FIDUCIARY DUTIES AND MINORITY SHAREHOLDER OPPRESSION FROM THE DEFENSE PERSPECTIVE: DIFFERING APPROACHES IN TEXAS, DELAWARE, AND NEVADA

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2012 Securities Regulation and Business Law Conference
February 9-10, 2012 – Dallas – Belo Mansion

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I. Introduction

Suits by minority shareholders in Texas are on the rise and represent an expanding, cutting-edge area of civil litigation in this state and across the country. While the Texas Supreme Court and several appellate courts in Texas have yet to recognize a cause of action for shareholder oppression or to define its parameters, a growing number of courts have upheld claims for shareholder oppression or at least recognized it as a viable claim. But these courts' justifications for recognizing a broad shareholder oppression claim are questionable, because they rely on: (1) a Texas Supreme Court case that never blessed shareholder oppression as a valid claim, (2) a Texas receivership statute that allows relief from oppression only in limited and extreme circumstances, and (3) a Texas appellate court case that relied on the previous two faulty grounds and on inapplicable case law from other jurisdictions. Given this weak foundation, it is doubtful whether the Texas Supreme Court will recognize a claim for shareholder oppression beyond the purview of the receivership statute, if and when it confronts the issue.

Given the paucity of Texas precedent in the area of shareholder oppression, Texas courts often look to Delaware law for guidance on business issues, given the specialized nature of Delaware courts considering business disputes.[1] In addition, because of the "Internal Affairs Doctrine," Delaware law can apply to a suit filed in Texas if the corporation or LLC is chartered in Delaware. The Texas practitioner must be familiar with the differences between Texas and Delaware law, and the circumstances that can trigger the application of Delaware rather than Texas substantive law.

This paper first addresses fiduciary duty requirements in Texas and Delaware, and the mechanisms available under the "Internal Affairs Doctrine" that may mandate the application of another state's law instead of Texas' in the context of fiduciary and shareholder litigation. There follows a discussion of Texas law on the evolving legal theory of "Minority Shareholder Oppression." As will be seen, unlike the broad and amorphous formulation of the doctrine some Texas Courts of Appeals have adopted (absent meaningful guidance so far from the state's supreme court), Delaware has rejected the Texas lower courts' approach of adopting a vague and general, almost standard-less cause of action called "shareholder oppression," in favor of a case-specific approach designed to protect minority shareholders in limited circumstances, such as squeeze-out mergers and freeze-outs. Delaware courts do this mostly through the way they interpret fiduciary and disclosure duties as well as minority shareholder appraisal rights. Finally, this paper concludes with a brief analysis of minority shareholder oppression in Nevada, a state that is seen as an increasingly attractive alternative forum for incorporation.

II. Breach of Fiduciary Duty

A. Fiduciary Duties in Texas and Delaware

In Texas, fiduciary duties arise in one of two ways: (1) a formal fiduciary relationship can exist as a matter of law between two parties; or (2) an informal fiduciary relationship may arise from the facts of the case. *Hoggett v. Brown*, 971 S.W.2d 472, 487 (Tex. App.—Houston [14th Dist.] 1997, pet. denied) (quoting *Crim Truck & Tractor Co. v. Navistar Int'l Transp. Corp.*, 823 S.W.2d 591, 593-94 (Tex. 1992)). As discussed below, officers, directors, and majority shareholders owe formal fiduciary duties to the corporations they serve. But fiduciary duties may exist between other corporate actors if the facts support an informal fiduciary relationship.

Informal fiduciary duties arise under Texas law "from a confidential relationship 'where one person trusts in and relies upon another, whether the relation is moral[,] social, domestic or merely personal.'" *Id.* (quoting *Crim Truck & Tractor*, 823 S.W.2d at 593-94, and *Hallmark v. Port/Cooper*, 907 S.W.2d 586, 592 (Tex. App.—Corpus Christi 1995, no writ)). Mere subjective trust, however, is insufficient to create such a duty. *Schlumberger Tech. Corp. v. Swanson*, 959 S.W.2d 171, 177 (Tex. 1997). Rather, the reliance must be justified. *See Hoggett*, 971 S.W.2d at 488 ("A person is justified in placing confidence in the belief that another party will act in his or her best interest only where he or she is accustomed to being guided by the judgment or advice of the other party, and there exists a long association in a business relationship, as well as personal friendship."). Moreover, to impose an informal fiduciary relationship in a business transaction, "the relationship must exist prior to, and apart from the agreement made the basis of the suit." *Willis v. Donnelly*, 199 S.W.3d 262, 277 (Tex. 2006)

[1] *See, e.g., Grant Thornton L.L.P. v. Prospect High Income Fund*, 314 S.W.3d 913, n.19 (Tex. 2010) (citing Delaware law for the proposition that individual shareholder claims remain state law actions); *In re Schmitz*, 285 S.W.3d 451, 457 (Tex. 2009) (citing Delaware law to hold that a demand-required derivative suit must name the shareholder on whose behalf it is made); *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 570 (Tex. 1963) (citing *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939)); *Neurobehavioral Assocs., P.A. v. Cypress Creek Hosp., Inc.*, 995 S.W.2d 326, 328-29 (Tex. App.—Houston [1st Dist.] 1999, no pet.) (relying on *Rothschild Int'l Corp. v. Liggett Group, Inc.,* 474 A.2d 133, 136 (Del.1984)).

(quoting *Schlumberger Tech. Corp.*, 959 S.W.2d at 177). Creation of an informal fiduciary relationship is a fact-specific inquiry. *See id.* (stating that an informal fiduciary duty may arise from the facts of the case) (citing *Schlumberger Tech. Corp.*, 959 S.W.2d at 177).

Officers and directors owe fiduciary duties to the corporations they serve as a matter of law. *See Int'l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 576 (Tex. 1963); *Landon v. S&H Marketing Group, Inc.*, 82 S.W.3d 666, 672 (Tex. App.—Eastland 2002, no pet.). Officers and directors do not, however, owe formal fiduciary duties to the corporation's shareholders. *Myer v. Cuevas*, 119 S.W.3d 830, 836 (Tex. App.—San Antonio 2003, no pet.) ("Corporate officers do not owe fiduciary duties to individual shareholders unless a contract or special relationship exists between them in addition to the corporate relationship."); *Hoggett*, 971 S.W.2d at 48 ("A director's fiduciary duty runs only to the corporation, not to individual shareholders or even to a majority of the shareholders.").

In 2003, the Texarkana Court of Appeals created confusion on this point by stating, "It has been well established that the directors of a corporation stand in a fiduciary relationship to the corporation *and its stockholders* …." *Pinnacle Data Servs. v. Gillen*, 104 S.W.3d 188, 198 (Tex. App.—Texarkana 2003, no pet.) (emphasis added). *Pinnacle Data Services* should not be interpreted, however, to impose fiduciary duties on officers and directors to individual shareholders. First, the case on which *Pinnacle Data Services* relies to support this proposition does not indicate that such a duty exists. *Compare id. with Duncan v. Bushey*, 263 S.W.2d 148, 151-52 (Tex. 1953) (allowing shareholders to challenge directors' actions, because the corporate charter had been forfeited). Second, this statement in *Pinnacle Data Services* should be interpreted consistent with an earlier decision by the same court, where it held, "[a] corporate officer [and director] owes a fiduciary duty to the shareholders collectively, *i.e*. the corporation, but he does not occupy a fiduciary relationship with an *individual* shareholder." *Faour v. Faour*, 789 S.W.2d 620, 621 (Tex. App.—Texarkana 1990, writ denied). Such an interpretation brings *Pinnacle Data Services* in line with the wealth of other Texas cases holding that officers and directors do not owe fiduciary duties to individual shareholders absent an informal fiduciary relationship.

1. Fiduciary Duties Under Texas Law

Three broad duties stem from officers' and directors' roles as fiduciaries in Texas: duties of obedience, loyalty, and due care. *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984) (applying the duties to directors, but recognizing that the fiduciary duties of officers are generally identical to those of directors); *Landon v. S & H Marketing Group,* 82 S.W.3d 666, 672-73 (Tex. App.—Eastland 2002, no pet.) (applying the duties to officers and directors alike).

a. Duty of Obedience

The duty of obedience "requires a director to avoid committing *ultra vires* acts, *i.e.*, acts beyond the scope of the powers of a corporation as defined by its charter or the laws of the state of incorporation." *Gearhart*, 741 F.2d at 719. An officer or director will only be personally liable for such *ultra vires* acts if his actions are also illegal. *Id.*

b. Duty of Loyalty and the Safe Harbor Defense

The duty of loyalty "requires an extreme measure of candor, unselfishness, and good faith on the part of the officer or director." *Pinnacle*, 104 S.W.3d at 199. Stated another way, the duty of loyalty "dictates that a corporate officer or director must act in good faith and must not allow his or her personal interest to prevail over the interest of the corporation." *Landon*, 82 S.W.3d at 672. An officer or director is considered "interested" when he "makes a personal profit from a transaction by dealing with the corporation or usurps a corporate opportunity." *Id*. at 673 (citing *Gearhart*, 741 F.2d at 719-20). A corporate opportunity "arises when a corporation has a legitimate interest or expectancy in, and the financial resources to take advantage of, a particular business opportunity." *Icom Sys., Inc. v. Davies*, 990 S.W.2d 408, 410 (Tex. App.—Texarkana 1999, no writ) (citing *Dyer v. Shafer, Gilliland, Davis, McCollum & Ashley, Inc.*, 779 S.W.2d 474, 477 (Tex. App.—El Paso 1989, writ denied)). In addition, an officer or director is considered "interested" when he "buys or sells assets of the corporation," "transacts business in his director's capacity with a second corporation of which he is also a director or significantly financially associated," or "transacts business in his director's capacity with a family member." *Landon*, 82 S.W.3d at 673 (citing *Gearhart*, 741 F.2d at 719-20).

When an officer or director enters into a contract with the corporation he serves, he should ensure that the transaction satisfies one of the safe harbor provisions contained in the Texas Business Organizations Code. *See* TEX. BUS. ORGS. CODE ANN. § 21.418 (Vernon Supp. 2010). Specifically, such a transaction will be found valid in the following instances:

> 1. Upon the affirmative, good faith vote of a majority of disinterested directors provided that the material facts of the contract or transaction is disclosed to or known by the board;
> 2. Upon the affirmative, good faith vote of the shareholders provided that the material facts of the contract or

Title search: Fiduciary Duties and Minority Shareholder Oppression From the Defense Perspective: Differing Approaches in Texas, Delaware, and Nevada

First appeared as part of the conference materials for the
34th Annual Conference on Securities Regulation and Business Law session
"Ripe Fruit or Withered on the Vine: Plaintiff and Defense Perspectives under Texas and Delaware Law"