“BUSINESS DIVORCE CLAIMS AND LITIGATION – THE LEGAL LANDSCAPE IN TEXAS”

TexasBarCLE

BUSINESS TORTS INSTITUTE 2010

October 28-29, 2010 – Dallas - Westin Park Central Hotel

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A. Introduction

Starting a new business is relatively easy in Texas and requires minimal red tape. But, a key business issue that is often overlooked when a new company is formed is how to handle the departure of one or more owners who want to exit the business in the future. The absence of an exit strategy among co-founders of a new business is especially common when the company is started by a group of close friends or family members.

As a result, investors who buy a minority stake in the new private company may become "locked in" to their investment long after they desire to sell their ownership interest. Unless the minority owner obtains a redemption agreement (or some other buyout/exit right) at the time he buys stock or purchases his limited partnership interest, he lacks the ability to "monetize" his investment at a time of his choosing in the future. In most cases, no market exists for the stock of a minority shareholder in a private company or for a limited partnership interest. Further, there is no requirement for the company or other investors to repurchase the stock or limited partnership interest and the transfer may be restricted. The minority shareholder or limited partner is therefore stuck hoping for a liquidity event such as a sale of the business, a merger, recapitalization or an Initial Public Offering (IPO).

This article focuses on conflicts among minority and majority owners of privately-held Texas companies. The increasing number of lawsuits filed by minority shareholders and limited partners in Texas private companies has not yet resulted in an extensive number of appellate decisions construing these claims. As Texas courts increasingly grapple with these cases, however, they are being called on to examine the rights of minority investors and the duties of majority owners of private firms. The specific focus of this article is on remedies that <u>may</u> be available to minority shareholders, minority LLC members and limited partners in private Texas companies who did not secure a redemption agreement or any other contractual buy out right at the time they acquired their minority interest. Minority investors in this position may find that they have no remedy available, or at best, that their remedies are limited to some form of court-ordered equitable relief. The extent to which the minority owner can secure relief will depend on his ability to show that the majority shareholders, majority LLC members or the general partner engaged in improper and/or oppressive conduct.

As a preliminary matter, it should be noted that outside the provisions of the Texas Limited Liability Company Act, there is very little case law construing claims by LLC members holding a minority ownership interest against other LLC members holding a majority interest. The LLC appears to be something of a hybrid construct, which includes elements of corporations and also of partnerships. Management of an LLC may be vested in its owners (members), which is a member managed entity more akin to a partnership, or the role of management of the LLC may be delegated to one or more managers, which is more akin to a corporation and to the relationship that exists between shareholders, directors and officers. *See* TEX. LIMITED LIABILITY COMPANY ACT, Art. 2.23 (Vernon's 2010). Further, under the provisions of Article 8.12, all references to corporations in the TBCA are expressly intended to include LLC's.

B. The Closely Held (Private) Corporation

Large public corporations dominate the financial news, but most new businesses start out as private companies. Non-institutional investors in public companies are most often passive investors, who have no role in the business. By contrast, in private companies, the investors are often active participants and they serve as directors, officers, and employees. While investors in public companies can sell their shares at any time in the public market, investors in private companies lack a ready market for their shares.

Often, the owners of private companies do not enter into shareholder agreements or secure redemption rights that ensure that they will have a way to monetize their ownership interest in the future. Indeed one of the important negatives associated with ownership of a minority interest in a private company is the lack of a defined exit right by minority owners. As a result, shareholders in private corporations, LLC's and limited partnerships often find that it is much easier to "get in" and become a minority owner than it is to "get out" and sell their minority, non-controlling interest in the business.

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) decide on the compensation to be paid to officers, (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 members can therefore 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.,* denial of dividends paid currently.

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. REV. LTD. PARTNERSHIP ACT Art. 3.03 (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 they 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.

C. Claim for Minority Shareholder Oppression

Minority shareholders in a private Texas companies have both rights and remedies when the controlling, majority shareholders use their power to deny minority shareholders the right to share in the financial returns of the company. At that point, the minority shareholders may bring a claim alleging shareholder oppression, a relatively recent judicial construct in Texas and other jurisdictions, which is still evolving. At least 10 different appellate districts in Texas have

recognized shareholder oppression as a valid claim that affords relief to holders of minority interests in private companies from the improper exercise of control by majority owners. The Texas Supreme Court, however, has not yet upheld minority shareholder oppression as a distinct or separate cause of action.

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. CODE ANN. ART 7.05-7.06 (Vernon's 2010). 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 "directors or those in control." These statutory remedies, however, are often viewed as unduly harsh to the parties involved, and they are therefore disfavored by trial courts. When a private company is able to continue functioning -- particularly when the company is profitable – it is rarely viewed as subject to a receivership or 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 that is available to oppressed minority shareholders under Texas statutes, case law has developed in Texas to provide additional remedies to minority shareholders who claim oppressive conduct by majority shareholders. 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 supporting one of the definitions of oppression below:

(1) [O]ppression should be deemed to arise only when the majority's conduct substantially defeats the expectations that objectively viewed were both reasonable under the circumstances and were central to the minority shareholder's decision to join the venture

(2) Oppressive conduct refers to] burdensome, harsh and wrongful conduct, a lack of probity and fair dealing in the affairs of a company to the prejudice of some of its members, or a visible departure from the standards of fair dealing and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely.[1]

The seminal Texas case in this area quoted above, *Davis v. Sheerin*[2] relies on language from Articles 7.05 and 7.06 to adopt the doctrine of minority shareholder oppression. 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

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[1] *Davis v. Sheerin*, 754 S.W.2d 375, 377-380 (Tex. App.—Houston [1st Dist.] 1988, writ denied); *Gimpel v. Bolstein*, 477 N.Y.S.2d 1014, 1017-1018 (N.Y. Supr 1984).

[2] 754 S.W.2d 375, 382-83 (Tex.App.–Houston [1st Dist.] 1988, writ denied). 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.

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.

D. Examples of Oppressive Conduct

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

To establish a claim for oppression, the minority shareholder must prove that the majority shareholder engaged in actions of the types listed below, but this 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 reduce or eliminate the minority shareholder's interest,
- Usurping corporate opportunities,
- Using corporate assets for personal benefit, and
- 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."[3]

Similarly, the Court of Appeals in Houston considered a shareholder oppression claim in *Willis v. Bydalek*[4] a decade after *Davis*, and placed limitations on the oppression doctrine. In *Willis*, the corporation operated a nightclub that had never earned a profit and never paid any dividends. Eventually, the plaintiff was removed from management by the majority, but the court in *Willis* did not find that there was sufficient evidence to support a finding of oppression, despite the minority shareholder having been locked out of the corporation's nightclub and deprived of employment. The jury found a wrongful lock-out, but did not find that the majority had misused corporate funds or had suppressed dividends (the company was never profitable and dividends were never distributed to <u>any</u> shareholders – minority or majority).[5]

The court declined to view these acts as oppressive, and determined that the firing of the minority investor/employee was not oppression, because he was an at-will employee without an employment contract.[6] The *Willis* decision set boundaries on the broad language in *Davis* and stressed that "[c]ourts must exercise caution in determining what shows oppressive conduct."[7]

E. <u>Application of Texas Revised Limited Partnership Act</u>

The Texas Revised Limited Partnership Act ("TRLPA") provides a remedy similar to the provisions that are included in the TBCA. Section 8.02, of the TRLPA, allows for the judicial dissolution of a limited partnership when:

(1) the economic purpose of the limited partnership is likely to be unreasonably frustrated;

(2) another partner has engaged in conduct relating to the limited partnership business that makes it not reasonably practicable to carry on the business in limited partnership with that partner; or

(3) it is not reasonably practicable to carry on the business of the limited partnership in conformity with the partnership agreement.

The theory behind 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.[8] In *Susman v. Venture*, the general partners had a dispute with Susman, a limited partner, over the sale of the partnership

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[3] *Davis v. Sheerin*, *supra*, 754 S.W.2d at 380.
[4] *Willis v. Bydalek*, 997 S.W.2d 798 (Tex.App.–Houston [1st Dist.] 1999, pet. denied.
[5] *Id.* at 802.
[6] *Id.*
[7] *Id.* at 801 (citing *McCauley*, 724 P.2d at 237).
[8] *Susman v. Venture,* 114 Ill.App. 3d 668, 70 Ill. Dec. 268, 449 N.E.2d 143 (1982).

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.

F. Application of The Texas Limited Liability Company Act

It appears that minority oppression claims initiated under the Texas Limited Liability Company Act ("LLC Act") would be handled similarly to claims brought under the TBCA and the TRLPA. Article 2.02, of the LLC Act, grants each limited liability company ("LLC") "the power provided for a corporation under the TBCA and a limited partnership under the Texas Revised Limited Partnership Act." Further, the provisions of Article 8.12 of the LLCA state that Section 7.05, of the TBCA, which authorizes courts to appoint receivers and order liquidation for oppressive conduct is expressly made applicable to LLC's. In fact, the language of Article 6.02, of the LLC Act, authorizes that "a court of competent jurisdiction may decree dissolution of a limited liability company if it is not reasonably practicable to carry on the business of the limited liability company in conformity with its articles of organization and regulations."

While this provision of the LLC Act 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. A Departure From the Business Judgment Rule

It is not surprising that Texas courts have fashioned remedies for minority shareholders contending they have been oppressed in light of the vague, general nature of the Texas statutes that empower shareholders in certain dire situations to dissolve private companies. The "less-harsh" non-dissolution remedies set forth in *Davis v. Sheerin* are completely judicial in nature, and are not prescribed in the statute. Nevertheless, these remedies continue to provide the basis for the state's minority shareholder oppression doctrine as it evolves.

Before *Davis v. Sheerin*, Texas courts had been reluctant to issue rulings that impacted the relationships among shareholders or partners and the entities in which they had invested. In this pre-*Davis v. Sheerin* era, courts accorded great deference to company officers and directors under the "business judgment rule."[9] The long-standing existence of the business judgment rule led courts to adopt a hands-off approach to officers and directors under the common law rule that they "shall not be held liable for an honest mistake of judgment if he acted with due care, in good faith, and in furtherance of a rational business purpose."[10]

While *Davis v. Sheerin* did not seek to overturn the business judgment rule, the Texas minority shareholder oppression doctrine contains elements that conflict to at least some extent with the rule. 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

[9] *See Cates v. Sparkman*, 11 S.W. 846, 849 (Tex. 1889)
[10] *FDIC v. Wheat*, 970 F.2d 124, 130-131 (5th Cir. 1992).

they engaged in "burdensome, harsh, and wrongful conduct"[11] and to assess whether the majority owners' actions have thwarted the "reasonable expectations"[12] of the minority shareholders. The Fifth Circuit Court of Appeals, in *Hollis v. Hill*[13], 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."[14]

The *Hollis* court affirmed the lower court's decision requiring 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 engages in breaches of fiduciary duties, that improper conduct gives rise to another 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 the entity.

The longstanding general rule in Texas is that corporate fiduciary duties are owed solely by the corporation's officers and directors to the entity itself, not to its individual shareholders.[15] A corporate director's fiduciary duties have been deemed to run solely to the corporation, and 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.[16]

Closely held companies present a different scenario, however, as borne out by cases that focus on this 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." *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). 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. Id. at 34-35; *Joseph v. Koshy*, No. 01-98-01432-CV, 2000 WL 124-685, at *4 (Tex. App. – Houston [1st Dist.] February 3, 2000, no pet).

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[11] *See supra* note 2.
[12] *See supra* note 1.
[13] 232 F.3d 460 (5th Cir. 2000).
[14] *Id.* at 467.
[15] *See Hoggett v. Brown*, 971 S.W.2d 472, 488 (Tex.App.–Houston [14th Dist.] 1997, writ denied).
[16] *Faour v. Faour*, 789 S.W.2d 62 (Tex. App.–Texarkana 1990, writ denied).

Private, closely held companies can constitute an exception to the 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*[17], the Fort Worth appellate court 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."[18]

Dating back almost 50 years ago, the Texas Supreme Court held that the failure of a majority shareholder to declare dividends constituted fraud and an abuse of his controlling position.[19] 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." 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.[20]

In the partnership context, oppression based upon a breach of fiduciary duties has also been upheld.[21] The Court of Appeals in Tyler ultimately held in *Cleaver v. Cleaver* that the plaintiff was not a partner (and therefore lacked standing to assert a claim for breach of fiduciary duties). The 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.

I. <u>Review of Shareholder Derivative Claims</u>

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 been filed often as derivative actions for the benefit of the company. Shareholder derivative actions are governed by statute. *See* TEX. BUS. ORG. CODE ART. 21.551, et seq. (Vernon's 2010). *See* TEX. BUS. CORP. CODE ART. 5.14 (Vernon's 2010).

The problem for majority shareholders in pursuing derivative actions is that they 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. *See* TEX. BUS. ORG. CODE ART. 21.552 and 553 and (Vernon's 2010). The shareholder's failure to comply with these procedural hurdles can result in a dismissal of the derivative lawsuit.

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[17] 671 S.W.2d 948 (Tex.App.–Fort Worth 1984, writ ref'd n.r.e.).
[18] *Id.* at 950.
[19] *Patton v. Nicholas*, 279 S.W.2d 848 (Tex. 1955).
[20] *Id.* at 849.
[21] *Cleaver v. Cleaver*, 935 S.W.2d 491 (Tex.App.–Tyler 1996, no writ).

Importantly, under the Texas Business Corporation Act, the majority of the procedural requirements that exist for shareholders in a derivative action are eliminated for a closely held company. *See* TEX. BUS. CORP. ACT. 5.14(L)(West 2010). 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." 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 still proceeds in the name of the company, but the court has the authority to permit the recovery in the action to do 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 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. *See Litman v. Prudential-Bache Properties, Inc.,* 611 A.2d 12, 16 (Del. Ch. 1992). 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 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 has resulted in a substantial benefit to the domestic or foreign corporation." *Id.* at 21.561; *see also O'Neill v. Churches,* 910 F.2d 263 (5th Cir. 1990); *Basralian v. Hatfield*, 1998 WL 40415 (Tex.App.—Amarillo 1998) (NO. 07-96-0326-CV) (not designated for publication); and *Bayoud v. Bayoud,* 797 S.W.2d 304 (Tex.App.—Dallas 1990, writ denied), but note that all of these cases were decided before the adoption of the Business Corporation Act authorizing recovery of legal fees and costs in derivative action).

J. Remedies for Minority Shareholder Oppression

The harshest remedy for shareholder oppression is authorized by the Texas statute that permits liquidation of the corporation. Texas courts have interpreted their equitable powers to permit them to respond broadly to oppression claims. Specifically, courts have held 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.[22] Using their equitable powers, courts have discretion to tailor the remedy to the fit the specific factual situation.[23]

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[22] *Davis v. Sheerin*, 754 S.W.2d 375, 380 (Tex. App.—Houston [1st Dist.] 1988, writ denied) (same); *Duncan v. Lichtenberger*, 671 S.W.2d 948 (Tex.App.–Fort Worth 1984, writ ref'd n.r.e.); *Redmon v. Griffith*, 202 S.W.3d 225 (Tex. App.—Tyler 2006, pet. denied); *Gibney v. Culver*, No. 13-06-112-CV, 2008 WL 1822767, at 17 (Tex. App.—Corpus Christi Apr. 24, 2008, n.p.h.).

[23] *Davis v. Sheerin*, 754 S.W.2d 375, 380 (Tex. App.—Houston [1st Dist.] 1988, writ denied).

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 shareholder's interest by the majority shareholder(s).[24] 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

A central issue in any buyout case 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."[25] Public company data is more readily available to valuation experts, and these experts generate valuations of private closely held companies using data from comparable public companies.[26] Private companies and public companies have important differences, however, and valuation experts and courts have therefore developed techniques to adjust for those differences.

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."[27] A fair market value will usually substantially discount the minority interest in a close corporation for lack of marketability and lack of control.[28] The lack of control discount reflects a reduction in value for the inability to control the corporation's actions because the buyer is buying less than a controlling interest in the company.

Many courts refuse to include a lack of control discount in a valuation in the context of a court-ordered buyout, however, because it would "deprive minority shareholders of their proportionate interest in a going concern"[29] 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."[30]

The lack of marketability discount, however, is more debatable and courts will consider adjusting the valuation to reflect the fact that shares in the close corporation lack liquidity.[31] While majority shareholders will argue strenuously in favor of applying discounts and using the

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[24] *Lund v. Krass Snow & Schmutter, P.C.*, 879 N.Y.S.2d 127, 2009 N.Y. Slip Op. 03996, 2009 WL 1406312 (N.Y.A.D. 1 Dept. , May 21, 2009) (affirming trial court judgment ordering a buyout of the minority shareholder Court of appeals affirmed judgment awarding plaintiff a buyout plus postjudgment interest).

[25] *See* 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).

[26] *See generally* SHANNON P. PRATT, VALUING A BUSINESS THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES 261-309 (5th Ed. 2008) (outlining valuation methodologies for closely held companies by comparison to public companies).

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

[28] *See* PRATT, *supra* note 10 at 397-459; DOUGLAS K. MOLL & ROBERT A. RAGAZZO, THE LAW OF CLOSELY HELD CORPORATIONS §8.02[B][3] (2009).

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

[30] *Id*. *See also Balsamides v. Protameen Chems., Inc.*, 734 A.2d 721, 734-35 (N.J. 1999).

[31] *Pueblo Bancorporation v. Lindoe, Inc.*, 63 P.3d 353, 357 n.2 (Colo. 2003); *Advanced Commc'n Design, Inc. v. Follett*, 615 N.W.2d 285, 291 (Minn. 2000).

fair market value standard to determine the value of the minority shareholder's interest, minority shareholders seek buyouts of their interest at fair value, a valuation that includes no discounts, and in which the minority shareholder receives a full, proportionate share of the entire enterprise value based on the percentage of ownership.[32]

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 as an alternative to dissolution. For example, California permits the corporation or the shareholder with more than 50% to avoid dissolution by buying the dissenters stock for "fair value." 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.[33]

L. <u>Other Non-Buyout Remedies That May be Available to Minority Shareholders</u>

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.[34] Illinois's statutes identify eleven alternatives.[35] California simply instructs its courts to do equity.[36] 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 provisional directors;
- Appointing an individual to be an officer or 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;

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[32] *See* 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).
[33] CAL. CORP. CODE §2000 (West 2010).
[34] S.C. CODE 33-18-410 (West 2010).
[35] 805 ILL. COMP. STAT. 5/12.56 (West 2010).
[36] 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.").

- 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.[37]

M. A Look at the Future: Uncharted Waters

Some lawyers who litigate shareholder oppression claims have privately expressed concern that a conservative Texas Supreme Court may overturn or at sharply curtail the scope of relief afforded to minority shareholders under *Davis v. Sheerin*. Yet, there are other currents at work that may cause the Supreme Court to give credence to the minority shareholder oppression doctrine. Chief among these trends is the strong public perception that the corporate leaders of public companies have run amok in recent years. The distress over the misconduct of officers in public companies, and the devastating result to their companies and shareholders, led to the passage of the federal Sarbanes-Oxley Act in 2003. SOX has now been in place for most of this past decade, but the corruption factor does not seem to have abated as frauds and large Ponzi schemes have dominated the news over the past three years.

It is difficult to predict what effect, if any, governmental regulation of public companies will have on: (i) the duties owed by majority owners of private companies under common law and (ii) the common law rights of minority shareholders. The increased public sensitivity to offensive, self-dealing conduct by corporate leaders in the public arena, however, seems to be consistent with cases that uphold rights and remedies of minority shareholders when they are able to establish that they have been subject to economic oppression by majority owners of the private business entity.

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[37] *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).