The Risky World of the Minority Shareholder

Too often, people enter into business relationships with friends and family without crafting an exit strategy. Without fail, the beginning of a new business relationship brings palpable excitement, with dreams of big business and big returns. I rarely hear anyone, who is embarking on a new business venture, discuss anything other than the great success, which awaits. After all, "we're all the best of friends;" "I've known her all of my life;" "we're family" ….

But … what if? … What if the business venture is not all rainbows and unicorns? … What if the relationship sours? … What if the person is not the kind soul you thought him to be? … What if you end up with a new owner in the company because someone died or got divorced? The unfortunate reality is that, when it comes to money, people often act much differently than they do over dinner. If that happens and if the relationship becomes unsupportable, how does one get out of the swamp?

The surest way for shareholders and owners to protect themselves is to require a shareholders' agreement (also referred to as an "owners' agreement" or a "company agreement"), including buy-sell provisions. It is commonly known that selling one's shares in a closely held corporation (a company with less than 35 owners, which is <u>not</u> publicly traded) is often difficult, if not impossible. The shareholders' agreement provides a road map for getting around obstacles which necessarily arise in business relationships and identifies a path for exiting the relationship, which typically includes a process for buying out an owner's interest. And, as long as everyone gets along, no one will think about, look at, or (heaven forbid) read the shareholder's agreement. But, if the relationship sours, each of the owners will immediately run to their respective desks (where their copy of the operating agreement likely has sat since the day it was signed), pull out the wrinkled document, blow off the dust, and begin to read … because this document holds answers.

As a minority owner in a closely held company, one wants the protection of a buy-sell agreement. Too often, minority shareholders find themselves at the whim of the majority owners, who run the company at their discretion, make determinations regarding compensation for workers (which may include both the majority owner and the minority owner), and decide when and how much cash will be distributed to the owners. In this situation, the shareholders' agreement will often provide direction on management, meetings, compensation, distributions, and buy-out and should work to avoid freeze outs or squeeze outs. But, what if a minority owner does not have a shareholder's agreement?

For more than 25 years, *Davis v. Sheerin*[1] was the prevailing law on minority oppression in Texas and provided some protections to minority owners. *Davis* held that minority shareholders in closely held corporations were entitled to a buy-out of their shares if they were "oppressed" (singled out and treated badly) by the majority shareholders. The *Davis* opinion recognized that minority shareholders in closely held corporations are particularly vulnerable to oppression and cannot freely obtain a buy-out of their interest in the company. For more than 25 years, that was the law ….

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

On June 20, 2014, the Texas Supreme Court in *Ritchie v. Rupe*[2] finally addressed the issue of minority shareholder "oppression", and in a 6-3 opinion, the Court declined to recognize a common law cause of action for shareholder oppression and concluded that the only *statutory* remedy for "oppressive" actions is a receivership. *Ritchie* involved a dispute between majority shareholders and a minority shareholder in a closely held corporation, which did not have a shareholder's agreement. At trial, the jury found in the minority owner's favor and valued the stock at $7.3 million. Then, the trial court, under its equity power, ordered the company to purchase the minority owner's stock for $7.3 million dollars in a forced buy-out. The appellate court, based on the longstanding law in *Davis,* upheld the trial court's order requiring the company to purchase the minority owner's shares, but remanded the case to the trial court for a new determination of the shares' fair value.

The majority owners appealed the case to the Texas Supreme Court, which reversed the appellate court, holding that:

- "oppressive" actions occur when directors or managers of a company abuse their authority over the corporation with the intent to harm the interests of one or more of the shareholders, in a manner that does not comport with the honest exercise of their business judgment, and by doing so, create a serious risk of harm to the corporation;
- no common law cause of action for shareholder oppression exists in Texas -- the Texas Supreme Court has *never* recognized a common law cause of action for oppression and the Court refuses to do so here;
- the only claim for shareholder oppression is found in the TEXAS BUSINESS ORGANIZATIONS CODE and it does not provide a "buy-out" remedy;
- no *formal* fiduciary duty is owed by majority shareholders to minority shareholders, but an *informal* fiduciary duty may arise based on a relationship of trust and confidence between the shareholders (a position which it reinforced one week later in *Cardiac Perfusion Services, Inc. v. Hughes*[3]).[4]

Amazingly, after spending 20 pages analyzing the "oppression" issue, the Texas Supreme Court seemingly gave up. Rather than continue along the logical line it was following, the Court refused to rule on whether a "buy-out" is a viable remedy for a breach of an informal fiduciary duty claim by a shareholder:

> Thus, if the court of appeals concludes that Rupe may recover on her "breach-of-fiduciary-duty" claim and that the buyout order is available as a remedy, it will need to remand the case to the trial court for a redetermination of the value of Rupe's shares

[2] *Ritchie v. Rupe,* 443 S.W.3d 856 (Tex. 2014).

[3] *Cardiac Perfusion Servs.. v. Hughes,* 436 S.W.3d 790 (Tex. 2014).

[4] The Court's ruling in *Ritchie* has been criticized by some commentators (and the Dissent) as bad law and bad policy. This writer believes that the Court strictly construed the statute and, based on a plain reading of the statute's language, the Court came to the correct conclusion. The Court should be applauded for avoiding the desire to legislate from the bench. Notwithstanding, it would seem that policy demands an "oppression" claim and a related "buy-out" remedy, and the Texas Legislature should take on the mantle of revamping the statutory scheme.

> and whether the buyout is equitable in light of the newly determined value and the impact that a buyout at that price will have on [the company] and its other shareholders.[5]

After side-stepping the "buy out" issue, the Texas Supreme Court seemingly took another step towards invalidating the remedy in *Cardiac Perfusion.* In that case, the Court held that:

> Texas law does not authorize the buy-out order as a remedy. In *Ritchie,* we clarified that a claim for shareholder oppression is only available under section 11.404 of the Texas Business Organizations Code, and that the only remedy available under that statute is a rehabilitative receivership. … Because a buy-out order is not available under a common-law claim for shareholder oppression or under the receivership statute, and because no alternative claim supports the trial court buy-out order, we reverse that part of the trial court's judgment.[6]

While one might infer from this excerpt that the Court is invalidating the buy-out remedy, a careful reading reveals that the remedy still has a faint heartbeat. That is, a claim for a breach of an informal fiduciary duty (as discussed in *Ritchie*) may still yield a buy-out under the court's equitable powers.

In summary, *Ritchie* conclusively holds that majority shareholders cannot be liable for oppression against minority shareholders unless their conduct is irrational and harmful to the corporation as a whole. The decision may set the stage for abusive conduct toward minority shareholders, who did not have the foresight to protect themselves through a shareholders' agreement. We agree with the *Ritchie* Court, which noted that a shareholders' agreement, including buy-sell provisions, is a more "ideal" way of deciding shareholder disputes as opposed to litigation. While there are no guaranties against a lawsuit, such an agreement is the surest way for a minority shareholder to protect himself or herself from abuse by majority shareholders.

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[5] The Court's seemed to show patent weakness in refusing to rule on whether the "buy out" remedy was available under common law. Effectively, the Supreme Court instructed the appellate court to rule on the viability of the remedy, and then, reserved the right to determine whether the appellate court was right in its decision. However, it wasted little time in addressing the issue in Cardiac Perfusion.

[6] *Cardiac Perfusion,* at 792.