Feature

BY LADD A. HIRSCH

A Way Out for MINORITY INVESTORS in Private Texas Companies

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

An investor who buys a minority stake in a private Texas company without an exit strategy in place is likely to become locked in to the investment long after he/she desires to sell out. This situation arises because unless the minority investor obtains a redemption agreement (or some other contractual exit right) at the time he/she buys the stock, he/she lacks the right to choose when he/she can later "monetize" the investment. In most cases, no market exists for the minority shareholder's stock in a private company, and there is no requirement for the company or any other investors to repurchase his/her stock. The minority shareholder is stuck hoping for a liquidity event such as a sale of the business, a merger or an initial public offering (IPO).

Fortunately, all hope is not lost for minority investors who do not obtain any type of redemption agreement. Texas statutes and case law provide minority shareholders in private companies with exit rights if they can establish that they were "oppressed" by the conduct of the majority shareholder(s). In these limited circumstances, the minority shareholder may be able to secure a court-ordered remedy that provides value for his/her ownership interest in the company.

HOPE FOR THE LOCKED IN MINORITY INVESTOR

How does a minority shareholder get sprung from the "jail" of his/her locked-in investment in a closely held (private) Texas company? This article answers that question and three other similar questions: when does a claim for minority shareholder oppression typically arise; what makes for a strong case of oppression by a minority shareholder; and what remedies are available to a minority shareholder who can show that he/she was

oppressed by the actions of the majority shareholder(s)?

As a starting point, in specific, limited circumstances, an oppressed minority shareholder has a statutory right to relief from the majority shareholder's oppressive actions. See Articles 7.05-7.06 of the Texas Business Corporation Act. Under this statute, Texas trial judges may appoint a receiver or other liquidation of the company upon a showing of "illegal, oppressive or fraudulent" conduct by the "directors or those in control." Unfortunately, these statutory remedies are seen as harsh and are disfavored by trial courts. A private company that continues to function – particularly one that is profitable – is rarely viewed as properly subject to a receivership or liquidation. Instead, a court is far more likely to issue a preliminary injunction that preserves the status quo of 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 under Texas statutes, Texas case law has developed to offer additional remedies to minority shareholders when majority shareholders engage in oppressive conduct. Courts define "oppression" in this context as conduct by the majority shareholder(s) that substantially defeats the reasonable economic expectations of the minority shareholders under circumstances that were central to the minority shareholders' decision to join the venture.

One of the key Texas cases upholding a claim for minority shareholder oppression described improper, oppressive conduct by the majority shareholder as: "burdensome, harsh and wrongful conduct, a lack of probity and fair dealing in the affairs of the company to the prejudice of some of its members, or a visible departure from the standards of fair dealing and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely."

Davis v. Sheerin, 754 S.W.2d 395 (Tex Ct. of App. – Houston [1st Dist.] 1988, writ denied). A very recent case upholding a claim for minority shareholder oppression was issued by the Dallas Court of Appeals in March 2011. *Ritchie v. Rupe*, No. 05-08-00615-CV (Tex. App.—Dallas Mar. 28, 2011), available at http://www.5thcoa.courts.state.tx.us/cgi-bin/as_web.exe?c05_11.ask+D+4938914.

WHEN DOES A CLAIM FOR MINORITY SHAREHOLDER OPPRESSION ARISE?

Most investors who make substantial investments in closely held companies in Texas are neither silent nor absent from the operations of the business. More often, they are active participants in the daily operations and governance of the company in which they invested. They also enjoy benefits from their active participation in the company, including compensation and perks. A claim for oppression therefore arises when the majority shareholder or control group exploits its power to remove those benefits in an effort to "squeeze out" or "freeze out" the minority shareholder.

The following actions reflect squeeze-out or freeze-out techniques by majority shareholders:

- denying material information to the minority shareholder;
- removing the minority shareholder from the board or as a manager, thereby removing him/her from any role in company management;
- reducing the minority shareholder's compensation (or reducing his/her bonus) or completely terminating his/her employment, thereby removing him/her from any ongoing role at the company;
- declaring large bonuses after the minority shareholder is terminated to avoid distributing any of the company's profits to him/her;
- refusing to declare dividends or distribute the company's profits;
- siphoning off profits to the majority shareholder or control group in other ways, e.g., through perks; and
- diluting the minority shareholder's interest through inequitable means.

As a final, significant act of oppression, the majority shareholder or control group may offer to buy out the minority shareholder's ownership interest for an amount that is far below the true fair value of his/her interest. This lowball offer may be made after the majority shareholder has removed the minority shareholder from the company's management and eliminated or reduced his/her compensation and benefits. The majority's tactics place the minority shareholder between a rock and a hard place. Once the freeze-out begins, the minority shareholder faces a Hobson's choice of being deprived of all or most of the value of his/her investment on a current basis, or accepting the majority shareholder's lowball buyout offer for all or most of the minority shareholder's ownership interest in the company.

A CASE STUDY: THE SOFTWARE COMPANY CO-FOUNDER

A recent case that we handled for a substantial minority shareholder provides a good example of a shareholder oppression claim. In this case, two men formed a startup computer software business in 1980 with the majority owner buying 53 percent of the stock and the minority buying 47 percent. Both parties were corporate officers as well as the only two board members, and they received virtually the same annual compensation for almost 26 years. During this 26-year time period, they retained almost all of the company's profits and accumulated approximately $150 million in retained earnings, which they invested primarily in municipal bonds.

Approximately 26 years after the two co-owners formed the company, the minority shareholder contends that the majority shareholder began to engage in a series of oppressive actions toward the minority shareholder. These oppressive actions included all of the following:

- reducing the minority shareholder's compensation by 70 percent;
- refusing to declare a large dividend requested by the minority owner;
- concealing material information from the minority shareholder about financial matters affecting the company, including an Internal Revenue Service (IRS) audit and assessment of a $1.2 million penalty for excessive retained earnings;
- engaging in self-dealing transactions such as billing personal trips to the company, selling himself a condominium owned by the company and making undisclosed charitable contributions with corporate funds; and

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Minority Investors

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- making a lowball buyout offer to the minority shareholder that included large discounts for lack of marketability and control, which would result in payment to the minority shareholder of an amount that was approximately $40 million less than the fair value of his ownership interest.

Based on these factual allegations, we asserted claims for the minority shareholder against the majority shareholder, which included shareholder oppression, malicious suppression of dividends, and fraud. As a remedy for ongoing oppression, we requested the jury to award a large mandatory dividend from the company's stockpile of accumulated earnings and to distribute these funds to the two shareholders according to their ownership percentage (53/47). More specifically, we requested the jury to award a mandatory $90 million dividend to the company's two shareholders.

In defense of these claims, the majority shareholder relied on the business judgment rule (see sidebar on page 33) and the doctrine of ratification. The majority shareholder alleged that all of his actions were based on his reasonable business judgment, and he also argued that his conduct had been later ratified by the board (which he controlled).

In response to the minority shareholder's claims, the jury agreed with the minority shareholder's claims, rejected the majority shareholder's defenses based on the business judgment rule and ratification, and concluded that the majority shareholder had used oppressive actions toward the minority shareholder. As a result, the jury awarded a mandatory dividend of $65 million at trial, which the trial court later increased to a total of $85 million (after a $5 million credit).

WHAT MAKES THIS A STRONG MINORITY SHAREHOLDER OPPRESSION CASE?

In answering this question, it is important to appreciate that the court, not the jury, ultimately decides whether the majority shareholder's actions toward the minority shareholder constituted oppression. In short, whether oppression exists is a legal question for the court, not a fact question for the jury. The jury will be asked whether certain acts of an allegedly oppressive nature took place, but the judge determines whether, in fact, the minority shareholder was oppressed. Further, once the trial judge determines that the majority shareholder's actions were oppressive, the trial court also selects the proper remedy to redress the majority shareholder's improper conduct. In the case we filed against the software company co-founder, the claim of shareholder oppression was an especially strong one for several reasons.

Evidence of Squeeze Out. The majority shareholder had admitted in a letter that the company sent to the IRS to justify retaining its earnings that there was a secret plan to "phase out" the minority shareholder from the business. Also, the severe pay cut of 70 percent that the majority shareholder imposed on the minority shareholder was never approved by the board, the minority shareholder never received a performance review, and the majority shareholder disregarded the company's compensation practice for the past 25 years.

Material Non-Disclosure. The majority shareholder secured the minority shareholder's consent to retaining millions of dollars in earnings by concealing the plan to phase him out. The minority shareholder believed he was approving investment in the company's growth when, in fact, he was acquiescing in the majority shareholder's plan to use these retained earnings to buy out the minority shareholder's ownership interest.

Refusal to Declare Dividends. The majority shareholder refused to declare any of the large dividends that the minority shareholder requested after his compensation was cut.

Lowball Buyout Offer. Finally, after cutting the minority shareholder's pay and refusing to declare dividends, the majority shareholder made what the minority shareholder considered to be a lowball offer to redeem his stock. This buyout offer sought to impose large discounts on the value of the minority shareholder's stock based on the lack of marketability and lack of control associated with the ownership of this stock. The jury found that this offer was an oppressive act because the discounts demanded by the majority shareholder were not applicable to his attempt to gain 100 percent ownership and control of all stock in the company (i.e., he was not a hypothetical or third-party buyer).

AVAILABLE REMEDIES FOR OPPRESSED MINORITY SHAREHOLDERS

Once the trial court concludes that the majority shareholder has engaged in oppressive conduct, the court has broad equitable power to right the wrong. The court can direct the majority shareholder or control group to take actions such as the following:

- reinstating the minority shareholder to the director and/or officer position from which he/she had been terminated –

Ladd A. Hirsch, is a business litigation partner with the Dallas office of Diamond McCarthy LLP, and he has extensive experience representing clients in complex business disputes and arbitration proceedings. A substantial focus of his practice is handling business divorce litigation and disputes among the owners and investors in privately held Texas companies. Ladd can be reached at LHirsch@diamondmccarthy.com.

with reinstatement of salary and benefits;

- requiring the majority shareholder to provide full disclosure of material information that was withheld from the minority shareholder;
- requiring the majority shareholder to institute a dividend policy at the company that will permit the minority shareholder to receive his/her pro rata share of all amounts distributed by the company;
- actually declaring a sizable dividend that will permit the minority shareholder to receive his/her pro rata share of the investment in the company; or
- requiring the majority shareholder to buy out of the minority's ownership interest in the company for its "fair value."

In a case of this nature, the oppressed minority shareholder most often seeks a buyout of his/her entire minority ownership interest for its fair value. Buyout statutes in a number of large, commercial states include a buyout remedy and use the term "fair value," which is critically different from a fair market value calculation. When there is a court-ordered buyout of the minority shareholder's stock for fair value based on a finding that the majority shareholder engaged in oppressive conduct, the fair value the majority shareholder is required to pay to the minority shareholder does not include discounts for lack of marketability or lack of control. By contrast, fair market value of a minority interest in a private company generally includes these discounts associated with minority ownership in closely held businesses.

THE ESCAPE HATCH IS OPEN

With apologies to Willie Nelson, babies who grow up to be minority investors in private Texas companies may be able to escape their locked-in status even if they failed to obtain a redemption agreement at the time of their investment. Specifically, minority shareholders may be able to secure a buyout of their interest in the company or other equitable relief if they can show that the majority shareholder(s) engaged in improper conduct such as self-dealing. Once a majority shareholder has acted in his/her own self-interest to harm the company, the business judgment rule is no longer a defense that will justify the business decisions. ■

BUSINESS JUDGMENT RULE

Most minority investors without a redemption agreement cannot secure a buyout when they disagree with business decisions made by the majority shareholder due to a rule of corporate law known as the business judgment rule. Under this rule, courts will not interfere with business decisions made by directors acting in good faith, with ordinary care and with no conflicts of interest. In public companies, officers and directors generally prevail when their decisions are challenged by shareholders who bring claims against them provided that the officers and directors acted in good faith (without any personal benefit or self-dealing) and they can present the court with a rational business purpose for their decisions.

This dynamic changes in closely held companies as a number of courts have held that a greater degree of judicial scrutiny is required in private companies. One Texas commentator who writes in this area argues that the deference of the business judgment rule is inappropriate when the decisions of officers and directors are challenged in closely held Texas companies. See Prof. Douglas Moll: "Shareholder Oppression in Texas Close Corporations: Majority Rule (Still) Isn't What it Used to Be," *Texas Journal of Business Law*, Vol. 43, No. 1, p. 21 (Spring 2009).

The upshot for minority investors is that an oppression claim against the majority shareholder has the best chance of defeating a business judgment rule defense when they can show that the majority shareholder engaged in misconduct, which constitutes a breach of fiduciary duty. The fiduciary duties of directors and officers under Texas law include the duty to act with loyalty (including acting in good faith), the duty of care and duty of obedience.

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