the limited relief available to oppressed minority shareholders in Texas statutes, case law has developed in Texas to provide additional remedies to minority shareholders who can prove that the majority shareholders have engaged in oppressive conduct. A claim for oppression is based on tort, but there is no single set of definitive actions that constitute oppression. A minority shareholder in Texas can file a lawsuit alleging oppression when the investor can establish facts that meet one of the definitions of oppression below:

(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.[5]

---

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

[5] *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).

The seminal Texas case in this area, *Davis v. Sheerin*,[6] 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) to adopt the doctrine of minority shareholder oppression that authorizes court-ordered equitable remedies. The appellate court in *Davis* 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 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. The appellate court in *Davis* also relied on the Texas Supreme Court's holding in *Patton v. Nicholas*,[7] which was also recently cited with approval by the Dallas Court of Appeals in *Ritchie v. Rupe.*[8] More than 55 years ago, the *Patton* Court upheld the right of a trial court to impose a mandatory dividend when the majority owners wrongfully suppressed the issuance of dividends with the intent to harm the minority shareholder.[9]

The defendants in minority shareholder oppression cases often contend that this claim rests on questionable underpinnings, and it has never been directly considered and upheld by the Texas Supreme Court. Alternatively, defendants will urge Texas trial and appellate courts to apply Delaware law, which is more favorable to majority ownership interests. Although it is true that the Texas Supreme Court has not directly upheld a claim for shareholder oppression, the claim has been a fixture in Texas law for more than 20 years.[10] Since the Houston appellate court issued its seminal decision in *Davis v. Sheerin* in 1988, Texas appellate courts have consistently held that a claim for minority shareholder oppression is a valid, and upon proof, will permit minority shareholders of private companies to obtain relief when they are harmed by a majority owner's abusive exercise of control.

A review of Texas law since *Davis* reflects that more than 25 reported decisions in 11 of the 14 Texas appellate districts that have upheld minority shareholder oppression as a viable cause of action. Most recently, in March 2011, the Dallas Court of Appeals considered the claim for the first time in *Rupe*, and upheld the claim unanimously after extended discussion. The Dallas Court relied on the same out-of-state cases that defense lawyers have often

---

[6] 754 S.W.2d at 382-83. 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.

[7] *Patton v. Nicholas*, 279 S.W.2d 848, 855-57 (Tex. 1955).

[8] 339 S.W.3d 275 (Tex. App.—Dallas 2011, pet. denied) (citing *Patton*) (the "Rupe Decision"). As of January 13, 2012, a motion for rehearing in Rupe remains pending before the Supreme Court of Texas.

[9] *Patton v. Nicholas*, 279 S.W.2d 848, 855-57 (Tex. 1955).

[10] *See, e.g.*, *Davis v. Sheerin*, 754 S.W.2d 375 (Tex. App.—Houston [1st Dist.] 1988, writ denied); *Feldman v. Kim*, No. 14-11-00184, 2012 WL 50623, at *3-5 (Tex. App.—Houston [14th Dist.] Jan. 10, 2012, no pet. h.) (reversing summary judgment in favor of majority shareholders and holding, under *Davis* and *Ritchie*, that defendants failed to show their conduct was "outside the definition" of shareholder oppression where "the defendants acted to squeeze [the minority shareholder] out of [the business venture] by increasing their own share of the returns from a profitable business at [the minority shareholder's] expense").

criticized.[11] To date, defendants' efforts urging Texas appellate courts to apply Delaware law—which is much more onerous to minority shareholders—has gained no traction.

By contrast, no appellate court has ever held that shareholder oppression does not exist under Texas law. In addition, numerous federal courts (applying Texas law) have recognized minority shareholder oppression as a valid, individual cause of action.[12] Texas courts recognize that shareholder oppression is an individual (rather than derivative) claim that may be asserted by the oppressed minority shareholder against the majority shareholder—and is not a claim made by or against the corporation itself.[13]

D. CLAIM FOR MINORITY SHAREHOLDER OPPRESSION UNDER DELAWARE LAW

1. INTRODUCTION

Delaware is often portrayed as a "safe haven" by defense counsel who urge their majority shareholder clients to form private companies there under the view that, under Delaware law, they are immune from any oppression claims.[14] While a fair reading of Delaware law indicates that courts there are less receptive—relative to Texas courts—to minority shareholder oppression claims, the contention by some defense counsel that minority shareholder oppression is not a valid claim under Delaware law overstates the case. This defense argument relies on dicta from just one Delaware case, *Nixon v. Blackwell*,[15] that approved a "liquidity disparity" between controlling and minority shareholders, but did not consider—nor expressly reject—the

[11] *See Rupe*, 339 S.W.3d at 289 (citing *Gimpel v. Bolstein*, 477 N.Y.S.2d 1014 (N.Y. Sup. 1984).

[12] *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).

[13] *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 plaintiffs 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).

[14] Under the law of the forum doctrine, oppression claims by minority shareholders against majority shareholders will be governed by the state of incorporation.

[15] *Nixon v. Blackwell*, 626 A.2d 1366 (Del. 1993).

"reasonable expectations" standard announced just one year earlier in *Litle v. Waters.*[16] Indeed, since the *Nixon* Court issued its decision in 1993, Delaware courts (and federal courts applying Delaware law) have continued to recognize *Litle* as the defining legal standard when analyzing a minority shareholder's claim for oppressive conduct by the controlling majority shareholders.[17]

In light of *Nixon* and its progeny, however, minority shareholders who invest in Delaware companies are well-advised to secure a shareholders agreement at the time of their investment. A shareholders agreement provides minority shareholders with, among other things, a critical right of redemption for the fair (undiscounted) value of their stock in the event they become subject to oppressive conduct by the majority shareholders.

In Delaware, minority shareholders confront two issues in bringing their claims: (1) the Delaware courts' resistance—under certain circumstances—to accept the cause of action for shareholder oppression; and (2) two different standards of review (and shifting burdens of proof) for a breach of fiduciary duty claim against the controlling shareholder(s). The case law is not extensive, but Delaware courts first recognized a claim for shareholder oppression in 1991, and no Delaware court has since rejected this cause of action. Most minority shareholder plaintiffs allege claims for breach of fiduciary duties in efforts to secure a review of their claims under the "entire fairness" doctrine, which requires majority shareholders to demonstrate the fairness—in terms of price and dealing—of their conduct rather than under the "business judgment rule" which gives the majority shareholders far more latitude in their decision-making.

2. <u>Fractured Foundation Of Minority Shareholder Claims in Delaware</u>

Starting in the early 1990's, Delaware courts have adopted a varied stance toward the existence of a cause of action for minority shareholder oppression. One court decision in 1992 held that this cause of action existed; but a 1993 court hinted it might not, and the law remains unsettled two decades later. The three Delaware cases reviewed below demonstrate the split in legal authorities that exists in Delaware applicable to oppression claims by minority shareholders.

---

[16] *See* CA No. 12155, 1992 WL 25758, at *6 (Del. Ch. Feb. 11, 1992) (citing *Gimpel v. Bolstein*, 477 N.Y.S.2d 1014, 1018-19 (N.Y. Sup. 1984)).

[17] *See, e.g., Orloff v. Shulman*, No. Civ. 852-N, 2005 WL 3272355, at *8 n.52 (explaining that *Litle* is "[t]he only Delaware case that squarely addressed the issue of [shareholder] oppression"); *In re Marriott Hotel Props. II Ltd. P'ship*, No. Civ. 14961, 2000 WL 128875, at *13 (Del. Ch. Jan. 24, 2000) (recognizing application of *Litle* to minority shareholder's claim that "defendant had frozen dividends in order to effectuate an oppressive squeeze-out"); *In re Skyport Global Commc'ns, Inc.*, No. 10-03150, 2011 WL 111427, at *35 (Bankr. S.D. Tex. Jan. 13, 2011) (applying Delaware law) (citing *Litle* and stating that "Delaware courts ***have*** recognized oppression as a cause of action") (emphasis in original); *Reserve Solutions Inc. v. Vernaglia*, 438 F.Supp.2d 280, 290 (S.D.N.Y. 2006) (applying Delaware law) (approving *Litle* and denying motion to dismiss shareholder oppression claim); *Minor v. Albright*, No. 01-C-4493, 2001 WL 1516729, at *2-3 (N.D. Ill. Nov. 28, 2001) (applying Delaware law) (recognizing definition of oppressive shareholder conduct from *Litle* and denying motion to dismiss plaintiff's claims that majority shareholder "attempted to freeze them out").

a. *Litle v. Waters*: Minority Shareholder Prevails On Claims For Breach Of Fiduciary Duty and Shareholder Oppression.

Initially, in *Litle v. Waters,* the Delaware Court of Chancery considered a minority shareholder plaintiff's two claims for breach of fiduciary duty and shareholder oppression, both arising from the majority shareholders' refusal to declare dividends despite the company's profitable status—which created a significant tax burden on the plaintiff.[18] For the breach of fiduciary duty claim, the *Litle* court noted "an important issue" was that both controlling directors were "interested directors" which triggered a judicial review under the more stringent "entire fairness" standard. Under this standard, "the burden shifts to the defendants to demonstrate that the decision to not declare dividends and to repay the company's debt to [a majority shareholder] was intrinsically fair."[19] By contrast, the majority shareholders sought review under the business judgment rule that defers to the business decisions of the controlling shareholders.[20] The *Litle* court refused to apply the deferential business judgment rule, and declined to accept the defendants' argument that the declaration of a dividend was solely within the majority shareholders' business discretion.[21]

The second claim in *Litle* was for shareholder oppression where the plaintiff alleged that the director defendants' refusal to declare dividends (causing the minority shareholder to bear a high tax burden) constituted "a gross and oppressive abuse of discretion."[22] The *Litle* court held that the minority shareholder's claim "includes allegations sufficient to state a claim for oppression,"[23] and also reasoned that the failure to pay dividends "can be especially devastating [to the minority shareholder]."[24] After noting that few Delaware cases had addressed oppressive shareholder conduct, the *Litle* Court applied standards from a New York case defining oppression as: (1) "a violation of the 'reasonable expectations' of the minority;" and (2) "burdensome, harsh and wrongful conduct."[25] The *Litle* court then explained that neither shareholder expected their stock to become "a liability" (caused by a tax burden when no dividends were paid) and the plaintiff's claims set forth "a classic squeeze out situation" that constituted shareholder oppression.[26]

---

[18] *See* 1992 WL 25758, at *3, *6.

[19] *Id.* at *5 (citing *Weinberger v. Uop,* 457 A.2d 701, 703 (Del. 1983)).

[20] *Id.* at *4 (noting that defendants "imply that the business judgment standard applies").

[21] *Id.* at *3.

[22] *Id.* at *6.

[23] *Id.* at *7 (noting that minority shareholder plaintiff alleged in complaint that "the company was rich with cash and that the only reason that the company did not make dividends was to aid [the majority shareholder] to buy [the minority shareholder] out for less than fair value").

[24] *Id.* at *9.

[25] *Id.* at * 7-8 (citing *Gimpel v. Bolstein*, 477 N.Y.S.2d 1014, 1018-19 (N.Y. Sup. 1984); *see also Orloff v. Shulman*, No. Civ. 852-N, 2005 WL 3272355, at *8 n.52 (Del. Nov. 23, 2005) (explaining that *Litle* is "[t]he only Delaware case that squarely addressed the issue of [shareholder] oppression").

[26] *Id.* at *8.

b. *Nixon v. Blackwell*: Delaware Supreme Court's Limited Holding Related to Breach of Fiduciary Duty

Just 16 months after *Litle*, the Delaware Supreme Court pivoted toward a contract-focused approach to the rights of minority shareholder in *Nixon v. Blackwell*.[27] In *Nixon*, the Supreme Court considered the narrow issue of a minority shareholder's claim for breach of fiduciary duty where, importantly, the plaintiff did not plead a separate claim for shareholder oppression.[28] The Delaware Supreme Court took a less protective stance toward the minority shareholders in discussing the fiduciary duties of majority shareholders, and suggested that all protections or rights of shareholders should be defined by contract, not through judicial remedies.[29]

In *Nixon*, the minority shareholders alleged that the majority shareholder directors had breached their fiduciary duties by creating a "liquidity disparity" in two different ways by: (1) creating an Employee Stock Ownership Plan ("ESOP") that allowed only certain employees the ability liquidate their stock; and (2) funding a "Key Man" insurance plan in which proceeds of the policy would be pay off corporate debts, but also trigger the purchase of a certain percentage of stock from the deceased (and remaining controlling) stockholders.[30] Simply put, the controlling shareholders enabled employees (through retirement) and directors (through the insurance policy) the ability to liquidate their shares, but did not provide minority shareholder plaintiffs with a similar right.

One similarity to *Litle* was the initial determination—for purpose of fiduciary duty analysis—that the majority shareholders in *Nixon* were "on both sides of the transaction" which caused the burden to shift to the majority shareholder defendants to show the "entire fairness" of the challenged transactions.[31] While the entire fairness standard generally requires a two-pronged inquiry into both the "fair price" and "fair dealing" of the challenged transaction,[32] the *Nixon* Court admitted that its analysis was limited "only [to] the issue of fair dealing."[33]

---

[27] 626 A.2d 1366 (Del. 1993)

[28] *Id.* at 1374 ("The only issue before this Court is the ruling by the trial court . . . that the defendants breached their fiduciary duties by failing to provide a parity of liquidity.").

[29] *Id.* at 1379 (discussing, in dicta, question "raised at oral argument" and casting doubt that "there should be any special, judicially-created rules to 'protect' minority shareholders of closely-held Delaware corporations") (citations omitted).

[30] *Id.* at 1371-73.

[31] *Id.* at 1375-76 (affirming trial court's application of "entire fairness" standard after noting that majority shareholders benefited from the challenged transactions "beyond that which benefitted other stockholders generally"). But where the majority shareholders implement certain procedural protections (through involvement of an independent committee or a majority vote of minority stockholders), the burden of proof under the "entire fairness" standard could shift back to the plaintiff. *See, e.g.*, *In re John Q. Hammons Hotels Inc. Shareholder Litig.*, No. 785-CC, 2009 WL 3165613, at *14 n.48 (Del. Ch. Oct. 2, 2009) ("Although the procedural protections in this case were not sufficient to invoke business judgment protection, they could have been sufficient to shift the burden of demonstrating entire fairness to the plaintiffs.").

[32] *See Weinberger v. Uop*, 457 A.2d 701, 711 (Del. 1983) (explaining the concept of "fair dealing" as concerning how "the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained," and the "fair price" prong "relates to the economic

Initially, the Delaware trial court sided with the minority shareholders but, on appeal, the Delaware Supreme Court framed the issue as whether the majority shareholders "breached their fiduciary duties by failing to provide a parity of liquidity."[34] According to *Nixon*, under the entire fairness standard, the minority shareholders did not have "a right to 'liquidity' equal to [the majority shareholders]," and the Supreme Court said—in dicta—that it would not "fashion a special judicially-created rule for minority investors" because minority shareholders should negotiate for better rights:

> The tools of good corporate governance are designed to give a purchasing ***minority stockholder the opportunity to bargain for protection before parting with consideration***. It would do violence to normal corporate practice . . . to fashion an ad hoc ruling which would result in a court-imposed stockholder buy-out for which the parties had not contracted.[35]

The *Nixon* Court did recognize that minority shareholders often lack the ability to sell their shares (without a market or market valuation), and are thus bound by the majority's consent.[36] After approving of a series of actions that benefited the majority shareholders (and disproportionately increased their ability to liquidate shares of stock), the *Nixon* Court explained that the minority shareholders were "entitled to be treated fairly, but not necessarily to be treated equally."[37] The solution, according to *Nixon*, for minority shareholders in Delaware is to "enter into definitive stockholder agreements . . . [that] provide for elaborate earnings tests, buy-out provisions, voting trusts, or other voting agreements."[38] For those reasons, the *Nixon* Court dismissed the minority shareholder's breach of fiduciary duty claims, but never explicitly considered—and never rejected—any cause of action for shareholder oppression, which was not plead as a cause of action in the plaintiff's complaint.

While the "entire fairness" standard is more exacting than the deferential business judgment rule,[39] the court's application of this higher standard does not necessarily assure

---

and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock"); *see also In re Marriott Hotel Props*, 2000 WL 128875, at *14 ("[T]he entire fairness test properly applies to protect minority shareholders from the tyranny of the controlling entity.").

[33] *Nixon*, 626 A.2d at 1376

[34] *Id.* at 1374.

[35] *Id.* at 1379-80.

[36] *Id.* at 1379 (noting that "there is no market and no market valuation" and stating that "[i]t is not difficult to be sympathetic, in the abstract, to a stockholder who finds himself or herself in that position").

[37] *Id.*

[38] *Id.* at 1380.

[39] *See Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (noting that business judgment rule is the default standard of review and presumes that "in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company"); *see also Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 457 (Del. Ch. 2011) (noting that, under business judgment rule, the

victory for a minority shareholder plaintiff. In most instances, the plaintiff's path to the entire fairness standard involves either: (1) rebutting the "business judgment" rule; or (2) demonstrating that a controlling shareholder is engaging in self-dealing or other acts of bad faith.[40] Despite application of the more stringent standard of review, however, the *Nixon* Court approved the benefit plans adopted by the majority shareholders—relying exclusively on the "fair dealing" prong—even though the controlling shareholders were positioned to benefit personally from the actions that the minority shareholder claimed constituted a freeze out.[41] In sum, the *Nixon* Court did not reject a cause of action for shareholder oppression (which was never pled), but the Delaware Supreme Court confirmed that majority shareholder defendants can meet their burden under the "entire fairness" standard to defeat a claim for breach of fiduciary duty.

c. *Riblet Products v. Nagy*: Delaware Supreme Court Narrowly Decides Certified Question from Seventh Circuit

Three years later, in *Riblet Products v. Nagy*, the Delaware Supreme Court considered a similar fiduciary duty issue in a case filed in federal court in Indiana (but governed by Delaware law).[42] On appeal, the Seventh Circuit certified a question to the Delaware Supreme Court asking "whether corporate law requires controlling shareholders to act as fiduciaries toward minority shareholder-employees."[43] The Seventh Circuit Court of Appeals confronted this issue of minority shareholder rights, but did not rely on – or even reference – the *Nixon* decision, and instead cited to another case, *Ueltzhoffer v. Fox Fire Development Co.,* as the "closest approach" to the topic.[44]

In answering the certified question in *Riblet*, the Delaware Supreme Court did not confront the fiduciary duty issue, because the dispositive question turned on rights arising under an employment contract.[45] The Supreme Court therefore reformulated the certified question (focusing on the contract issue, not fiduciary duties),[46] and determined that the minority

---

decisions of controlling shareholders decisions will be upheld unless it cannot be attributed to "any rational purpose").

[40] *See Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162 (Del. 1995); *see also Ebay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 36-37 (Del. Ch. 2010) ("There are a number of ways that plaintiff can rebut the business judgment, including by showing that the majority of directors who approved the action (1) had a personal interest in the subject matter of the action; (2) were not fully informed in approving the action, and (3) did not act in good faith in approving the action.").

[41] *Nixon*, 626 A.2d at 1381.

[42] *See Nagy v. Riblet Prods. Corp.*, 79 F.3d 572 (7th Cir. 1996).

[43] *See Nagy*, 79 F.3d at 573-74.

[44] *Id.* at 577 (citing *Ueltzhoffer*, No. 9871, 1991 WL 271584, at *8 (Del. Ch. Dec. 19, 1991) (concluding that majority stockholder did not terminate employment contract of minority shareholder "for the sole and improper purpose of freezing him out of the corporate entities")).

[45] 683 A.2d 37 (Del. 1993).

[46] *Id.* at 39 (narrowing the Seventh Circuit's certified question as "[w]hether majority stockholders of a Delaware corporation may be held liable for violation of a fiduciary duty to a minority stockholder who is an employee of the corporation under an employment contract with respect to issues involving that employment").

shareholder's "contractual rights are separate from his rights as a stockholder."[47] Still, the *Riblet* Court leaned closer to the decision issued in *Litle*—rather than its own opinion in *Nixon*—when it noted that "[t]o be sure," the majority stockholders "may well owe fiduciary duties" to the minority stockholder.[48]

In closing, three Delaware decisions — *Litle*, *Nixon*, and *Riblet* — have caused a number commentators to conclude that the existence of a cause of action for shareholder oppression remains an unsettled question.[49] But, Delaware courts have expressly noted that "under some circumstances," fiduciary duty law in Delaware recognizes a claim for oppression by minority shareholders.[50]

The Fifth Circuit also confirmed the uncertainty of Delaware law regarding minority shareholder claims when it stated that: "the Delaware Supreme Court has yet to consider the precise issue . . . whether a controlling shareholder is liable for actions taken with the purpose and effect of freezing out another shareholder."[51] Moreover, a sizable number of courts have explained that Delaware courts have not foreclosed a cause of action for all minority shareholder claims, including a freeze out in close corporations.[52]

3. <u>Litigation of Minority Shareholder Claims In Delaware</u>

Three basic points flow from the limited number of Delaware cases regarding claims for minority shareholder oppression: (1) minority shareholders should contract at the outset, if possible, to have the right to redeem—or secure a buyout of—their interest when on reasonable terms; (2) the standards for a shareholder oppression claim in *Litle* continue to be recognized by

---

[47] *Id.* at 40

[48] *Id.*

[49] *See* Robert A. Ragazzo, *Toward a Delaware Common Law of Closely Held Corporations*, 77 Wash. U.L.Q. 1099, 1150-51 (1999) (arguing that notwithstanding *Nixon*, "the death of special shareholder duties in Delaware corporations has been greatly exaggerated"); *see also* Jeffrey M. Leavitt, *Burned Angels: The Coming Wave of Minority Shareholder Oppression Claims In Venture Capital Start-Up Companies*, 6 N.C. J. L. & Tech. 223, 252-55 (2005) (endorsing the view that "Delaware's law has not yet weighed in on the question of shareholder oppression in close corporations").

[50] *See Gagliardi v. TriFoods Int'l, Inc.*, 683 A.2d 1049, 1051 (Del. Ch. 1996) ("I need not address the general question whether Delaware fiduciary duty law recognizes a cause of action for oppression of minority shareholders; I assume for purposes of this motion, that under some circumstances it may."); *see also Orloff v. Shulman*, 2005 WL 3272355, at *8 n.52 (explaining that *Litle* is "[t]he only Delaware case that squarely addressed the issue of [shareholder] oppression"); *see also In re Marriott Hotel Props. II Ltd. P'ship*, No. Civ. 14961, 2000 WL 128875, at *13 (Del. Ch. Jan. 24, 2000) (recognizing application of *Litle* to minority shareholder's claim that "defendant had frozen dividends in order to effectuate an oppressive squeeze-out").

[51] *See Hollis v. Hill*, 232 F.3d 460, 469 & n.28 (5th Cir. 2000).

[52] *See, e.g,, Carstarphen v. Milsner*, 693 F.Supp.2d 1247, 1250 (D. Nev. 2010) ("But the holding of *Nixon* did not entirely preclude the possibility of a direct cause of action for minority shareholders in at least some circumstances."); *Clemmer v. Cullinane*, 815 N.E.2d 651, 652-63 (Mass. 2004) (applying Delaware law) (holding that minority shareholder stated a claim for freezeout and "[d]espite the sweeping dicta, the *Nixon* decision did not preclude a cause of action for minority shareholder freezeout in close corporations."); *Mroz v. Hoaloha Na Eha, Inc.*, 410 F.Supp.2d 919, 934-35 (D. Hi. 2005) (citing *Clemmer* with approval regarding limits of *Nixon* decision).

both Delaware and federal courts (applying Delaware law) and the "very strong dicta" [53] in *Nixon* has not foreclosed the assertion of oppression claims;[54] and (3) where a claim involves a breach of fiduciary duty, a plaintiff's allegation concerning the majority stockholder being "on both sides" of a deal will warrant the application of the more subjective "entire fairness" standard which requires courts to review and consider the majority shareholder's "fair dealing" and whether a "fair price" was offered.

Thus, while most minority shareholder plaintiffs in Delaware will opt to bring a claim for breach of fiduciary duty, the potential for a separate cause of action for shareholder oppression continues to be viable despite the sweeping dicta in *Nixon*.

E. 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;

---

[53] S*ee Hollis v. Hill*, 232 F.3d 460, 469 n.28 (5th Cir. 2000) ("[T]he Delaware Supreme Court has yet to consider the precise issue . . . whether a controlling shareholder is liable for actions taken with the purpose and effect of freezing out another shareholder.").

[54] *See supra* at nn. 17, 25 & 50; *see also Reserve Solutions Inc. v. Vernaglia*, 438 F.Supp.2d 280, 290 (S.D.N.Y. 2006) (applying Delaware law) (approving *Litle* and denying motion to dismiss shareholder oppression claim); *Minor v. Albright*, No. 01-C-4493, 2001 WL 1516729, at *2-3 (N.D. Ill. Nov. 28, 2001) (applying Delaware law) (recognizing definition of oppressive shareholder conduct from *Litle* and denying motion to dismiss plaintiff's claims that majority shareholder "attempted to freeze them out").

- 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."[55]

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*.[56] 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.[57]

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.[58] 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."[59]

F. 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,[60] 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

---

[55] 754 S.W.2d at 380.

[56] 997 S.W.2d 798 (Tex. App.—Houston [1st Dist.] 1999, pet. denied).

[57] *Id.* at 802.

[58] *Id.*

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

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

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) 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.[61] 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.

G. DEPARTURE FROM THE BUSINESS JUDGMENT RULE

In light of the vague, general nature of the Texas statutes that empower shareholders in dire situations to dissolve private companies, it is not surprising that Texas courts have fashioned remedies for minority shareholders contending they have been oppressed by the majority owners. The "less harsh" non-dissolution remedies set forth in *Davis* are judicial in nature, and are not prescribed by statute. Nevertheless, these remedies continue to provide relief to minority shareholders who allege claims for minority shareholder oppression.

---

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

Before *Davis*, 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 would give great deference to company officers and directors under the "business judgment rule."[62] 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."[63]

While *Davis v. Sheerin* 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"[64] and to assess whether the majority owners' actions have thwarted the "reasonable expectations"[65] of the minority shareholders. The Fifth Circuit Court of Appeals, in *Hollis v. Hill*,[66] 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.[67]

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.

H. 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

---

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

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

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

[65] *Id.*

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

[67] *Id.* at 467.

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.[68] Shareholders were therefore without standing to enforce those duties, except through the vehicle of a derivative lawsuit that was filed on behalf of the corporation.[69]

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."[70] 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.[71]

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*,[72] 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."[73]

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.[74] 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."[75] 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.[76]

---

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

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

[70] *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).

[71] *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).

[72] 671 S.W.2d 948 (Tex. App.—Fort Worth 1984, writ ref'd n.r.e.).

[73] *Id.* at 950.

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

[75] *Id.* at 854.

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).[77] The *Cleaver* court noted, however, that fiduciary duties would have to be weighed for a court to properly assess the policy of the managing partner that was subject to challenge, *i.e.*, retaining earnings rather than declaring distributions.[78]

I. 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.[79]

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.[80] 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.[81] 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."[82]

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

---

76 *Id.* at 849.

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

78 *Id.* at 495-96.

79 *See* TEX. BUS. ORG. CODE § 21.551, et seq. (Vernon's 2010).

80 *See* TEX. BUS. ORG. CODE § 21.552-553 (Vernon's 2010).

81 *Id.* § 21.563 (Vernon's 2010).

82 *Id*.

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 their proportionate interest in the partnership.[83] 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."[84]

J. REMEDIES FOR MINORITY SHAREHOLDER OPPRESSION

The harshest remedy for shareholder oppression is liquidation of the corporation, which is authorized by Texas statute. *See* TEX. BUS. ORG. CODE § 11.404 (Vernon's 2011). Texas courts, however, have interpreted their equitable powers broadly to permit them to narrowly tailor remedies for oppression. Specifically, courts have reasoned that if they are empowered to dissolve the corporation—the harshest equitable remedy—then they are also empowered to impose other equitable remedies that provide an outcome less drastic than dissolution.[85] Using their equitable powers, courts have discretion to tailor the remedy to the fit the specific factual situation.[86]

Given the harshness of the dissolution remedy and the reluctance of courts to apply it, a more common remedy for shareholder oppression is a court-ordered buyout of the minority

---

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

[84] *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).

[85] *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.).

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

shareholder's interest by the majority shareholder(s).[87] Texas courts order buyouts under their general equitable powers as a remedy that is 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.

K. 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 "fair market value."[88] 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."[89] A fair market value will usually substantially discount the minority interest in a close corporation for lack of marketability and lack of control.[90]

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,"[91] and would undermine the remedial goal of protecting "minority shareholders from being forced to sell at

---

[87] *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).

[88] *See generally* Douglas K. Moll, *Shareholder Oppression and "Fair Value": Of Discounts, Dates, and Dastartdly 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).

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

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

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

unfair values imposed by those dominating the corporation while allowing the majority to proceed with its desired corporate action."[92] 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.[93] 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.[94]

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.

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.[95]

The appellate court in *Rupe* also favorably cited commentary by Professor Doug Moll, who has written extensively regarding minority shareholder oppression claims.[96] Prof. Moll, in turn, has expressed the view that trial courts should adopt a flexible approach in construing

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

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

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

[95] 339 S.W.3d at 299.

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

minority shareholder oppression claims and fashioning remedies for oppressed minority shareholders.[97]

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."[98] 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.[99]

L. 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.[100] Illinois's statutes identify eleven alternatives.[101] California simply instructs its courts to do equity.[102] 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;

---

[97] *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).

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

[99] *Id.*.

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

[101] 805 ILL. COMP. STAT. 5/12.56 (West 2010).

[102] 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.").

- 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.[103]

M. A LOOK AT THE FUTURE: UNCHARTED WATERS

The defense perspective, plainly, is that the Supreme Court of Texas will decisively overrule *Davis* and its progeny as soon as the opportunity arises. While that prospect may give some comfort to the defense bar, there are several factors to consider that should postpone any celebration of the hope that the death of minority shareholder oppression claims is fast approaching.

First, the Supreme Court of Texas has not accepted any case presenting this claim, and there is no certainty as to when, if ever, the Court will decide whether a claim for shareholder oppression is a valid cause of action under Texas law. *Davis* was decided almost 24 years ago, and the Court seems in no hurry to take up this issue. Moreover, there is no brewing conflict among the Texas appellate courts. In fact, all eleven appellate courts that have considered the issue have held that minority shareholder oppression is a valid claim.

Second, there is a strong public perception that corporate leaders of both public and private companies have run amok in recent years. This is particularly the case in Texas where claims regarding the Stanford *Ponzi* scheme are still being litigated and the corruption within Enron's senior management has not been forgotten. The continuing distress over the misconduct of corporate officers, and the devastating result to their companies and shareholders, led to the passage of the Sarbanes-Oxley Act in 2003. SOX has been in place for most of this past decade, but as the Stanford case shows, the corruption factor remains. The Texas Supreme Court may be reluctant to jettison a claim that has served Texas reasonably well, particularly when its underpinnings are based on fiduciary duties.

Third, and finally, the precedential value of more than twenty years of appellate case law will not be lightly disregarded by the Supreme Court. Many astute appellate judges have studied this claim and concluded that shareholder oppression is a cause of action well-placed in Texas law. As a result, if the Supreme Court does consider the claim, it may devote its efforts to making more definite the standards that apply to claims for minority shareholder oppression. The Court may not be willing to overturn the case precedents that established this claim and have carried it forward for more than two decades thus far.

---

[103] *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).