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Minority Shareholder Rights After The Texas Supreme Court's Decision In Ritchie v. Rupe (June 2014)

“The most significant holding in Ritchie, is the Court’s decision to jettison a court-ordered buy-out as a remedy for minority shareholder oppression under the statute.”

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CURRENT ISSUES AND TRENDS IN BUSINESS DIVORCE LITIGATION

The summer of 2014 was an unsettling one for minority investors in Texas private companies after the Texas Supreme Court issued three decisions in June that dramatically altered the legal landscape in an unfavorable manner for minority investors. For more than two decades leading up to last summer's trilogy of Supreme Court opinions, minority shareholders in private companies who could prove they had been oppressed by the company's majority owners could obtain a court-ordered buyout requiring the majority owners to purchase their stock. The claim for shareholder oppression required minority investors to show that either: (i) their reasonable economic expectations had been frustrated by the majority owners or (ii) that the majority owners had engaged in burdensome, harsh or wrongful conduct. In its June 2014 decisions, however, the Supreme Court largely diminished the claim for shareholder oppression by: (i) imposing a much stricter legal standard for minority owners to establish that they had been oppressed, (ii) limiting the remedy for oppression solely to the appointment of a rehabilitative receiver and (iii) holding that no claim for oppression exists in Texas common law. *See in Ritchie v. Rupe*, — S.W.3d —, 57 Tex. Sup. Ct. J. 771, 2014 WL 2788335 (Tex. June 20, 2014).

I. TEXAS SUPREME COURT REJECTS COURT-ORDERED BUYOUT OF MINORITY SHAREHOLDER AS REMEDY FOR OPPRESSION

This article reviews the impact of the Texas Supreme Court's holdings in *Ritchie* and two other cases that the Court also decided last year regarding minority shareholder oppression claims. Before addressing these new cases, however, it is helpful to look back at the law as it existed for minority investors before the *Ritchie*

trilogy of decisions substantially altered Texas law governing the rights of minority shareholders in private companies.

A. Review of *pre-Ritchie* Texas Law Regarding Claims by Minority Shareholders

As far back as 1995, the Texas Legislature enacted statutes that provided remedies for "illegal, oppressive, or fraudulent" actions by controlling shareholders in closely-held corporations.¹ This Texas "oppression statute" is now codified in Section 11.404, of the Business Organizations Code. The statute expressly authorizes Texas trial courts to appoint a receiver, or to order the company to be liquidated when there is a showing of "illegal, oppressive or fraudulent" conduct by the "governing persons" of the business entity. *Id.* § 11.404(a)(1)(C).

These statutory remedies of court-ordered receiverships and liquidation were often viewed by trial judges as too harsh in application, and as a result, they were disfavored and rarely applied. Before appointing a receiver, however, courts reviewed the statutory language directing them to consider whether "all other available legal and equitable remedies . . . are inadequate." *Id.* at §11.404(b)(3). In response to this statutory direction, trial courts crafted "equitable" remedies they perceived to be less harsh than receivership to address oppressive conduct by majority owners. These equitable remedies included awarding dividends, issuing preliminary injunctions to preserve the status quo until trial, and most often, requiring a buyout of the minority's ownership interest.

As noted, before the Supreme Court's decision in *Ritchie* in June 2014, a minority

¹ The original oppression statute was codified in Articles 7.05 and 7.06 of the Texas Business Corporations Act and, as discussed above, it is currently found in section 11.404 of the Texas Business Organizations Code.

shareholder in a Texas private company could prevail in a lawsuit alleging oppression by the company's majority owners if the minority investor could present facts meeting either one of two definitions of oppression as set forth below:

- 1) the majority shareholder's conduct substantially defeated the minority's expectations that, objectively viewed, were reasonable under the circumstances and also central to the minority shareholder's decision to join the venture; or
- 2) the majority owner's conduct was burdensome, harsh and wrongful and reflected a lack of probity and fair dealing in the company's affairs to the prejudice of some members; or a visible departure from the standards of fair dealing and a violation of fair play on which each shareholder is entitled to rely.²

This two-part oppression test came from a seminal Texas case, *Davis v. Sheerin*,³ which relied on language from Section 11.404 of the Texas Business Organizations Code discussed above. *Davis* adopted the doctrine of minority shareholder oppression and held that the Texas statute authorizes trial courts to grant equitable remedies. In *Davis*, the appellate court upheld a jury verdict of oppressive conduct, based on:

- i) findings of a conspiracy by the majority shareholders to deprive

the plaintiff of his ownership interest in the corporation,

- ii) findings that the majority shareholders wasted corporate funds and received dividends that were withheld from the plaintiff, and
- iii) undisputed evidence that the plaintiff would be denied any future voice in the corporation's management.

Davis and its progeny set the legal standard for shareholder oppression under Texas law for state trial and appellate courts more than 25 years. The Supreme Court then upended this standard in *Ritchie*, which is summarized below along with two other cases the Court decided at about the same time.

- *Ritchie v. Rupe*, — S.W.3d — , 2014 WL 2788335 (Tex. June 20, 2014). The trial and appellate courts in *Ritchie* held that the company's majority owners oppressed the minority shareholder by, among other things, refusing to meet with potential buyers of the minority owner's stock. In a 6-3 decision, the Supreme Court majority reversed the trial court's buy-out order and made three primary holdings:

- 1) the only statutory remedy for "oppressive" actions by majority owners is a rehabilitative receivership -- a buy-out remedy is not available under the Texas statute;
- 2) the statutory definition of "oppressive" actions requires minority shareholders to defeat the application of the business judgment rule (defense) to prevail; and
- 3) No common-law cause of action for shareholder oppression exists in Texas.

The *Ritchie* appeal involved a claim by Ms. Rupe, a minority shareholder who

² *Davis*, 754 S.W.2d at 381-82; see also *Gimpel v. Bolstein*, 477 N.Y.S.2d 1014, 1017-18 (N.Y. Sup. 1984).

³ 754 S.W.2d at 382-83. The *Davis* court crafted a court-ordered buy-out of the plaintiff's stock at fair value, as an acceptable "less harsh" remedy to the statutorily authorized liquidation, available to the court under its "general equity powers" when "oppressive conduct" had occurred. *Id.* at 378, 380, 382-83.

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