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Shareholder Disputes in Closely-Held Companies

By Kelli Hinson
214.855.3110 | khinson@ccsb.com

"Two guys go in on a bar." This could either be the start of a bad joke or the petition in a business ownership dispute. But imagine that two guys do go in on buying a bar. Jack puts in $55,000; Daniel puts in $45,000; and they become 55% and 45% shareholders. They initially contemplate that Daniel will tend bar and Jack will keep the books, and that they will take their money out in modest salaries. But the two have a falling out, and Jack uses his majority vote to fire Daniel, depriving Daniel of the ability to earn his salary. And, because Jack now has to tend bar too, he doubles his own salary. Jack also enters into a deal to purchase the bar's liquor through a company Jack owns, which charges a 50% handling fee. The bar is never going to make enough money to pay Daniel back his $45,000 investment. Does Daniel have viable claims for shareholder oppression, breach of fiduciary duty, or other claims?

Shareholder Oppression

The claim of "shareholder oppression" has become an increasingly popular tool for minority shareholders who believe they have been denied a voice or an appropriate return on investment in a closely-held entity. But the Texas Supreme Court is currently considering three cases that could drastically alter the legal landscape for these claims. Each case was brought by a minority shareholder alleging that the majority shareholders had wielded their majority power so as to unfairly prejudice or "oppress" the minority. The minority shareholders all prevailed in front of Dallas juries on the theory of "shareholder oppression," but then had mixed results in the Dallas Court of Appeals.[1] The Texas Supreme Court is now considering all three cases and will, many hope, bring some clarity to this cause of action.

Until then, business owners can only speculate whether the Texas Supreme Court will adopt the theory of shareholder oppression and if so, how it will define the rights and duties of those in control of a closely-held company. For example, can a group of shareholders who are dissatisfied with the job performance of another shareholder terminate that shareholder's employment? What if salary was the only way the minority shareholder was receiving a return on his investment? Can a group of shareholders consistently vote their shares together so as to out-vote the minority on all important decisions? Can they exercise the buy-out rights set out in a shareholders' agreement in a way seems "harsh and unfair"? How far must those in control go to help facilitate the minority's sale of his stock to a third party?

Briefing is complete in the three shareholder oppression cases currently pending in the state's high court, so at least some of these questions may be resolved in the coming months.

Breach of Fiduciary Duty

Meanwhile, another weapon in the disgruntled shareholder's arsenal is the breach of fiduciary duty claim. The minority shareholder may claim that those in control of the corporation failed to look out for his interests and so breached their fiduciary duties to him. While this type of claim may be successful in other states, it would be subject to more scrutiny under Texas law. The case law is not entirely consistent, but it is generally understood in Texas that those in control of a corporation owe their fiduciary duties to the corporation, and not to each other or to minority shareholders. There are exceptions to this rule, however, including where the shareholders have a special relationship that pre-dates the formation of the corporation. But even in the absence of a fiduciary duty to shareholders, shareholders may still assert derivative claims (discussed below) based on a breach of duty to protect the interests of the corporation.

Shareholder Derivative Claims

It is long-standing Texas law that a shareholder generally cannot sue for a wrong done to the corporation, even if that wrong indirectly results in injury to the shareholder. So, for example, Daniel in our hypothetical above arguably could not sue Jack directly for entering into the liquor handling fee agreement because that was a wrong done, if at all, to the corporation. A shareholder can bring a "derivative claim" asserting claims on behalf of the injured corporation, but the damages awarded go to the corporation, which would only benefit the shareholder indirectly. For closely-held corporations with less than 35 shareholders, however, the rules are different. Texas Business Organizations Code Sec. 21.563(a) allows a court to treat a derivative proceeding as if it were a direct action brought for the shareholder's own benefit, and the damage award may be paid directly to the shareholder.

Protecting Yourself Against Shareholder Claims

Regardless of the legal form they take, shareholder disputes take their toll on all parties involved—including the corporation. Investors in closely-held companies would be well served to define their rights and obligations themselves through a shareholders' agreement rather than relying on a court to intervene after a dispute has arisen. Through such an agreement, the investors can define at the outset their expectations of each other in terms of contributing to the business enterprise, how the investors will receive a return on their investment (whether through salary, dividends, etc.), what rights they will have to sell their shares, how a purchase price will be determined in the event the company redeems an investor's shares, and how conflicts will be resolved. Deciding these issues at the outset of the relationship may save headaches—and possibly litigation—in the future.

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1. *Ritchie v. Rupe,* 339 S.W.3d 275 (Tex. App.—Dallas 2011, pet. granted); ARGO Data Resource Corp. v. Shagrithaya, 380 S.W.3d 249 (Tex. App.—Dallas 2012, pet. filed); Cardiac Perfusion Services v. Hughes; 380 S.W.3d 198 (Tex. App.—Dallas 2012, pet. filed). Please ***click here*** to read the Appellate Blog post describing these cases.