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Litigating Minority Shareholder Rights

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Introduction

- Everything is always rosy when business owners start a business.
- They are good friends or family members and trust each other.
- They never think that the other could do anything to hurt them or their business.



Introduction

- Unfortunately, it is all too common for closely held businesses to break up, and that break up can be very painful.
- Minority shareholders are often mistreated and excluded from management decisions.
- They and their attorneys need to know their rights.



Areas Of Discussion

- The areas we will discuss are:
- Shareholder oppression claims;
- Minority shareholder rights;
- Fiduciary duties; and
- Attorney representation issues.

Shareholder Oppression



Shareholder Oppression

- Typically, shareholder oppression involves a majority shareholder or shareholders taking actions to oppress or disenfranchise minority shareholders in some way.
- This may include: terminating the minority shareholder as an employee and ending compensation, failing to disclose company information, refusing to allow minority shareholder to make management decisions, refusing to make distributions or dividends, refusing to buy back a minority shareholder's interests and locking them in or trapping them, offering less than fair value for the interests, refusing to let the minority shareholder transfer his or her interests, taking actions that devalue the interests, etc.

Shareholder Oppression Claim

- Many Texas intermediate courts of appeals held that majority owners owed duties to minority shareholders, and that there was a claim for shareholder oppression that required a majority shareholder to buy-out a minority shareholder at a fair price.
- In *Ritchie v. Rupe*, however, the Texas Supreme Court held that there was no such claim in Texas. 443 S.W.3d 856 (Tex. 2014).
- Texas is in the minority of jurisdictions on this issue.

Shareholder Oppression Claim

- In *Ritchie*, the Court held that Texas had a receivership statute that expressly allowed a party to seek and obtain a rehabilitative receivership when there was shareholder oppression.
- The Court held that the receivership statute did not provide authority for any other remedies: “The statute does not create a cause of action for unspecified lesser remedies that are not otherwise available under the law; the only cause of action the statute creates is for receivership.” *Id.* at 875.

Shareholder Oppression Claim

- The Court held that there were other means and remedies available for oppressive conduct but acknowledged that there was a gap in protection: “We recognize that our conclusion leaves a ‘gap’ in the protection that the law affords to individual minority shareholders, and we acknowledge that we could fill the gap by imposing a common-law duty on directors in closely held corporations not to take oppressive actions against an individual shareholder even if doing so is in the best interest of the corporation.” *Id.*

Shareholder Rights



Contractual Rights

- The first place to look for a minority shareholder's rights is the entity's formation documents: articles of incorporation, bylaws, and shareholder agreements.
- In *Richie*, the Texas Supreme Court stated: "Shareholders of closely-held corporations may address and resolve such difficulties by entering into shareholder agreements that contain buy-sell, first refusal, or redemption provisions that reflect their mutual expectations and agreements."
- These may set out buy-out rights that require fair compensation, redemption rights for fair compensation, employment rights, dissolution rights, etc.

Contractual Rights

- Where the documents are unambiguous, the parties must follow the rights and procedures outlined in the document.
- Where a party fails to properly initiate a buy-out right under the document, it does not have such a right.
- If the agreement is ambiguous, a party may be entitled to a jury trial on the intent of the parties.

Rights Regarding Stock

- An owner's rights regarding stock ownership generally involve the right to vote unless the stock is a class that does not allow voting.
- An owner generally has no preemptive rights (to acquire proportional amounts of stock) unless preemptive rights are expressly provided.
- If parties have preemptive rights, they can file suit to enforce them.
- A minority owner can have his or her interests greatly impacted by a majority approving a merger, interest exchange, conversion, and/or sale of assets, and the Code potentially may allow a shareholder to obtain "the fair value of the ownership interests" if he or she dissents and follows the procedures for same.

Right to Information

- The Code requires a corporation to maintain certain information, like books and records of accounts and the minutes of the proceedings of the owners and governing authority.
- A shareholder has a right to examine these records: “On written demand stating a proper purpose, a holder of shares of a corporation for at least six months immediately preceding the holder’s demand, or a holder of at least five percent of all of the outstanding shares of a corporation, is entitled to examine and copy, at a reasonable time, the corporation’s books, records of account, minutes, and share transfer records relating to the stated purpose. The examination may be conducted in person or through an agent, accountant, or attorney.”

Right to Information

- A corporation that refuses to allow a person to examine and make copies of account records, minutes, and share transfer records is liable to the shareholder for any cost or expense, including attorney's fees, incurred in enforcing the shareholder's rights.
- On written request of a shareholder, a corporation "shall mail to the shareholder: (1) the annual statements of the corporation for the last fiscal year that contain in reasonable detail the corporation's assets and liabilities and the results of the corporation's operations; and (2) the most recent interim statements, if any, that have been filed in a public record or other publication."

Right to Dividends

- Texas statutes generally do not dictate when directors must declare dividends or how much the dividends must be.
- Instead, those decisions fall within the discretion of a corporation's directors.
- When a corporate director violates the duty to act solely for the benefit of the corporation and refuses to declare dividends for some other, improper purpose, the director breaches fiduciary duties to the corporation, and the minority shareholders are entitled to relief, either directly to the corporation or through a derivative action.

Right to Employment

- Texas is an at-will state, and employees and employers have the right to separate.
- However, a shareholder agreement can expressly set forth employment rights, which can be the basis for a breach of contract claim.
- Further, if the firing of the minority shareholder is very detrimental to the company, there may be a breach of fiduciary duty claim for mismanagement.

Receivership Rights



Receivership Rights

- In *Richie*, the Court held that there was no shareholder oppression claim because there was a potential receivership remedy.
- Three types of receiverships: assets, rehabilitation, and liquidation.
- If the entity is a domestic entity, then the only avenue for a receivership is the Texas Business Organizations Code.
- If the entity is foreign, then a party can still use the Texas Business Organizations Code or the Texas Civil Practice or Remedies Code or Equity.

Receivership Rights

- For rehabilitation, a stock holder can file suit for a receivership for the entity's property and business if: (A) the entity is insolvent or in imminent danger of insolvency; (B) the governing persons of the entity are deadlocked in the management of the entity's affairs, the owners or members of the entity are unable to break the deadlock, and irreparable injury to the entity is being suffered or is threatened because of the deadlock; (C) *the actions of the governing persons of the entity are illegal, oppressive, or fraudulent*; (D) the property of the entity is being misapplied or wasted; or (E) with respect to a for-profit corporation, the shareholders of the entity are deadlocked in voting power and have failed, for a period of at least two years, to elect successors to the governing persons of the entity whose terms have expired or would have expired on the election and qualification of their successors.

Receivership Rights

- In *Ritchie*, the Court held that directors or managers engage in oppressive actions when they abuse their authority over the corporation with the intent to harm shareholder interests, 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 and absent such evidence.
- The Court mentioned the improper termination of the minority shareholder, the misapplication of company property, and the diversion of corporate opportunities as possible grounds.

Receivership Rights

- A court may appoint a receiver only if: (1) circumstances exist that are considered by the court to necessitate the appointment of a receiver to conserve the property and business of the domestic entity and avoid damage to interested parties; (2) all other requirements of law are complied with; and (3) the court determines that all other available legal and equitable remedies, including the appointment of a receiver for specific property of the domestic entity under Section 11.402(a), are inadequate.
- Court may turn a rehabilitative receivership into a liquidation receivership when: “the entity is in receivership and the court does not find that any plan presented before the first anniversary of the date the receiver was appointed is feasible for remedying the condition requiring appointment of the receiver.”

Fiduciary Litigation



Fiduciary Litigation

- Business divorce litigation is ripe for breach of fiduciary duty claims.
- For example, in *Cardiac Perfusion Servs. v. Hughes*, the Texas Supreme Court held that a minority shareholder in a closely held corporation can recover relief through a derivative action for breach of fiduciary duties.

Fiduciary Duties

- If a party breaches a fiduciary duty, there can be serious consequences.
- The breach of a fiduciary duty is a tort and can result in the award of actual damages, exemplary/punitive damages, disgorgement relief, forfeiture relief, injunctions, receiverships, rescission, accounting, constructive trust, equitable liens, maybe attorney's fees, and other relief.
- There can be criminal consequences for misapplication of fiduciary property and other similar types of crimes.

Corporate Officers and Directors

- Directors and officers must use care and be diligent when making decisions on behalf of the company.
- The duty of care is met by making choices in good faith, with the care of a reasonable person in a similar situation, and with belief that each choice is made with the best interests of the corporation in mind.
- The business judgment rule protects officers and directors in most jurisdictions from negligent actions.
- The business judgement rule is a presumption that directors and corporate officers make their decisions in good faith, and honestly believe their actions are in the corporation's best interests.

Corporate Officers and Directors

- There is a duty of loyalty, which provides that corporate officers and directors must always put the interests of the corporation and shareholders above their own self-interests.
- This means that they should not usurp corporate opportunities for personal gains, avoid conflicts of interests, avoid personal benefits (other than compensation), avoid fraud on the corporation and misappropriation of assets.
- There is a duty to be loyal and to use uncorrupted business judgment for the sole benefit of the corporation.
- There is typically no business judgment rule defense to breaches of loyalty.

Corporate Officers and Directors

- There is a duty to use the utmost good faith in the relations with the corporation.
- There is a duty to fully disclose all matters affecting the corporation (including any personal interest the officer or director has in the subject matter of a contract the officer or director is negotiating with the corporation).

Corporate Officers and Directors

- Traditionally, a corporate officer owes a fiduciary duty to the shareholders collectively, i.e., the corporation, but he or she does not occupy a fiduciary relationship with an individual shareholder unless some contract or special relationship exists between them in addition to the corporate relationship.

Others With Fiduciary Duties

- Attorneys, trustees, power of attorney agents, etc. all create fiduciary duties in those capacities.
- Spouses owe fiduciary duties, at least until they file for divorce.
- Persons who are dating generally do not owe fiduciary duties to each other.
- Confidential relationships can create fiduciary duties.
- In these circumstances, if there is a breach of a duty in the formation of the business, a minority shareholder can potentially rescind the business altogether and get their investment back.

Compliance with Duties

- The business and remaining owners should comply with all statutory or contractual duties.
- This may include a right to information by a minority shareholder; distribution rights; notice of meetings and voting; right to vote on matters; governance rights; rights regarding merger, interest exchange, conversion, and/or sale of assets; buy-out rights; redemption rights; dissolution or termination rights; employment rights; severance rights; duty to not misapply corporate property or divert corporate opportunities; duty to not manipulate stock value; etc.

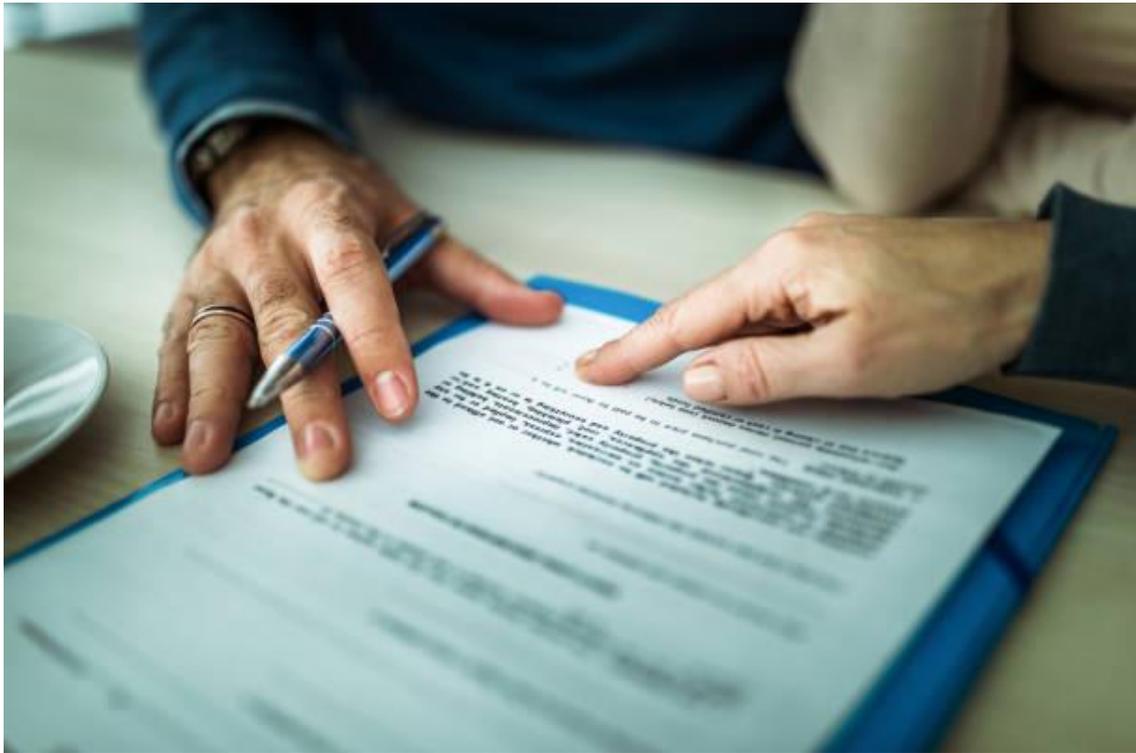
Derivative Action



Derivative Action

- In most cases, shareholders who believe that the company's officers and directors have breached their fiduciary duties must file a derivative lawsuit to pursue a claim because under Texas law, because they owe fiduciary duties to the company rather than to the individual shareholders.
- Normal rules require that the shareholder must have been an owner at the time of the act or omission complained of; send an adequate demand and wait the period to file, fend off a motion by the company to dismiss the claim, and then any relief awarded would solely benefits the company and not the shareholder, individually.
- Importantly, these requirements do not apply for closely-held businesses (under 35 shareholders).

Attorney Client Issues



Attorney Client Issues

- An attorney can represent more than one party.
- Be careful of conflicts that arise and require withdrawal.
- An attorney can represent someone or some entity without a formal engagement letter and without getting paid: implied relationships.
- You do not want to owe fiduciary duties to someone or something that you do not know that you owe duties towards.
- Have a written engagement letter that clearly specifies your client, the capacity, and who is not your client.
- Be care of attorney/client communications and do not waive the privilege.

Conclusion

- There are many issues related to business divorces.
- Due to the nature of business divorce litigation, fiduciary duties are an important component of any dispute.
- Counsel should carefully review all corporate documents and be creative in determining minority shareholder rights and how to trigger those rights and appropriate remedies.

