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Texas High Court Changes Shareholder Dispute Landscape

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On June 20, 2014, the Texas Supreme Court issued an important decision in Ritchie v. Rupe, Cause No. 11-0447, defining the rights and remedies of minority shareholders of Texas businesses. In Rupe, the Supreme Court substantially limited the circumstances under which minority shareholders can invoke the doctrine of minority oppression by (1) narrowly construing the definition of what constitutes "oppression"; (2) refusing to recognize a statutory right to an equitable buyout of a minority shareholder's interest; and (3) refusing to recognize any common law cause of action for minority oppression.

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In light of this new decision, the legal landscape in disputes among shareholders of closely held businesses is substantially different. While it is far too early to determine Rupe's long-term impact on Texas businesses, there is no question that investors need to pay closer attention to their prospective contractual rights when buying a minority interest in a business and carefully evaluate their potential remedies before undertaking costly litigation against other shareholders.

Freeze-Outs and Squeeze-Outs: The Risks of Minority Oppression

Minority shareholders of closely held businesses are uniquely vulnerable to being taken advantage of by majority shareholders. Generally, closely held businesses are governed by a board of directors or by managing members, and the right to control management of the company is directly proportional to the number of shares owned by the investor. Unquestionably, the value of a majority stake in a business is the right to control the company. In comparison, a minority shareholder's ability to recover a return on investment is often tied to a right to employment and a salary. This arrangement is subject to abuse.

For example, majority shareholders may engage in tactics designed to "freeze out" a minority owner by terminating employment and cutting off salary, limiting any right to access the company's books and records, refusing to pay dividends, and voting to use corporate funds that indirectly benefit the majority shareholders through higher salaries or bonuses.

Locked out of the company and with limited access to information, minority shareholders often simply want to sell their shares and exit the business. This opens the door to a "squeeze-out," where majority shareholders will seek to acquire the minority shareholder's interest for a fraction of their true value.

This is possible because interests in private, closely held companies are not freely marketable and are subject to substantial valuation discounts.

Majority shareholders can enhance these obstacles by refusing to meet with potential buyers, refusing to approve new shareholders, manipulating the share price and otherwise preventing the minority shareholder from leaving the business without accepting a substantial discount on the sale of their shares.

A freeze-out is often undertaken for the sole purpose of executing a squeeze-out. This "one-two punch" is a tactic most other business owners in Texas never have to face. Partners in a Texas partnership have the statutory right to withdraw from the partnership and receive either their share of the proceeds if the remaining partners terminate the partnership or a fair value buyout of their shares if the remaining partners continue the partnership. Shareholders of public companies never face this risk because they can exit the company at any time and sell their shares without an arbitrary discount because of the availability of a market.

The unfortunate combination of lack of control, lack of marketability, and lack of a statutory right to exit the business means that minority shareholders of closely held companies are uniquely at risk. In light of these circumstances, most states recognize either a statutory or common law claim for minority shareholder oppression. The vast majority of Texas intermediary courts that have analyzed the issue have likewise recognized such a claim. In Rupe, however, the Texas Supreme Court substantially limited any statutory basis for such a claim and held that no such cause of action exists under Texas common law.

The Supreme Court's Holding in Rupe

The Texas Business and Organizations Code grants district court judges the authority to appoint a receiver to rehabilitate a business when, amongst other things, “the acts of the directors or those in control of the corporation are illegal, oppressive or fraudulent.” However, the statute permits such an appointment only when all other available remedies, either at law or in equity, are ruled inadequate.

Prior to Rupe, a majority of Texas appellate courts interpreted this language to authorize a lesser remedy of a “buyout.” This remedy required the corporation to purchase the minority shareholder’s interest for fair value, applying discounts for lack of marketability and lack of control, although some courts held that these discounts would not apply when the minority shareholder had no desire to leave the corporation and was being forced to relinquish her ownership position by the oppressive conduct of the majority.

These courts applied the buyout remedy in cases of “oppression,” which was defined to mean situations where majority either (1) engaged in conduct that substantially defeated the minority’s objectively reasonable expectations that were central to the minority’s decision to join the venture, or (2) engaged in conduct that was burdensome, harsh, or wrongful and which reflected a visible departure from the standards of fair dealing and fair play.

In Rupe, the Supreme Court rejected both of these principles. First, the court concluded that the receivership statute did not create any remedies other than appointment of a receiver. Thus, the court interpreted the statute’s reference to “other remedies” to mean those remedies that are available under existing common law causes of action, not remedies that could be imported into the statute and enforced in the context of “oppression.”

After limiting the statute to the remedy of a receivership, the court rejected the broad definitions of "oppression" previously recognized and concluded that a statutory claim for oppression only exists when: (1) the majority shareholders abuse their authority over the corporation with the intent to harm the interests of one or more of the shareholders; (2) in a manner that does not comport with the honest exercise of their business judgment; and (3) by doing so creates a serious risk of harm to the corporation.

After concluding that there was only a narrow statutory claim for minority oppression, the Supreme Court next refused to recognize any common law basis for such a claim, holding that existing remedies were sufficient to protect the interests of minority shareholders.

While it is perhaps too early to evaluate the court's ultimate claim regarding the sufficiency of other common law remedies, it is important to note that even the majority recognized that its decision would leave a "gap in the protection that the law affords to individual minority shareholders. ..." This gap is unlikely to be filled by the statutory cause of action recognized by the court because of the enormous difficulty in overcoming the presumptions of the business judgment rule and the fact that minority oppression can often be orchestrated in such a manner that the corporation is actually benefited through reclaiming shares for what would otherwise be less than fair value.

While one's position regarding the validity of the court's analysis in Rupe likely turns on the number of shares they own, it is undeniable that the Supreme Court has emphatically rejected any broad claims for minority oppression under Texas law. Consequently, minority investors, and their legal counsel, must carefully analyze the other options that might be available.

Potential Options for Minority Shareholders in Texas

The court's decision in Rupe certainly narrows the options for minority shareholders, but it does not leave them completely empty-handed. In light of the court's decision, minority shareholders and potential investors looking to acquire a minority interest in a business must take stock of their position and consider what, if any, remedies might fit their situation. For example, minority shareholders should consider the practicalities of contracting for greater rights.

Generally, minority shareholders find themselves in situation with limited options because they invest in closely held companies that do not have an operating agreement. In Rupe, the court broadly recognized the parties' right to negotiate contractual remedies under an operating agreement, including the right to incorporate remedies similar to a partner's statutory right to exit a business.

Other contractual rights that can be negotiated as part of an operating agreement include buy-sell agreements, rights of first refusal and redemption provisions, each of which can be tied to an arbitration provision allowing for prompt resolution of any disagreement. Moreover, even in the absence of an operating agreement, minority shareholders can negotiate specific contractual remedies that will protect their interests.

If a minority shareholder is investing in a business under the assumption that their investment will be recouped primarily through a salary, then they should negotiate an agreement limiting the corporation's right to terminate the minority shareholder except for cause. A minority shareholder's best safeguard against oppression is foresight.

Second, minority shareholders may have other statutory and common law rights available to them. The Texas Business and Organizations Code contains several provisions that are unique to closely held companies, including the right to institute proceedings to enforce contractual rights, appoint a provisional director, or appoint a custodian.

The Texas Business and Organizations Code also grants shareholders of a closely held company the right to bring a derivative action without many of the procedural hoops required of larger companies and, when justice requires, they may bring such an action directly and for their own benefit. Minority shareholders may also have common law remedies available to them, including claims for an accounting, breach of fiduciary duty, breach of contract, fraud and constructive fraud, conversion, fraudulent transfer, conspiracy, unjust enrichment, and quantum meruit. While these claims have limitations not found by a common law cause of action for minority oppression, they do provide some avenue to protect minority rights.

Third, minority shareholders who can satisfy the more onerous definition of “oppression” adopted by the Supreme Court may seek a rehabilitative receiver and request that the district court authorize the receiver to implement a buyout remedy. Generally, rehabilitative receivers only have the powers and duties that are stated in the order appointing them. Thus, an order granting a receiver the right to implement a buyout remedy might indirectly provide for a recovery that the statute does not provide for directly.

However, such an order would be proper only when necessary to avoid damage to an interested party and to conserve the property and ongoing business of the entity. Moreover, the minority shareholder seeking this remedy would need to establish it would not hurt the company because the receiver’s authority is tied to the best interest of the enterprise, not the owners.

Fourth, minority shareholders may be able to seek equitable remedies, including the equitable remedy of a buyout, in connection with other recognized common law claims, such as breach of fiduciary duty. While this right and remedy will obviously be dictated by the facts of any given case, the overall availability of this option is likely limited given the Supreme Court’s refusal in Rupe to recognize any duty owing directly to individual shareholders, meaning such claims must be brought derivatively or in circumstances where an informal relationship of trust and confidence might exist.

Finally, any long-term or comprehensive solution to fill the “gap” left by Rupe will likely necessitate a legislative solution. The court’s conclusions were based on its interpretation of the existing statute and the language selected by the Texas Legislature. If existing statutory and common law remedies are ultimately found to be insufficient, the Legislature might need to amend the Texas Business and Organizations Code to broaden the definition of “oppression” and/or to provide a statutory right to a buyout similar to those in the partnership context.

For example, the Model Business Corporations Act includes provisions relating to closely held companies that grant buyout right in cases of minority oppression. Other states, such as Illinois, have followed this approach. A democratic solution through the Legislature would give all stakeholders a say in the process and could ultimately lead to a more secure and definitive solution to the problem of minority oppression.

In the meantime, Rupe has made clear that minority shareholders are now primarily responsible for crafting their own redress for oppressive majority conduct by negotiating explicit buyout procedures and other contractual remedies as part of their agreement to invest. Investors would be well served to

consult legal counsel about the risks of making an investment and to negotiate additional contractual protections should the relationship sour.

No one invests money in an enterprise with the expectation that they will get into a dispute with the other owners. Those with the forethought to protect their interests on the front end, however, may find they have substantially more options should a dispute arise than their fellow investors who entered such relationships with little more than the dream of success.

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