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**GAME ON: LITIGATION BY MINORITY
SHAREHOLDERS AND OTHERS IN
PRIVATE TEXAS COMPANIES**

Ladd A. Hirsch

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I. MINORITY SHAREHOLDER LITIGATION IN PRIVATELY-HELD COMPANIES: WHAT IS IT AND WHY IS MORE OF IT BEING FILED?

A. INTRODUCTION

Claims and lawsuits by minority shareholders and other stakeholders holding minority interests in private businesses appears to be on the rise. Although this paper does not include a statistical analysis of this perceived trend, a more challenging economic environment is playing a role in causing minority shareholders, limited partners and other owners of minority interests in private companies to seek legal relief. The common sense explanation is that a less than vibrant economy eliminates, or sharply reduces, the prospect for minority owners in a privately-held business from cashing out through an acquisition, a merger or an initial public offering.¹ The disgruntled holder of a minority position therefore has little recourse other than filing a lawsuit when his (or its) rights are violated by the majority owners in operating the business.²

This article focuses on conflicts among minority and majority owners of privately-held entities in Texas. The increased frequency of lawsuits by minority shareholders in Texas private companies has not yet resulted in an extensive number of appellate decisions dealing with these issues. As Texas courts start to grapple with these claims, however, they are reexamining the rights of and duties of majority owners of private companies. This paper therefore includes an examination of various business entities that exist in Texas, and legal issues typically presented when claims are made by a disgruntled minority shareholders in close corporations, privately held corporations, and LLCs. The rights of limited partners will also be addressed, although the term “minority shareholders” is used in the article to refer globally to minority stakeholders in Texas private companies without regard to the specific, actual business entity that is at issue.

B. SCOPE OF ARTICLE

This article considers the legal claim for “minority shareholder oppression,” a relatively recent judicial construct in Texas and other jurisdictions, which is still evolving. Courts have referred to this claim in providing relief to holders of minority interests in privately-held entities from the improper exercise of control by majority owners, but the Texas Supreme Court has not yet recognized minority shareholder oppression as a distinct or separate cause of action.

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

² For the purposes of this article, the assumption is made that the minority owner does not have a shareholders 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.

Several appellate courts in Texas have granted relief to minority shareholders challenging the improper exercise of majority control in two forms: when majority owners engage in conduct that substantially frustrates the reasonable expectations of the minority shareholder³; and “bad behavior” by the majority owners that offends the court’s notions of fair play and violates the fiduciary responsibilities of the majority owners.⁴

Shareholder oppression seems to occur, at least at times, because those who have power and control in a private company often find it difficult to abide by their statutory, contract and common law duties to minority owners of the company. As an introductory matter, this article provides an overview of governance of private corporations, close corporations, limited liability corporations and limited partnerships with the focus on management actions, omissions and decisions that can be the catalyst for claims of oppression by minority stakeholders. The article analyzes litigation issues that face a minority shareholder or a limited partner who does not have a contract that authorizes a buy-out or a redemption of its interest. The paper also offers some suggested guidelines for protecting the business entity – and minority investors – through procedures adopted upon formation, which should help to avoid later disputes.

Finally, the article concludes with a look at recent case law and developments related to minority shareholder issues in private companies. Special attention is given to cases outside Texas that may forecast the direction in which the Texas doctrine of minority shareholder oppression is headed as the case law develops.

C. STRUCTURAL AND ECONOMIC FACTORS THAT FOSTER CLAIMS OF MINORITY SHAREHOLDER OPPRESSION

The “minority shareholder oppression” scenario arises uniquely in the context of the private business structure, including the close corporation. An investor in a large, publicly-held corporation can certainly feel oppressed, *i.e.*, that his investment goals are being thwarted by the management’s operation of the company or that management has engaged in “bad acts.” The “blue chip” investor has a ready exit available, however, because his shares may always be sold

³ “Oppression 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.” *Davis v. Sheerin*, 754 S.W.2d 375, 381-82 (Tex.App.–Houston ([1st Dist.] 1988, writ denied).

⁴ Oppression can be manifested as “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 play on which every shareholder who entrusts his money to a company is entitled to rely.” *Id.* At 382.

in the open market.⁵ The owner of stock in a closely held company lacks this option, however, because typically there is no market for the shares of a close corporation. Moreover, in many close corporations, a shareholder's agreement includes restrictions on the stock's sale or transfer by the minority shareholder. The non-marketable nature of an investment in a close corporation makes it possible for a controlling shareholder to "squeeze out" the minority shareholder from any role in the company's management or daily operations, while also "freezing out" the ability of the minority owner to cash out on his or its investment in the company.

As noted earlier, the downturn in the economy in the past few years has largely removed opportunities to resolve shareholder disputes in private companies through a buy-out. Initial Public Offerings and mergers, once so plentiful in the boom economy, have become somewhat more frequent, but they still are well below the pace of the mid to late 1990's. As a result, many investors/owners in private, or closely-held businesses, who lack control over those companies, have been frustrated by a structural and economic inability to monetize their investments. In the wake of this frustration and absence of express legal authority, these investors are turning to the courts to seek relief from the oppression they have experienced by the controlling majority.

II. THE IMPACT OF CORPORATE GOVERNANCE ON POTENTIAL MINORITY SHAREHOLDER CLAIMS

A. TEXAS STATUTORY OVERLAY

1. Texas Business Corporations Act

Texas statutes do not provide a remedy for minority shareholders in private companies who allege oppression except in extreme circumstances. Article 5.14(L), of the Texas Business Corporations Act ("TBCA"), does authorize a direct action by a shareholder against a corporation for the shareholder's own benefit in a closely held company. Although the TBCA allows the minority shareholder to bring a claim directly against the company rather than through a procedure-laden derivative suit in closely held company, the statute does not expressly provide an oppressed minority shareholder with the right to redeem their shares based on oppression by the majority owners. In short, the statute does not provide a simple mechanism to a frustrated minority shareholder to redeem his shares if he cannot receive the benefit of his investment because of oppressive actions by the majority owners who control the company.

There is a statutory hammer, however, that judges have used to chip away at the business judgment rule and to craft a remedy for oppressed minority shareholders. Articles 7.05 and 7.06, of the TBCA, do authorize courts to appoint a receiver or to liquidate the company as remedies for "illegal, oppressive, or fraudulent" conduct by "directors or those in control." (emphasis

⁵The 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.

added) The landmark Texas case in this area, *Davis v. Sheerin*⁶ (discussed later in depth in this article), relies on the language of 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 interest in the corporation, (ii) findings that the majority wasted corporate funds and received dividends that were withheld from the plaintiff, and (iii) undisputed evidence that the plaintiff would be denied any future voice in the corporation's management.

2. Texas Revised Limited Partnership Act

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.⁷ 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.

3. 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

⁶ 754 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.

⁷ *Susman v. Venture*, 114 Ill.App. 3d 668, 70 Ill. Dec. 268, 449 N.E.2d 143 (1982).

Revised Limited Partnership Act.” An LLC, then, would likely enjoy the statutory benefits typically awarded to both corporations and partnerships.

The negative implication of these powers is that a court would likely view an oppressed minority member of an LLC in much the same light as an oppressed shareholder or an oppressed limited partner. In other words, relief would be available to a member under the LLC Act only in the same type of extreme circumstances as required by the TBCA and TRLPA. 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, or alternatively “less-harsh”⁸ remedies, to protect an LLC member with a minority ownership interest who was being oppressed by the members holding a majority interest in the organization.

B. ADDITIONAL FACTORS ADDRESSED BY THE COURTS

1. 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

⁸ *Davis*, 754 S.W.2d at 380.

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).

While *Davis v. Sheerin* certainly did not overturn the business judgment rule, the Texas minority shareholder oppression doctrine contains elements that conflict to 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 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.

2. Fiduciary Duties Imposed on Majority Owners for the Benefit of the Minority Owners

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

The doctrine of minority shareholder oppression in Texas, however, makes an exception to this precedent, because breaches of fiduciary duties the majority owners owe directly to the minority shareholders are considered grounds for a judicial finding of oppression. In *Duncan v.*

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).

*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.

III. DEFINING THE CAUSE OF ACTION FOR MINORITY SHAREHOLDER OPPRESSION

A. WRONGS COMMONLY SUFFERED BY THE MINORITY OWNER

As previously noted, a minority shareholder, limited partner, or LLC member without a contractual buy-out right may have little hope of monetizing (liquidating) his investment (even a substantial investment) for its fair value before the majority decides to sell the business or enter a merger that requires unanimous consent of all shareholders. Majority owner(s) can – and have – deprived minority owners of any say in management, discharged the minority from any position with the company, suppressed dividends, and effectively denied the minority any return on its investment.

This article mentions two distinct avenues for relief by shareholders or minority interest owners who conclude that their ownership rights are being oppressed by the majority. In Texas,

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).

case law supports claims by minority owners for breach of fiduciary duty against the majority owners. There is also a line of cases, primarily outside Texas, that fleshes out the statutory right to secure judicially ordered dissolution as an extreme remedy for oppression.²² Cases arising in other jurisdictions, including West Virginia, North Dakota and New Jersey, also support claims for statutorily authorized judicial dissolution, which expand the range of remedies available for shareholder oppression to include receivership, forced buyout, dividend, reduction of excessive management salaries and injunction against further oppressive acts.²³

It is typical to find one or more of the following freeze-out techniques in cases where minority shareholder oppression has been alleged:

- Termination of the minority interest owner's employment with the company;
- Retention of dividends/earnings by the company, *i.e.*, payment of salaries and benefits to the majority owners rather than dividends shared by minority owners;
- Removal of the minority shareholder from management and from the opportunity to participate in corporate decision-making;
- Denial of access by the minority shareholder to financial and business information regarding the company's activities and operations.

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.”²⁴

²² See *Davis v. Sheerin*, *supra*, 754 S.W.2d at 382-83.

²³ See *Masinter v. Webco Co.*, 262 S.E.2d 433 (W.Va. 1980) (listing ten possible forms of relief for oppressive conduct); *Balvik v. Sylvester*, 411 N.W.2d 383 (N.D. 1987) (listing alternatives to dissolution such as receivership, buyout, and forced dividends); and *Brenner v. Berkowitz*, 634 A.2d 1019 (N.J. 1993) (noting that courts have a wide variety of equitable remedies available to address shareholder oppression situations). *But cf. Giannotti v. Hamway*, 387 S.E.2d 725 (Va. 1990) (which calls dissolution the exclusive remedy for oppression).

²⁴ *Davis v. Sheerin*, *supra*, 754 S.W.2d at 380.

B. PARAMETERS OF OPPRESSIVE CONDUCT BY MAJORITY OWNERS TOWARD MINORITY SHAREHOLDERS UNDER TEXAS LAW

1. *Davis v. Sheerin* Validates the Claim

Davis v. Sheerin, decided in 1988, is regarded as a landmark, modern-day decision that established a minority shareholder's claim for oppression. The TBCA fails to define oppressive conduct²⁵ by majority shareholders, and *Davis v. Sheerin* and its progeny are the best source for defining the term although, again, it has not been recognized as a separate cause of action by the Texas Supreme Court. The *Davis* court did indicate, however, that oppressive conduct was an independent ground for relief – not necessitating any showing of fraud, illegality, deadlock, mismanagement, or wasting of assets. A substantial first attempt was therefore made by the *Davis* court to interpret the term “oppressive conduct” and to define the cause of action for minority oppression.

In *Davis*, a 45% minority shareholder brought suit individually and for the corporation against William Davis and Catherine Davis, alleging oppressive conduct and breach of fiduciary duty.²⁶ All parties were corporate officers and directors, with the plaintiff serving as president of the company and an employee running its daily operations. Over time, the relationship between the Davises and Sheerin deteriorated, to the point that Sheerin was denied access to the corporate books and records and was told he no longer had any ownership interest in the corporation.

The *Davis* court observed that “[o]ppressive conduct has been described as an expansive term that is used to cover a multitude of situations dealing with improper conduct, and, therefore, a narrow definition would be inappropriate.”²⁷ Consequently, the court continued, “[c]ourts may determine, according to the facts of the particular case, whether the acts complained of serve to frustrate the legitimate expectations of minority shareholders, or whether the acts are of such severity as to warrant the requested relief.”²⁸ The majority's actions in *Davis* – a willful conspiracy to deprive the plaintiff of his interest in the corporation, receipt of informal dividends through profit sharing contributions denied to the plaintiff, and wasting of corporate funds by paying for legal fees – were deemed to be oppressive because “[a]ppellant's conduct not only

²⁵ Texas Business Corporations Act, Articles 7.05 and 7.06.

²⁶ *Davis v. Sheerin*, *supra*, 754 S.W.2d at 377.

²⁷ *Id.* At 381 (citing *McCauley v. Tom McCauley & Son, Inc.*, 104 N.M. 523, 724 P.2d 232 (Ct. App. 1986).

²⁸ *Id.*

would substantially defeat any reasonable expectations appellee may have had . . . but would totally extinguish any such expectations.”²⁹

2. *Willis v. Bydalek* Establishes a Balance

Not every “bad act” by the majority owners, however, is considered oppressive. The Court of Appeals in Houston (1st Dist.) considered a shareholder oppression claim in *Willis v. Bydalek*³⁰ 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 any shareholders – minority or majority).³¹ 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.³² 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.”³³

C. JUDICIALLY-FASHIONED REMEDIES FOR MINORITY SHAREHOLDER OPPRESSION

1. Buyout For Fair Value of Minority Interest

Other than dissolution or receivership, the Texas statutes are silent as to other remedies for shareholder oppression. As a result, Texas courts have fashioned a varied range of solutions in efforts to provide a remedy for legitimately aggrieved minority shareholders after they have established oppression committed by the majority owners.

In *Davis v. Sheerin*, the court examined the majority’s conduct of denying the minority any voice in the corporation, and determined that an award of damages or injunctive remedies

²⁹ *Id.* at 382 (citing *In re Wiedy’s Furniture Clearance Center Co.* 108 A.D.2d 81, 487 NY.S.2d 901 (1985)).

³⁰ *Willis v. Bydalek*, 997 S.W.2d 798 (Tex.App.–Houston [1st Dist.] 1999, pet. denied).

³¹ *Id.* at 802.

³² *Id.*

³³ *Id.* at 801 (citing *McCauley*, 724 P.2d at 237).

were not adequate to fully protect the minority owner's interests and rights in the corporation.³⁴ The court opined that "[a]n ordered 'buy-out' of stock at fair value is an especially appropriate remedy in a closely-held corporation, where the oppressive acts of the majority are an attempt to 'squeeze out' the minority, who do not have a ready market for the corporation's shares, but are at the mercy of the majority."³⁵ The court concluded that "Texas courts, under their general equity power, may decree a 'buy-out' in an appropriate case where less harsh remedies are inadequate to protect the rights of the parties."³⁶

2. Reimbursement of Investment

The Fort Worth appellate court in *Duncan v. Lichtenberger* ordered that the minority shareholder plaintiffs be reimbursed all of the funds that they had paid to the corporation to acquire their stock.³⁷ The *Duncan* court noted that "[t]he remedy chosen by the appellees in the present case was the restoration of the monies conveyed to Duncan for their shares of stock"³⁸ This reimbursement of funds, while not contemplated in the Texas statutes, also seems to be a judicially accepted alternative to dissolution when oppression is determined.

3. Injunctive Relief

In a Texas Supreme Court case predating *Davis v. Sheerin* by several decades, *Patton v. Nicholas*³⁹, the Court also provided indications of the types of relief that trial courts are authorized to grant when receivership or liquidation is too extreme a remedy. In *Patton*, the trial court held that the majority holder of a close corporation had wrongfully dominated the board and prevented declaration of dividends. The trial court therefore issued a mandatory injunction that required the corporation to pay a reasonable dividend immediately and to continue paying substantial dividends in future years.⁴⁰ Dividends have been ordered in other jurisdictions as well as forms of injunctive remedy intended to redress majority oppression.⁴¹

³⁴ *Davis v. Sheerin*, *supra*, 754 S.W.2d at 383.

³⁵ *Id.* at 380.

³⁶ *Id.*

³⁷ *Duncan v. Lichtenberger*, *supra*, 671 S.W.2d at 953.

³⁸ *Id.*

³⁹ *Supra*, 279 S.W.2d 848.

⁴⁰ *Id.* at 857.

⁴¹ See, e.g. *Naito v. Naito*, 35 P.3d 1068, 1080 (Or. Ct. App. 2001) (in which the court ordered dividends to be paid from a corporation with over \$5 million in retained earnings after noting that "the corporation did not contemplate any new ventures that would call for extraordinary resources").

IV. PRACTICAL SUGGESTIONS TO AVOID SHAREHOLDER OPPRESSION CLAIMS

A. MEASURES TO CONSIDER IN FORMING BUSINESS ENTITY

When forming a close corporation, limited partnership or LLC in Texas, it is helpful to begin with the final objective in mind. Thoughtful planning during the formation stages can protect the entity from eventual oppression claims. Practical start-up suggestions for avoiding a minority shareholder oppression lawsuit include the drafting and inclusion of:

- **BUY-SELL AGREEMENT**

Create a redemption right in the Shareholder Agreement (or include a Buyout Requirement in the Partnership Agreement). A comprehensive buy-sell agreement will provide shareholders the opportunity to have their stock bought back by the corporation under specific circumstances. A formula must be included to determine the fair value of the stock at the time of redemption, either by independent experts or mutual appraisals. One effective, but more controversial form of redemption clause is the “Shotgun Buy-Sell.” A minority shareholder can trigger this mechanism by making an offer to the other shareholders to sell all his shares at a specific price per share, or to buy all of the majority’s shares at the same price per share. This forces a consolidation of the shares into the hands of either the majority or minority, and can be an effective way to terminate the co-shareholder relationship if irreconcilable disputes arise.

- **RIGHT OF FIRST REFUSAL**

A clause allowing a right of first refusal will give the majority the right to purchase a minority’s shares if the minority shareholder receives a bona fide offer from a third party to purchase all or part of his shares. Generally, this right contemplates that the majority can purchase the shares under the same terms and conditions that are contained in the third-party offer.

- **SURVIVORSHIP PROVISIONS**

Including a survivorship provision in the Shareholder’s Agreement can give the corporation the option to purchase any deceased minority shareholder’s shares, rather than having those shares pass automatically to the deceased’s heirs – heirs who may not have any knowledge or experience in the business and who might allege oppression claims if they are denied full access to the operations and management of the corporation, even if that denial appears justified to the majority.

- **DEFINED DIVIDEND POLICY**

If the company will not be declaring dividends, management should explain upfront the anticipated use of net revenues (if any) so as to avoid allegations that the majority is withholding distribution of profits and thereby oppressing minority shareholders.

- **EMPLOYMENT AGREEMENTS**

Compensation is often a way to distribute the profits of a close corporation, and a majority shareholder's decision to end the employment of a minority shareholder may therefore be considered oppressive.⁴² As a result, it may be advisable for the majority shareholders/managers to consider entering into employment contracts with top corporate executives for a specific term. With employment agreements in place, the contract may not be renewed at the end of the term, which lessens the thrust of a minority shareholder's claim for alleged freeze out based on a sudden termination of his employment.

B. POST-FORMATION ACTIONS BY MANAGEMENT

Even if minority shareholder oppression claims are not taken into consideration during the formation stages of a business entity, the majority still can take precautions in governing the entity to avoid the type of conduct that would support an oppression claim. Prudent practices by controlling majority shareholders include the following actions:

- **ADHERE TO BY-LAWS**

Follow the relevant statutes and operative by-laws of the entity.

- **CONDUCT REGULAR BOARD/MANAGERS MEETINGS**

Hold regular meetings, to serve as a forum to explain management decisions to the minority and to share the reasoning behind majority actions.

- **PROVIDE PERIODIC FINANCIAL REPORTING**

Issue periodic financial reports, in order to put the minority shareholders on notice of the financial situation of the corporate entity.

⁴² *But cf. Willis v. Bydalek, supra*, 997 S.W.2d at 802 (finding that the circumstances of the majority terminating the minority's at-will employment in this case did not constitute oppression).

- **ALLOW VOTING RIGHTS**

Provide all shareholders with the opportunity to vote.

- **ESTABLISH DIVIDEND POLICY**

Articulate and institute a dividend policy, if one was not included in the Shareholder's Agreement. (If the organization is an LLC, it would be wise to strongly consider issuing at least a dividend that will cover the member's tax liability, even if no other dividends are to be issued.)

- **AVOID APPEARANCES OF FIDUCIARY BREACHES**

Be sensitive in avoiding conduct that could be interpreted as self-dealing or as self-interested transactions. Policies of full disclosure, securing board approval for majority corporate actions, and ratification can all help avoid later allegations of improper acts by the majority.

- **REMOVE TRANSFER RESTRICTIONS ON STOCK**

Consider removing transfer restrictions on a minority's ability to sell his interest. Clearly, the pros and cons of this decision would have to be weighed carefully; however, it is unlikely that a court will find oppression where market-access is present.

V. SUMMARY OF CURRENT STATE OF THE LAW REGARDING MINORITY SHAREHOLDER OPPRESSION

In an economic climate in which opportunities for a merger/buyout or IPO are reduced, minority stakeholders claiming they have been oppressed have turned increasingly to the courts for relief. Therefore, the prudent legal advisor will provide guidance to majority owners at the time the entity is formed, as well as while it is being managed, in efforts to avoid or significantly limit the potential for claims by disgruntled minority stakeholders alleging oppression.

The failure by majority owners to take proper steps in forming the entity and to engage in sound post-formation practices that respect the rights of minority owners can result in a valid shareholder oppression claim that has severe consequences for the company and/or its majority owners. Courts have become less inclined to defer to the majority's business judgment upon solid proof of oppression, particularly when it is accompanied by the majority's misconduct.

It is correct that the minority shareholder oppression claim articulated in *Davis v. Sheerin* has not been adopted by the Supreme Court. It is also worthy of note that *Davis v. Sheerin* has been good law for 15 years, and there are other Texas cases that fully support the trial court's authority to provide relief to minority shareholders when oppression has been proven. The relief

afforded to minority shareholders upon proof of oppression includes ordering buyouts, forcing declaration of dividends, reinstating the discharged plaintiff, or ordering dissolution.

Future decisions by Texas courts will be critical as the doctrine of Minority Shareholder Oppression continues to take shape. If trends from other states provide any indication, the rights of the oppressed minority stakeholder may continue to be bolstered, while deference to the majority's business judgment continues to erode.

VI. READING THE TEA LEAVES: WHERE DOES THE SHAREHOLDER OPPRESSION DOCTRINE GO FROM HERE?

A. THE IMPACT OF SARBANES-OXLEY ON THOSE HOLDING OWNERSHIP INTERESTS IN PRIVATE TEXAS COMPANIES

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 frequently run amok in recent years. The distress over the recent flagrant 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.

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.

B. SUPPORT FOR *DAVIS V. SHEERIN* AND MINORITY RIGHTS

1. *Hollis v. Hill*: The Fifth Circuit Weighs In

The Fifth Circuit took the opportunity of the *Hollis v. Hill* case⁴³ to synthesize a “general” law of shareholder oppression among several jurisdictions. Although this case was decided in 2000, before Sarbanes-Oxley, it remains accepted law in the Fifth Circuit.

In *Hollis*, the alleged oppressive conduct took place in Texas, but it involved a Nevada corporation. Nevada does not have a minority shareholder oppression statute, and there are no

⁴³ 232 F.3d 460 (5th Cir. 2000).

Nevada Supreme Court decisions that lend guidance, which caused the Fifth Circuit to consider Texas law, as well as case precedent in other jurisdictions.

Hollis and Hill were each 50% shareholders, officers and employees in a corporation that marketed first-lien mortgage notes and other non-security financial products. Their wives were also both employed in the company. Hill had the more active management role, and was treated by the trial court as well as the Fifth Circuit as the “majority” shareholder. The Fifth Circuit affirmed the lower court finding of breach of fiduciary duty, based on a series of “oppressive” acts committed by Hill, “including the diminution and eventual termination of salary, the failure to deliver financial information, the closing of one of the company’s offices, termination of employment, and the cessation of benefits”⁴⁴ The appellate court recognized these were all “classic examples of acts typically shielded from judicial scrutiny under the business judgment rule”⁴⁵ – yet still affirmed that the acts, taken together, constituted a breach of fiduciary duties when perpetrated by the controlling shareholder within the context of a closely held corporation.

The Fifth Circuit affirmed the trial court’s decision in all but one major respect. The court-ordered buyout was upheld to remedy Hill’s breach of fiduciary duties toward Hollis, but the Fifth Circuit declined to adopt the valuation date the trial court had selected. Noting that “many of the actions upon which we base our finding of oppression occurred after this date,”⁴⁶ the Fifth Circuit instead declared that “the date of valuation for the court ordered buy-out should be the date suit was filed herein.”⁴⁷ The case was then remanded to the trial court to determine the proper valuation of Hollis’ shares in the company.

2. *Willis v. Donnelly*: Majority’s Oppressive Conduct and Domination of the Business Constitutes Breach of Fiduciary Duty to Minority

Akin to the corporate officers in several high-profile public companies who ran amok, the principal/majority shareholder in *Willis v. Donnelly*⁴⁸ also trampled on the rights of the oppressed minority shareholder. In a multi-claim case fraught with procedural issues, the court cited a long laundry list of oppressive activities by the majority owner harmful to the minority shareholder.

Willis, a Houston businessman, was the majority owner and principal of Urban Retreat, an upscale day spa and salon. Donnelly, a popular hairstylist in that area, was brought in to supply a salon clientele and also to manage the spa. He was offered eventual ownership in the

⁴⁴ *Id.* at 467.

⁴⁵ *Id.*

⁴⁶ *Id.* at 472.

⁴⁷ *Id.*

⁴⁸ 118 S.W.3d 10 (Tex.App.–Houston [14th Dist.] 2003).

company, a directorship, and a salary increase. A letter agreement was signed and the spa was launched. The business quickly went into debt, and was more than \$1 million under water within six weeks after its grand opening.

Willis continued to run the business in total derogation of his responsibility to Donnelly. Donnelly was eventually asked to leave and sued the principal/majority shareholder Willis and related parties. The court found that Willis “engaged in oppressive conduct and dominated control over the business.”⁴⁹ Willis had induced Donnelly to join the business with unfulfilled promises to provide capital, kept the business continually under-capitalized, allowed it to fall deeply into debt, and thereby rendered Donnelly’s shares worthless. The principal/majority owner also engaged in self-dealing transactions involving the spa’s realty, diluting the value of the shares and utilizing the business and its assets for his benefit alone. Willis also improperly transferred all the stock to his wife, ignoring Donnelly’s right of first refusal. He cut Donnelly’s salary, delayed issuance of his stock, and treated him like a non-owner. The court looked at the amassed evidence and declared that Willis “would owe a fiduciary duty to Donnelly in repurchasing his shares.”⁵⁰

C. POTENTIAL LIMITS IMPOSED ON THE MINORITY SHAREHOLDER OPPRESSION DOCTRINE

Not all cases in which oppression is alleged result in findings favorable to the minority owner. In the two cases noted below, the majority owners prevailed, and it remains to be seen whether this trend will increase, and thereby place limits on claims for minority shareholder oppression and diminish the importance of *Davis v. Sheerin*.

1. *Pinnacle Data Services, Inc. v. Gillen*: Allegations Must be Supported with Evidence

In *Pinnacle Data Services, Inc. v. Gillen*⁵¹, the Texarkana Court of Appeals considered the case after all of the plaintiff’s claims had been dismissed by the trial court on summary judgment, a combination of no evidence motion and traditional request for summary dismissal. The minority members in a Texas LLC had alleged that the majority had “committed member oppression by wrongfully withholding profit distributions, firing Max and Morris Horton from MJCM, failing to inform PDS of company actions, and paying for their personal legal fees in this lawsuit with MJCM funds.”⁵² The appellate court upheld the grant of the majority’s no-evidence

⁴⁹ *Id.* at 32.

⁵⁰ *Id.* at 33.

⁵¹ 104 S.W.3d 188 (Tex.App.–Texarkana 2003).

⁵² *Id.* at 196.

motion for summary judgment on the issue of member oppression, however, when the minority failed to produce any evidence in support of its oppression claim.

Clearly, mere allegations or recitations of oppressive conduct are not enough to support a claim – evidence of the oppression must be established. In this case, presenting better evidence of oppression (if it existed) likely would have allowed the minority to survive summary judgment regarding its member oppression claim. The types of oppression alleged by the Pinnacle Data Services minority members, if they had been proven, were precisely the types that warranted findings of oppression in other cases in which the minority was granted relief.

2. *Rudisill v. Arnold White & Durkee, P.C.*: Dissenters’ Rights Denied

In a recent case on a related subject, the Houston Court of Appeals declined to recognize the rights of minority owners/dissenters who alleged that the majority owners had acted in an oppressive manner. *See Rudisill v. Arnold White & Durkee, P.C.*⁵³

In *Rudisill*, three shareholders in a Houston law firm, Arnold White & Durkee (“AWD”) sought a declaration of their rights after their firm merged with another law firm, Howrey & Simon (“H&S”). The trial court granted summary judgment against the minority shareholders, who appealed. The appellants had voted against the proposed combination of the two law firms and declined to sign agreements making them partners in the new law firm. The case centered on the minority shareholder/dissenters’ claim that they were entitled to a “fair value” redemption of their ownership interest under the TBCA.

The dissenters based their redemption claim on their contention that AWD had been completely “subsumed”⁵⁴ into the new law firm and that the remaining shell corporation did not actually conduct any business. The court found that the TBCA does not require that any assets are retained in order for a company to remain “in business” – the court noted that “the drafters of the TBCA envisioned that a corporation could continue in business despite transferring all of its assets and receiving only cash or corporate stock in return.”⁵⁵ The firm was deemed to have remained “in business” even after the combination, and the merger therefore did not require any special authorization under art. 5.11(A)(2) of the TBCA. As a result, the three appellants were not entitled to exercise, or benefit from, dissenter’s rights of redemption.

The dissenters also contended, in the alternative, that they should be restored to their positions as shareholders and awarded their shares of any profits distributed since they resigned from AWD. The former minority-shareholders argued that article 5.13(A) of the TBCA would

⁵³See *Rudisill v. Arnold White & Durkee, P.C.* 148 S.W.3d 556 (Tex.App.-Hous. [14 Dist.] Sep 30, 2004) (NO. 14-03-00508-CV), rule 53.7(f) motion granted (Nov 17, 2004).

⁵⁴ *Id.* at 562.

⁵⁵ *Id.*

authorize them to return to shareholder status if their dissenter's rights claim was denied. The appellate court rejected this claim as well, holding that the TBCA provision would not apply because the shareholder status of the three appellants had been terminated before the dissenters' claim was made. The court placed great emphasis on the language of the AWD Redemption Agreement, which provided that the appellants' shares were considered redeemed the day that the shareholders' employment ended. The redeemed shares were deemed not to be "susceptible of revival and former shareholders [were] not entitled to reinstatement under the TBCA."⁵⁶

Rudisill demonstrates, among other things, that any judicial trend toward protecting the interests of minority shareholders may not cause a court to interfere with established procedures for corporate governance in regard to minority shareholders. The AWD Redemption Agreement, to which the shareholders had agreed, provided them with an adequate redemption and protected the company from an over-reaching attack by minority shareholders. The TBCA provisions that authorize minority shareholders to obtain relief may not apply when the majority shareholders enter into the business relationship with the documentation necessary to protect all concerned parties – minority and majority.

⁵⁶ *Id.* at 564.