OUT OF THE FRYING PAN INTO THE FIRE – THE PERILS OF ACQUIRING MINORITY STOCK OWNERSHIP IN A PRIVATE TEXAS COMPANY THROUGH DIVORCE SETTLEMENT OR DECREE

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Ladd's practice is characterized by his tenacity and creativity in handling complex litigation matters for and against private and public companies in the manufacturing, computer software, insurance, real estate, beer distribution, retail sales, health care, food service, commercial airline and music industries.

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Representative Cases

Admitted to Practice:
Federal District Courts in Texas

Texas

U.S. Court of Appeals, 5th Circuit

- Jury verdict awarding mandatory dividend of $65 million to two shareholders of closely held bank software company, and $2 million in back pay and legal fees for minority shareholder alleging claims of shareholder oppression and breach of fiduciary duties.
- Secured settlement of almost $10 million in cash and property for LLC member and limited partner alleging claims of shareholder oppression and breach of fiduciary duties.
- Arbitration award totaling close to $4 million (with interest) for purchaser of retail shopping center, who alleged breach of purchase agreement regarding property condition.
- Obtained substantial confidential settlement in litigation for multiple limited partners of large Texas beer distributorship, who alleged they had been deprived of partnership distributions following sale of assets.
- Obtained sizable confidential settlement in litigation for limited partner and founder of restaurant chain, who had been forced out of management role in the business.
- Secured summary dismissal of claims in Dallas Federal Court for acclaimed rock band arising out of events on national tour.

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A. INTRODUCTION

The divorcing spouse who receives a minority stock interest in a private Texas company without also obtaining a contractual exit right may be exchanging one legal battleground for another. Or as Willie Nelson might have sung if he had been asked to pen the lyrics to the difficulties faced by minority shareholders in Texas, "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 or acquires (by gift, inheritance, settlement or decree) a minority ownership stake in a private Texas company without also securing an exit strategy is likely to be "locked in" and unable to dispose of this ownership interest in the business when he/she desires to sell. Unless the minority owner obtains a redemption agreement (or some other contractual right to exit the business) when the interest is purchased (or received), the owner lacks the right to choose when he/she can later "monetize" the interest. 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 at any price. This leaves the minority shareholder with no option to dispose of the shares and stuck on the sidelines hoping for a liquidity event such as a sale of the business, a merger, or an Initial Public Offering (IPO).

This article focuses on the conflicts that arise between and among minority and majority owners of privately-held Texas companies. In this troubled economy, lawsuits filed by minority shareholders, as well as by limited partners and LLC members, of private companies against general partners and controlling owners appear to be increasing, but this spate of lawsuits is only now reaching the appellate courts. As Texas courts grapple with these oppression and breach of fiduciary duty claims by minority owners, they are reexamining and developing new legal principles regarding the rights minority owners and corresponding duties of the majority owners in private companies.

This article does not include a statistical analysis of this trend, but the common sense explanation for the increase in litigation by minority owners in private companies is that a down economy eliminates, or sharply reduces, the prospect for them to cash out of their investment.[1] Frustrated by their inability to monetize their minority positions, minority owners in private businesses are increasingly concluding that the majority owners have used their controlling power in an oppressive manner, and these minority investors are turning to the courts for relief.[2]

[1] The early 2000's reflected a dearth of IPO filings, which bumped up to 315 in 2004. This compares with 73 stocks that went public in 2003 and a peak of 864 IPO's during 1996. Among the IPO's of 2004 were Google, Texas Roadhouse and NavTeq, 41% owned by Phillips Electronics. It turns out, however, that 2004 was the high water mark for the decade of the 2000's in IPO filings. By 2008, the number was down to just 107 followed by 119 in 2009. The filings then increased somewhat to 259 in 2010 and 262 in 2011. Renaissance Capital IPO Home.

[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 minority owner's perspective, the good news is that remedies may be available to them even if they did not obtain a redemption agreement when they made their investment or acquired their ownership interest. Texas courts have recognized that minority shareholders in private companies have equitable "exit rights" if they can establish that they were "oppressed" by the majority shareholder(s). In these limited circumstances, minority shareholders may be able to secure a court-ordered buyout of their ownership interest in the company.

B. THE PRIVATE CORPORATION

The minority shareholder oppression scenario arises uniquely in the context of a private company, including the close corporation. An investor in a publicly-held corporation can feel oppressed, *i.e.*, that his investment goals are being thwarted by management. The public company investor has a readily available exit, however, because his/her shares can be sold in the public market.[3] By contrast and as noted, a shareholder in a private company lacks this option, because no market typically exists for the shares of a private company. Moreover, in many private companies, all shareholders are required to sign an agreement with other shareholders that restricts the sale or transfer of their stock. The non-marketable nature of a private company investment makes it possible for controlling shareholders to "squeeze out" the minority shareholder from the company's management and operations, while also "freezing out" the minority owner out of realizing any other monetary benefits from his/her ownership interest.

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 to control the board and, 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. 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. 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 private 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. This is an especially tenuous situation for a spouse who acquires his/her minority interest in the business in a divorce settlement or divorce decree when the other spouse is a longtime insider and the other, majority shareholders side with the spouse who is the company employee.

[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 majority shareholders have abused their power to deprive the minority owners of their right to share in the company's financial success, the minority owners may bring a claim for shareholder oppression. This claim for oppression and resulting equitable remedies was singled out in a Texas appellate case in Houston more than 20 years ago (and the claim is also upheld in other jurisdictions), but the contours of the claim continue to develop in more recent cases.[4]

The starting point for the assertion of an oppression claim resides 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 the minority owner makes a showing that "governing persons" engaged in "illegal, oppressive or fraudulent" conduct.

These statutory remedies of court-ordered receiverships and liquidation, however, are often viewed as unduly harsh, and the draconian remedies provided by statute are therefore largely disfavored by trial courts. When a private company is able to continue functioning – and particularly when it is profitable – it is rarely viewed as a company 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 developed to provide additional remedies to minority owners able to prove that the majority shareholders engaged in oppressive conduct. There is no single set of definitive actions that constitute oppression, but a viable claim exists when the facts meet one of the following two definitions of oppression established by *Davis v. Sheerin*, the seminal case in this area:

(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 court in *Davis v. Sheerin*[6] relies on language from Section 11.404 of the Texas Business Organizations Code to uphold a claim for minority shareholder oppression and to impose court-ordered equitable remedies. The court in *Davis* upheld a jury verdict of oppressive conduct, based on evidence that the majority owners: (i) engaged in a conspiracy by the majority shareholders to deprive the plaintiff of his ownership interest in the corporation, (ii) wasted corporate funds and received dividends that were withheld from the plaintiff, and (iii) would deny the minority owner any future voice in the corporation's management.

The *Davis* court also relied on the Texas Supreme Court's holding in *Patton v. Nicholas*,[7] also recently cited with approval by the Dallas Court of Appeals in *Ritchie v. Rupe.*[8] More than 55 years ago, the Supreme Court in *Patton* upheld the trial court's right to impose a mandatory dividend when the majority owners wrongfully suppressed the issuance of dividends with the intent to harm the minority shareholder.[9]

Defendants in minority shareholder oppression cases frequently point out that the claim has never been considered and upheld by the Texas Supreme Court, and they also contend that the claim rests on questionable case law from other jurisdictions. Finally, defendants will also urge Texas trial and appellate courts to apply Delaware law, which is more favorable to majority owners. In response to these legal arguments, minority owners may wish to point out that while the Texas Supreme Court has not yet upheld the claim for shareholder oppression, it has been a fixture in Texas law for more than two decades.[10] Since the Houston appellate court issued *Davis v. Sheerin* in 1988, appellate courts throughout Texas have consistently held that a claim for minority shareholder oppression is a valid, and upon proof, they grant relief to minority shareholders harmed by majority owners' abusive exercise of corporate control.

A review of Texas law since *Davis* reflects that more than 25 reported decisions in 11 of the 14 Texas appellate districts have upheld minority shareholder oppression as a viable cause of action. In March 2011, the Dallas Court of Appeals considered the claim for the first time in *Rupe*, and unanimously upheld the validity of the claim after extended discussion. The

[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. filed) (citing *Patton*) (the "<u>Rupe Decision</u>"). The Supreme Court of Texas has now asked for additional briefing in connection with the *Rupe* appeal.

[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").

Dallas Court relied on the same out-of-state cases that defense lawyers often criticize.[11] To date, efforts by majority owners urging Texas appellate courts to apply Delaware law—which is 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 the claim for 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]

[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).

D. CLAIM FOR MINORITY SHAREHOLDER OPPRESSION UNDER DELAWARE LAW

1. INTRODUCTION

Delaware is often held out as a "safe haven" by defense counsel who urge their majority shareholder clients to form private companies there under the view that majority shareholders are immune from oppression claims under Delaware law.[14] A fair reading of Delaware law indicates that courts there are much less receptive than Texas courts to minority shareholder oppression claims. Yet, the contention that a claim for minority shareholder oppression is not valid under Delaware law appears to overstate the case.

The argument that claims for minority shareholder oppression are not recognized under Delaware law relies on dicta from a single Delaware case. *See Nixon v. Blackwell.*[15] In *Nixon*, the court approved a "liquidity disparity" between controlling and minority shareholders, but did not consider—or expressly reject—the "reasonable expectations" standard that had been announced just one year earlier in *Litle v. Waters.*[16] Since the *Nixon* Court issued its decision in 1993, however, 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, minority shareholders who invest or acquire ownership interests 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 recognize a 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

[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).

[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").

extensive, but Delaware courts first recognized a claim for shareholder oppression in 1991, and no Delaware court has since expressly rejected this claim. 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. Fractured Foundation Of Minority Shareholder Claims in Delaware

Starting in the early 1990's, there is a split of authority within Delaware courts in regard to the claim for minority shareholder oppression. One court in 1992 held that the claim existed; but in 1993, another suggested it did not, and the law remains unsettled two decades later. The three Delaware cases reviewed below demonstrate the split of authorities in Delaware in regard to claims for oppression claims by minority shareholders.

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

In *Litle v. Waters*, the Delaware Court of Chancery first 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 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

[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.

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]

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 shareholders 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 was less protective of 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" by: (1) creating an Employee Stock Ownership Plan ("ESOP") that allowed only certain employees the ability liquidate their stock; and (2) by funding a "Key Man" insurance plan in which proceeds of the policy would 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 provided employees (through retirement) and directors (through insurance) the ability to liquidate their shares, but they did not give minority shareholders with a similar right.

[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.

[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.

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] The entire fairness standard generally requires a two-pronged inquiry into both the "fair price" and "fair dealing" of the challenged transaction,[32] but the *Nixon* Court admitted that its analysis was limited "only [to] the issue of fair dealing."[33]

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—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, 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

[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"). When 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 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").

"entitled to be treated fairly, but not necessarily to be treated equally."[37] The solution for minority shareholders in Delaware, according to *Nixon*, 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 did not explicitly consider—and never rejected—a claim for shareholder oppression, which was not pled 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 victory for a minority shareholder plaintiff. In most instances, the plaintiff's ability to obtain application of 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 claim for shareholder oppression (which was never pled), but the 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 Indiana federal court (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 did not rely on – or even reference – the *Nixon*

[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 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.

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 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 sum, three Delaware cases — *Litle*, *Nixon*, and *Riblet* — have caused a number commentators to conclude that it remains unsettled whether a claim for shareholder oppression exists in Delaware.[49] Delaware courts have expressly noted that "under some circumstances," fiduciary duty law recognizes a claim for oppression by minority shareholders.[50] The Fifth Circuit reflected 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] It should be noted that a number of courts have explained that Delaware

[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").

[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).

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 secure 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 both Delaware and federal courts (applying Delaware law) and the "very strong dicta" [53] in *Nixon* has not foreclosed the assertion of shareholder 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 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 scheme often includes the following elements: the majority shareholder terminates the minority shareholder's employment without cause, removes the minority shareholder from the board or from all aspects of management, refuses to provide financial information to the minority, and refuse 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. Thus, under this scheme, the majority shareholder freezes the minority owner out of the business and leaves no tangible financial benefit available from his/her ownership interest.

[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).

[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").

To establish a claim for oppression, the minority shareholder will prove that the majority shareholder engaged in actions of the types listed below, although 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 dilute or eliminate the minority shareholder's interest;
- Usurping corporate opportunities;
- Using corporate assets for personal benefit; and/or
- Making loans to family members.

Not every example of the conduct listed above rises to the level of minority shareholder oppression. For example, terminating the employment of a minority shareholder who is an employee at-will does not automatically translate into a valid oppression claim. The threshold question of **whether the majority shareholder engaged in oppression is a matter of law for the court to decide** 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]

One decade after its decision in *Davis*, the appellate court in Houston placed limitations on shareholder oppression claims in *Willis v. Bydalek*.[56] In *Willis*, the corporation operated a nightclub that never earned a profit. Even though the majority shareholder removed the plaintiff from management, the court in *Willis* did not find sufficient evidence to support a finding of oppression—despite the jury's finding of a wrongful lock-out. 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 hold that these acts were 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

[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.*

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 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

[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.

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

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 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.

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]

[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.

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 private companies have another avenue available to challenge the actions of majority/controlling owners in addition to a shareholder oppression claim. To the extent the majority shareholder or the general partner breaches his fiduciary duties, those acts would give rise to a separate tort claim. What remains unclear is whether the minority shareholder has a direct action for breach of fiduciary duty, or whether this claim must be brought as a derivative action by the investor in the name the corporate 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 therefore lacked standing to enforce the fiduciary duties that officers and directors owe to the corporation, except through the vehicle of a derivative lawsuit that they filed on behalf of the corporation.[69]

Private 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."[70] When courts hold this duty runs directly from the majority shareholder to the minority shareholders, they allow for minority shareholders to asserts breach of fiduciary duty claims directly against the majority (controlling) shareholders.[71] Private, closely held companies can therefore constitute an exception to the general rule when courts hold that majority owners owe fiduciary duties directly to the minority shareholders. 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]

[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.

In a related cause of action dating back more than 50 years, the Texas Supreme Court provided another avenue for relief to minority shareholders against majority owners. In *Patton v. Nicholas*, the Court held that the failure of a majority shareholder to declare dividends constituted fraud and an abuse of his controlling position.[74] 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]

In a much more recent case, *Allen v. Devon*,[77] the Houston court of appeals created a new, but very narrow, fiduciary duty in the LLC context. The court there held that a controlling LLC member may owe a fiduciary duty to the minority member where the controlling member is redeeming the minority member's ownership interest. This duty arose because the controlling member has far greater access to information about the company and its true value. Underlying this decision, as well, is the fact that the minority member has no other realistic options for the sale of its minority interest.

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).[78] 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.[79]

I. REVIEW OF SHAREHOLDER DERIVATIVE CLAIMS

In light of the more frequent holdings by Texas cases that majority shareholders do not owe fiduciary duties to other shareholders and owe these duties solely to the company, minority shareholders will often file claims for breach of fiduciary duty in derivative lawsuits that are filed for the benefit of the company. Shareholder derivative actions are governed by statute.[80]

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

[75] *Id.* at 854.

[76] *Id.* at 849.

[77] *Allen v. Devon, et. al,* -- S.W.3d ---, 2012 WL 876771 (Tex. App. – Hous. [1st Dist.] 2012, not pet. history).

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

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

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

The problem for minority shareholders in pursuing derivative actions is that they may require adherence to multiple procedural hurdles, which include all of the following: (1) the shareholder must have had an ownership interest in the company at the time of the alleged wrong and also 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 at issue in the derivative action and the company must refuse to do so before the shareholder files suit.[81] The shareholder's failure to comply with these procedural hurdles can result in the dismissal of the derivative lawsuit. Further, all of the recoveries that are obtained in the derivative lawsuit are recovered by and paid to the company, not to the shareholders who brought the derivative action.

Importantly, under the Texas Business Organizations Code, the majority of these procedural requirements that minority shareholders must comply with before filing a derivative action are eliminated if the entity involved is a closely held company.[82] 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."[83]

Based on this statute, a minority shareholder in a closely held company can file a lawsuit on his own behalf directly against the majority shareholder for breaches of fiduciary duty, but without having to comply with the procedural requirements that normally burden shareholders who want to bring derivative actions. In these derivative actions in the closely held company context, the minority shareholders will still need to name the company as a nominal defendant and the action must still proceed in the name of the company. Importantly, under this statute, minority shareholders who file a derivative action in the name of a closely held company may request the court to order that all recoveries obtained for the company in the action be paid directly to them rather than to the company.

In the limited partnership context, whether or not a limited partner in a Texas limited partnership has a direct action against the general partner for breaches of fiduciary duties when the company has sustained the injury 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.[84] Therefore, a limited partner faces a risk of dismissal in bringing a claim directly against the general partner for breach of fiduciary duties (rather than in a derivative action) if the injuries were sustained by the limited partnership itself rather than by the limited partner individually.

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

[82] *Id.* § 21.563 (Vernon's 2010).

[83] *Id*.

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

Another significant advantage that exists 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."[85] This is sometimes referred to as a "bounty hunter" type of statute because it authorizes recovery of attorney's for the successful prosecution of claims by shareholders who bring derivative actions.

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 have interpreted their equitable powers broadly, however, to permit them to narrowly tailor remedies for oppression that are less harsh than liquidation. 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 that would be less drastic than dissolution.[86] Using their equitable powers, courts have discretion to tailor an equitable remedy to the fit the specific factual situation.[87]

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).[88] Texas courts order buyouts under their general equitable powers as a less harsh remedy than dissolution, but courts also have the power to impose other less onerous equitable remedies, including reinstatement of the minority shareholder to the board or the mandatory issuance of court-ordered 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 the standard of value that is applied if the court orders a buyout of the, *i.e.*, should the shares be valued at "fair value" or "fair market value."[89] The decision on

[85] *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).

[86] *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.).

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

[88] *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).

[89] *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).

valuation standards is for the trial court to decide, because the issue of whether the majority shareholders oppressed the minority owner is a question of law. As noted earlier, the trial court decides whether oppression has been established as a matter of law based on factual disputes that are resolved by the jury in predicate act questions in the charge. 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. Any equitable relief the trial court awards to the minority shareholder may be overturned on appeal only for an abuse of discretion.

If oppression is found by the trial court, the valuation battle becomes the extent to which the court will apply "minority 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 the lack of control associated with minority ownership in the business. The fundamental distinction is between "Fair Value" also known as "Enterprise Value", on the one side, where no discounts apply to the minority interest, or "Fair Market Value", on the other side, where minority 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."[90] A fair market value will usually substantially discount the minority interest in a private company corporation for lack of marketability and lack of control.[91]

Before the *Rupe* opinion was issued by the Dallas Court of Appeals in March 2011, many courts declined to include a lack of control discount in the context of a court-ordered buyout. The courts reasoned that the discount would "deprive minority shareholders of their proportionate interest in a going concern,"[92] 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."[93] The lack of marketability discount, however, has been viewed as more debatable and courts consider adjusting the valuation to reflect the fact that shares in a close corporation lack liquidity.[94] Thus, majority shareholders argue strenuously for application of discounts and the use of the fair market value standard in valuing the minority shareholder's interest. By contrast, minority shareholders seek buyouts of their interest at fair value, with no discounts that provide the minority shareholder a full share of the enterprise value of the entire company based on the minority owner's percentage of ownership.[95]

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

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

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

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

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

[95] *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).

The *Rupe* decision was the first reported Texas case to require fair market discounts to be considered by the jury in valuing the minority shareholder's stock interest. The *Rupe* decision arose in the context of majority owners who refuse to meet with a potential buyer of the minority owner's interest in the company, which the jury and trial court found to be oppressive conduct. While the appellate court in *Rupe* upheld the trial court's finding that the minority shareholder had been oppressed (and upheld the existing of the claim for shareholder oppression), the court overturned a buyout award of more than $7 million – as determined by the jury – as the value of the minority shareholder's stock interest. The *Rupe* court requires that the jury consider, on retrial, the extent to which minority discounts for lack of control and lack of marketability should be applied in valuing the minority shareholder's stock interest in the company.

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.[96]

The appellate court in *Rupe* also favorably cited commentary by Professor Doug Moll, who has written extensively regarding minority shareholder oppression claims.[97] Prof. Moll has expressed the view that trial courts should adopt a flexible approach in construing minority shareholder oppression claims and fashioning remedies for oppressed minority shareholders.[98]

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."[99] 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.[100]

[96] 339 S.W.3d at 299.

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

[98] *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).

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

[100] *Id.*.

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.[101] Illinois's statutes identify eleven alternatives.[102] California simply instructs its courts to do equity.[103] In states lacking specific statutory authority, courts have nonetheless picked up the mantle of equitable creativity in addressing shareholder oppression.

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

- Altering or setting aside an action of the corporation, its shareholders or directors;
- Cancelling a provision in the articles of incorporation or by-laws;
- Ordering payment of dividends;
- Appointing a custodian to manage the business;
- Appointing an individual to be an officer or director, or a provisional officer/director;
- Removing a director or officer from office;
- Ordering an accounting;
- Awarding damages;
- Reinstating the minority as an employee;
- Requiring repayment of sums wrongly siphoned from the corporation;
- Limiting the salary of the majority or defining certain amounts of compensation as a constructive dividend;
- Ordering issued stock to be cancelled or redeemed; and/or
- Permitting the minority to purchase additional share.[104]

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

[102] 805 ILL. COMP. STAT. 5/12.56 (West 2010).

[103] 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.").

[104] *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).

M. A LOOK AT THE FUTURE: UNCHARTED WATERS

In light of the Texas Supreme Court's conservative leanings in both business and tort cases over the past decade, the conventional wisdom is that the claim for shareholder oppression will not be upheld when it is finally considered by the Court. The Court has not yet accepted a petition in any oppression case on appeal, although it has asked for additional briefing in the appeal of the *Rupe* decision by the Dallas Court of Appeals.[105] That prospect may give comfort to the defense bar, but plans for celebrating the end of minority shareholder oppression claims would be considerably premature.

First, as noted, 24 years of the *Davis* decision, the Supreme Court of Texas has not yet accepted a case presenting this claim for consideration as to its validity under Texas law. In this regard, there is no brewing conflict among the Texas appellate courts. On the contrary, all the different appellate districts (11 of the 14) that have considered the existence of this claim have concluded that minority shareholder oppression is a valid claim under Texas law.

Second, there is a strong public perception that corporate leaders of both public and private companies have run amok in the past decade. This is particularly the case in Texas where claims regarding the Stanford *Ponzi* scheme are still being litigated and the corrupt conduct of the senior management team at Enron 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 Sarbanes-Oxley in 2003. SOX has been in place for almost ten years, but as the Stanford case shows, the corruption factor remains an ongoing concern. The Texas Supreme Court may be reluctant to jettison a claim that has served Texas reasonably well in civil matters, particularly when its underpinnings are based on statute and longstanding fiduciary duties.

Finally, the precedential value of more than twenty years of appellate case law uniformly upholding claims for minority shareholder oppression will not be lightly jettisoned by the Supreme Court. Many astute and thoughtful judges at both the trial and appellate levels have studied this claim and concluded that shareholder oppression is a cause of action well-placed in Texas jurisprudence. As a result, if the Supreme Court does consider the claim at some point, it may choose to devote its efforts to making the legal standards for its application more definite rather than abandoning the claim entirely. Indeed, that is the approach that most appellants are taking during the appellate process, and it may prove to be a harbinger of things to come.

[105] *Rupe*, 339 S.W.3d 275 (Tex. App.—Dallas 2011, pet. filed)