# Texas Supreme Court Clarifies its Position on Shareholder Oppression in *Ritchie v. Rupe* and *Cardiac Perfusion Services v. Hughes*

*Samuel S. Nicholls*

*During June 2014, the Texas Supreme Court reversed two Texas appellate court decisions that had ruled in favor of minority shareholder oppression claimants. This discussion reviews the judicial decisions of* Ritchie v. Rupe *and* Cardiac Perfusion Services v. Hughes*, both decided in June 2014 by the Texas Supreme Court. In both matters, the absence of a shareholder oppression statute in Texas required the litigants to pursue a legal claim—the Texas receivership statute. The language of that statute does not define "oppression," and the legislative intent of that statute appears to have been to remedy instances of extreme mismanagement or criminal activity. Relief under a breach of fiduciary duty claim was not available because neither a formal nor informal fiduciary relationship could be established. Although relief may have been justified in the interest of fairness and supported through common law, as were the opinions of the trial and appellate courts in these matters, the Texas Supreme Court relied on the state statute. In the absence of clear language within the Texas receivership statute supporting the allegedly oppressed minority shareholders, the Texas Supreme Court had no choice but to interpret legislative intent, and to remand.*

*Of course, it is true that the words used, even in their literal sense, are the primary, and ordinarily the most reliable, source of interpreting the meaning of any writing . . . But it is one of the surest indexes of a mature and developed jurisprudence not to make a fortress out of the dictionary.*

Judge Learned Hand[1]

## Texas Supreme Court Jolts Shareholder Oppression: Will Shareholder Oppression Valuations Be Pressured?

Shareholder oppression statutes diverge across the various states. In Texas, the statutory waters are muddier than in most states. This is because the opinions of Texas trial and appellate courts have been at odds with the opinions of the Texas Supreme Court.

That judicial disparity may be resolved by the decision of the Texas Supreme Court in the matter of *Ritchie v. Rupe* ("*Ritchie*"), rendered on June 20, 2014. The *Ritchie* decision was followed by the decision on *Cardiac Perfusion Services v. Hughes* ("*Hughes*"), rendered on June 27, 2014. Both of these judicial decisions involved disputes arising out of transactions.

Until these recent judicial decisions, shareholder oppression in Texas was a murky realm of Texas jurisprudence. And, many practitioners of law awaited these Texas Supreme Court decisions with baited breath.

In Texas, as eventually determined by the Texas Supreme Court in *Ritchie*, the only statutory claim for shareholder oppression rests with the Texas rehabilitative receivership statute for corporations.[2]

That is, no specific shareholder oppression statute exists. And, prior decisions by other Texas courts have relied on either common law or on sections of the Texas Business Organizations Code that were written more for businesses that have been grossly mismanaged or whose management has engaged in illegal activity.

Texas trial and appellate courts have rendered many decisions in favor of plaintiff minority shareholders, including these two cases.[3]

Nonetheless, until the appeals of these two cases to the Texas Supreme Court, the Texas Supreme Court had never recognized oppression as a valid claim. In these two decisions, the Texas Supreme Court provided greater clarity on its position. The court declined to recognize a common-law cause of action for shareholder oppression in the cases it tried thus far. Instead, the court relied on the intent of the legislature when it enacted the Texas statute governing rehabilitative receivership.

This imbroglio, apparently the spawn of having to rely on a choice of law when few choices are available other than the receivership statute or a derivative suit, provokes several tangential debates over the repercussions for business valuation, dispute resolution, proactive forestalling of disputes through contracts, operating agreements, buy/sell agreements, and public policy in Texas insofar as the business climate is concerned.

## Will These Rulings Affect Business Valuation and Corporate Finance in Texas?

What are the implications for determining the fair market value of a fractional ownership interest in a Texas business, considering that the relative lack of marketability and lack of control of a noncontrolling ownership interest in a privately held Texas entity may be more pronounced than in other states? This is because noncontrolling shareholders face more risk of shareholder oppression without statutory relief.

Would you, as a prospective buyer of a noncontrolling ownership interest in a Texas business, feel encouraged by these Texas Supreme Court rulings? If oppressed noncontrolling shareholders in Texas have scant chances for remedy, controlling shareholders may also be affected when requiring capital through an equity offering, as prospective buyers of noncontrolling interests may demand lower valuation pricing multiples in light of the risk of being a noncontrolling shareholder in Texas.

## What Is the Future of Shareholder Oppression in Texas?

Will Texas legislature eventually draw from the Uniform Commercial Code (UCC) to clearly define what constitutes oppression? The UCC is not a statute. Rather, the UCC is a guideline to harmonize divergent state laws with respect to commerce. Notwithstanding any lack of an interstate nature of a dispute, the UCC offers sound business principles upon which states rely.

With respect to the decision in *Ritchie*, there is language within the decision of the Dallas Court of Appeals that sounds curiously similar to the language of the UCC "implied warranty of fitness." In the UCC, the absence of language within a contract does not excuse conduct that a counterparty would reasonably expect not to occur in a business transaction, an expectation on which the counterparty relied to make his or her decision to enter into the transaction.

Will the Texas Business Organizations Code be adapted to include language that draws from the "implied warranty of fitness" to accommodate myriad situations as manifest in prior shareholder oppression suits?

If judicial discretion through common law is to be shunned in the Texas legal system, should there not be better clarity by statute to accommodate the wide range of potential instances of shareholder oppression? Should not common practice serve as a guideline to what is considered to be a "reasonable expectation" for conduct by management that is not adverse to shareholders?

It is common practice for the management of a publicly traded corporation to meet with prospective purchasers of large blocks of shares, unless their intent is of an activist nature. Publicly traded companies conducting a capital raise will typically have so-called road shows. This procedure is not inscribed in law, but it is a common practice.

# *Ritchie v. Rupe*

## Overview

*Ritchie v. Rupe*, first filed during July 2006 in Texas, was eventually appealed to the Texas Supreme Court, which rendered its opinion on June 20, 2014.

In *Ritchie*, both the Texas trial court and the Dallas Court of Appeals held that the Rupe

Investment Corporation (RIC), specifically its controlling shareholders and management, acted oppressively towards Ann Caldwell Rupe, a noncontrolling shareholder of RIC. RIC refused to meet with prospective buyers of Ann Rupe's noncontrolling ownership interest.[4]

Lee Ritchie was president of RIC, a descendant of one of the founders, and he was the individual who had refused to meet with prospective buyers.

The Texas Supreme Court reversed the decision of the appellate court, neither recognizing common law nor finding that the word "oppressive," as inscribed in the Texas receivership statute, applied to the conduct manifest by management per the complaint. The case was remanded back to the appellate court to examine the merits of a "breach of fiduciary trust" claim.

## Facts of the Matter

Three different family trusts collectively owned approximately 72 percent of the RIC voting stock. There was no shareholder voting agreement or buy/sell agreement. Buddy Rupe, Ann's husband, had placed his 18 percent interest in RIC in a trust for the benefit of Ann Rupe and their son, naming Ann Rupe as trustee.

Buddy Rupe died in 2002, and the other families that were shareholders allegedly acted in a hostile manner to Ann Rupe, who was Buddy's second wife.[5]

Ann Rupe asked the controlling owners if they would be willing to buy the trust's (Buddy's) 18 percent ownership stake. The controlling owners gave an unacceptable, lowball offer of $1 million, and Ann Rupe then pursued other buyers.

The RIC sales exceeded $150 million, and it had assets in excess of $50 million.[6]

The refusal by the controlling owners and management to meet with prospective buyers undermined her efforts to sell her ownership stake. It stands to reason that such behavior may spook a prospective buyer, should it serve as a preview to the treatment a noncontrolling shareholder could expect from the controlling owners and management.

## Dallas Court of Appeals Rules in Favor of the Oppressed Minority Shareholder

In *Ritchie*, the Dallas Court of Appeals ruled that noncontrolling shareholder Ann Caldwell Rupe's claim of shareholder oppression was valid and deserving of remedy.

In reaching its decision,[7] the Dallas appellate panel applied *Davis v. Sheerin*, a 1988 Texas Court of Appeals decision that defined shareholder oppression and set precedent for future Texas cases. Certain words in that decision—"reasonable expectations," "wrongful conduct," and "fair dealing"[8]—weighed heavily in subsequent appellate decisions in Texas.

In *Ritchie*, shareholder oppression was defined by the Dallas Court of Appeals as follows:

> Texas courts have generally recognized two non-exclusive definitions for shareholder oppression: (1) majority shareholders' conduct that substantially defeats the minority's expectations that, objectively viewed were both reasonable under the circumstances and central to the minority shareholders' decision to join the venture; or (2) burdensome, harsh, or wrongful conduct; 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.[9]

The Dallas Court of Appeals further turned to Texas Business Corporation Act Article 7.05 when considering the appropriateness of a buyout remedy.[10]

Article 7.05, later amended to Section 11.404 of Texas Statutes: "Appointment of Receiver to Rehabilitate Domestic Entity," outlines the conditions for receivership, which include "that the acts of the directors or those in control of the corporation are illegal, oppressive or fraudulent." As would apply to *Ritchie*, the word "oppressive" was the operative word.

The Texas receivership statute further states that:

> A receiver may be appointed for the assets and business of a corporation by the district court for the county in which the registered office of the corporation is located, whenever circumstances exist deemed by the court to require the appointment of a receiver to conserve the assets and business of the corporation and to avoid damage to parties at interest, but only if all other requirements of law are complied with and if all other remedies available either at law or in equity, including the appointment of a receiver for specific assets of the corporation, are determined by the court to be inadequate.[11]

The court, in its determination that a buyout was the proper remedy under the receivership statute,

considered the phrase of the receivership statute: "if all other remedies available either at law or in equity, including the appointment of a receiver for specific assets of the corporation, are determined by the court to be inadequate."

Apparently, the court interpreted this language as meaning that since the actions of management were not so egregious that receivership was required, then the converse of the word "inadequate" may be applied (as intended by the legislature) if other remedies are, indeed, adequate.

The Dallas Court of Appeals mostly agreed with the trial court's remedy, which was a buyout of the Ann Rupe ownership interest by RIC at fair market value ($7.3 million).[12]

The Court of Appeals disagreed with the trial court's decision not to discount the buyout price for lack of control or lack of marketability.[13]

The remedy was a buyout at fair market value discounted for relative lack of control and lack of marketability, due to the ownership interest being a noncontrolling interest of a privately held entity. Such a price discount is what a willing buyer, under no compulsion to purchase the noncontrolling interest, would expect, because a buyer would then be subject to the same liquidity constraints as *Ritchie*, and would offer a price reflecting those liquidity constraints.

## Texas Supreme Court Reverses Court of Appeals Decision

*Ritchie* was appealed to the Texas Supreme Court, which issued its opinion on June 20, 2014. By a 6-3 vote, the court overruled the decision of the Dallas Court of Appeals.

The Texas Supreme Court did examine *Davis v. Sheerin*,[14] the outcome of which was the first Texas appellate court affirming a judgment whose building blocks were the words "oppressive actions" as appear within the receivership statute. The appellate court had justified its buyout remedy as follows: "Texas courts, under their general equity power, may decree a [buyout] in an appropriate case where less harsh remedies are inadequate to protect the rights of the parties."[15]

The trial court in *Ritchie* applied the "fair dealing" standard when instructing the jury as to what may constitute shareholder oppression. The fair dealing standard as recited by the *Davis* court is:

> An Oregon court's collection of oppression definitions, which included "'burdensome, harsh and wrongful conduct,' 'a lack of probity and fair dealing in the affairs of a company to the prejudice of some of its members,' or 'a visible departure from the standards of fair dealing, and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely.'"

The Texas Supreme Court, however, began by noting that the legislature had never defined the term "oppressive" in the Business Corporations Act or the Business Organization Code.[16]

The court then examined dictionary definitions: "In the absence of a statutory definition, we give words their common meaning."[17]

The court then turned to *Black's Law Dictionary* and other references, a familiar refrain when ambiguity in statutes leaves no recourse. This position is reminiscent of *BMC Software, Inc. v. Commissioner of Internal Revenue*, where the U.S. Tax Court ruled on the definition of "debt" as relates to interparty indebtedness between a U.S. taxpayer and its foreign subsidiary.[18] The trusty *Black's Law Dictionary* was put to use in that venue as well.

The Texas Supreme Court ruled that no act of oppression occurred. This is because, absent a clear definition of "oppression," the court relied on the intent of the legislature when crafting the receivership statute. The conclusion was that the circumstances were not marked with the severity intended by the legislature to apply the receivership statute.

The Texas Supreme Court, in *Ritchie*, defined oppression as follows:

> Considering all of the indicators of the Legislature's intent, we conclude that a corporation's directors or managers engage in "oppressive" actions under former article 7.05 and section 11.404 when they abuse their authority over the corporation with the intent to harm the interests of one or more of the shareholders, 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.[19]

The ending of the statement, "by doing so create a serious risk of harm to the corporation," may suggest how the court interpreted the legislature's intent—that is, a high threshold needs to be crossed in order to trigger receivership.

In its majority opinion, the court expressed the importance of having comprehensive operating agreements and buy-sell agreements:

> 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. In the absence of such agreements, however, former article 7.05 authorizes the appointment of a receiver only for specific conduct—in this case, allegedly oppressive actions—and the conduct relied on by the court of appeals here does not meet that standard.[20]

The court concluded by remanding the case back to the appellate court to determine if relief is available under a breach of fiduciary duty claim, and if so, to remand back to trial court:

> Thus, if the court of appeals concludes that Rupe may recover on her breach-of-fiduciary-duty claim, and that the buyout order is available as a remedy, it will need to remand the case to the trial court for a redetermination of the value of Rupe's shares and whether the buyout is equitable in light of the newly determined value and the impact that a buyout at that price will have on RIC and its other shareholders.[21]

### Why Did the Texas Supreme Court Rule the Way it Did?

The Texas receivership statute includes as a condition for receivership "illegal, oppressive, or fraudulent" actions by management. The Texas Supreme Court, in the absence of a definition of "oppressive," relied on the perceived intent of the legislature.

The Texas legislature, by conflating the word "oppressive" with "illegal" and "fraudulent," tinged the meaning of oppression with imagery of flagrant, dastardly deeds. Does this train of thought suggest that the legislature intended for the statute to apply only under dire circumstances, and for an ephemeral period until the business entity is on solid footing again? Or did the legislature simply intend to be vague, passing the baton to common law to add the detail?

### Did the Texas Supreme Court Suggest That the Door Is Still Open for Common Law?

Although the court has never recognized a common-law cause of action for shareholder oppression, including in *Ritchie*, the decision discussed common law at length, seemingly suggesting that the door was left open for other forms of alleged oppression, yet sparingly and with a reliance on statutory law when possible.

**"The Texas legislature, by conflating the word 'oppressive' with 'illegal' and 'fraudulent,' tinged the meaning of oppression with imagery of flagrant, dastardly deeds."**

In its majority opinion, the court listed a number of conditions requisite for a common-law cause of action, such as "the foreseeability, likelihood, and magnitude of the risk of injury,"[22] and discussed actions such as squeeze outs and freeze outs in the context of this condition for common-law application, concluding with:

> We thus conclude that the foreseeability, likelihood, and magnitude of harm sustained by minority shareholders due to the abuse of power by those in control of a closely held corporation is significant, and Texas law should ensure that remedies exist to appropriately address such harm when the underlying actions are wrongful.[23]

The majority also pointed to statutory venues such as a derivative suit,[24] and penalties available for management's refusal to allow inspection of the books, under Texas Business Organization Codes 21.218, 21.219, and 21.220.[25]

## *Cardiac Perfusion Services v. Hughes*

### Overview

In *Cardiac Perfusion Services v. Hughes* ("*Hughes*"),[26] like *Ritchie*, both the Texas trial court and Dallas Court of Appeals ruled in favor of the allegedly oppressed minority shareholder, Hughes.

Both courts held that the buy/sell agreement between the two shareholders, valued at the Hughes pro rata share of book value, was nullified due to shareholder oppression, and determined that the Hughes ownership interest was to be bought out at fair market value, determined to be $300,000. The trial court also awarded Hughes prejudgment interest, postjudgment interest, and attorney's fees.

The appellate court upheld the trial court's remedies, including the absence of discounts for relative lack of control and lack of marketability. This differs from *Ritchie*, where the appellate court determined that the trial court had erred in not applying such valuation discounts.

In *Ritchie*, the oppressed minority shareholder was not forced to sell her shares through the oppressive conduct of the controlling owners and management. In *Hughes*, Hughes was forced to relinquish his ownership position by the oppressive conduct of the controlling owners.[27]

The case was appealed to the Texas Supreme Court which, on June 27, 2014, reversed the decision of the appellate court for a buyout of the noncontrolling interest at fair market value.

## Facts of the Matter

Randall Hughes was hired by Michael Joubran to work at his company, Cardiac Perfusion Services (CPS), in 1991. In the following year, Hughes purchased a 10 percent ownership interest in the company for $25,000.[28]

CPS operates heart/lung machines during open heart surgery. As part of the transaction, a buy/sell agreement was executed whereby Joubran would be required to purchase the Hughes shares at book value should Hughes ever be terminated from employment.[29]

Joubran later terminated Hughes, sued Hughes for damages resulting from breach of fiduciary duty and tortious interference, and petitioned to enforce the buy/sell agreement. Hughes countersued claiming shareholder oppression.

The trial jury found in favor of Hughes regarding allegations that Hughes breached fiduciary duty and engaged in tortious interference. Regarding the Hughes claim of shareholder oppression, the trial jury agreed, finding that Joubran (1) suppressed payment of profit distributions to Hughes, (2) paid himself excessive compensation from the CPS corporate funds, (3) improperly paid his family members using CPS funds, (4) improperly used CPS funds to pay his personal expenses, (5) wrongfully used his control of CPS to lower the value of the Hughes stock, and (6) refused to let Hughes examine the CPS books and records.[30]

Although the trial court jury found there was no evidence of a fiduciary relationship, and hence no breach of fiduciary duty, the jury answered certain questions indicating that they believed there was a breach of fiduciary duty.[31]

## Dallas Court of Appeals Rules in Favor of the Oppressed Minority Shareholder

### What the Court Considered

The appellate court, in its opinion, cited *Davis* and *Ritchie* in determining the applicable law, pointing to the definitions of shareholder oppression as recognized by the Dallas Court of Appeals and other courts. The court considered the CPS and the Joubran argument that the trial court had erred in awarding Hughes fair market value rather than book value as agreed to in the buy/sell agreement.

CPS and Joubran relied on *Fortis Benefits v. Cantu*[32] primarily, as well as *Fortune Production Co. v. Conoco, Inc.,*[33] and *City of the Colony v. North Texas Municipal Water District*.[34]

Hughes relied on *Hayes v. Olmsted & Associates, Inc.*[35] *Hayes* was tried in Oregon, which CPS and Joubran argued rendered the citation irrelevant. Under Oregon law, those with a controlling ownership interest in a closely held corporation owe fiduciary duties to noncontrolling shareholders. In Texas, however, no such duty exists.

The Dallas Court of Appeals disagreed with CPS and Joubran, explaining that even if Texas and Oregon law differ as to claims for breach of fiduciary duty, the trial court found that there was shareholder oppression, and "like Oregon, Texas recognizes a cause of action for shareholder oppression."[36]

The appellate court further seemed to give weight to the impairment of book value through Joubran's excessive compensation as justification for not enforcing the buy/sell agreement. The argument was not one of a breach of contract, but rather shareholder oppression.[37]

Hughes argued a single issue on cross-appeal—the trial court erred when it declined to render judgment in his favor for breach of fiduciary duty.

The trial court jury had contradicted itself on its questionnaire, answering "no" as to whether a fiduciary duty existed between Joubran and Hughes, but answered "yes" as to whether Joubran had breached his fiduciary duties (the jury had been instructed not to answer that question unless they had answered "yes" as to whether a fiduciary relationship existed). The Dallas Court of Appeals disagreed, finding that no fiduciary relationship existed.

### CPS and Joubran Raise an Issue with the Hughes Valuation Analyst

Hughes had retained a valuation analyst (the "Hughes analyst") to render a fair value opinion of the Hughes ownership interest. CPS and Joubran argued that (1) the Hughes analyst fair value "was not supported by a coherent measure of value," (2) the Hughes analyst testimony was conclusory and therefore legally insufficient, and (3) the Hughes analyst valuation opinion is wrong because it is based on an erroneous assumption that CPS is an S corporation.[38]

The first complaint (no support for the measure of value) gained no traction with the court. The court declined to evaluate the methodology of the Hughes analyst, and in the judicial opinion, did not explain why.

The second complaint (the Hughes analyst testimony was conclusory) was ruled in favor of Hughes. As noted by the court, opinions are considered conclusory if there is no basis or support offered for the analysts opinion, but its reliability can be challenged nonetheless if the objection is made early enough for the court to conduct an analysis.[39]

CPS and Joubran argued that the Hughes analyst (1) did not compare Joubran's compensation with companies as small as CPS or with Joubran's peers at similar companies, (2) CPS and Joubran disagreed with the Hughes analyst over whether Joubran's quarterly bonuses should be characterized as dividends, (3) the Hughes analyst did not describe his discounted cash flow analysis to the jury, and (4) the Hughes analyst failed to consider the controlling effect of the buy/sell agreement, the unstable nature of the CPS business, and the lack of goodwill attaching to the corporation itself, apart from the professional goodwill of either Joubran or Hughes.[40]

The court disagreed with the second complaint of CPS and Joubran because, it noted, the Hughes analyst "gave detailed testimony about his valuation opinions and the relevant facts supporting those opinions."[41]

Specifically, the Hughes analyst "identified three categories of questionable expenses: (1) salaries paid to Joubran's college-age children, (2) excessive compensation paid to Joubran, and (3) certain credit card charges."[42]

The court considered Hughes testimony that CPS did hot hire replacements for Joubran's children when they left the payroll, nor did it terminate any employees when they were hired, suggesting that their hiring was not requisite to operations.

The Hughes analyst also analyzed compensation data for the relevant field, and concluded that the appropriate salary range for Joubran was between $132,500 and $275,123. Joubran's actual salary averaged $775,000 from 2003 to 2007.

The Hughes analyst also analyzed the credit card charges, and found $64,000 that were not apparently legitimate business expenses. The Hughes analyst, in his fair value determination, made adjustments for these excesses.

The third complaint (the Hughes analyst valuation opinion is wrong because it is based on an erroneous assumption that CPS is an S corporation) was ruled in favor of Hughes. This was despite the fact that CPS was in fact a C corporation. The contention was that because of the differing tax treatment between S and C corporations, the Hughes analyst arrived at an incorrect valuation conclusion when he mistakenly thought CPS was an S corporation.

CPS and Joubran cited plaintiff's exhibits 30 through 33, which were the CPS Form 1120 federal income tax returns for the years 2005 to 2008.

The Hughes analyst acknowledged on the stand that he had seen the Forms 1120 S, but responded that (1) although he was a CPA, he did not prepare tax returns; (2) he had seen income tax forms previously over the course of his career that he would not have expected to be used; (3) the financial statements he was given showed profits but no tax provision, which he believed suggested that CPS was an S corporation; and (4) he did provide two fair value estimates under both the S corporation and C corporation scenario.

In dismissing the third complaint, the court gave weight to the fact that the Hughes analyst was given documentation that was misleading or conflicting (the internal financial statements showing no income tax despite there being a profit). The court also considered that the Hughes analyst presented the trial jury with two valuations under both the C corporation and S corporation scenario, the valuations of which were not far apart—$2,142,507 versus $2,189,996.

### The Appellate Decision

The Dallas Court of Appeals affirmed the trial court's judgment.[43]

## Texas Supreme Court Reverses in Part Court of Appeals Decision

*Hughes* was petitioned to the Texas Supreme Court by CPS and Joubran. In its *per curiam* decision issued on June 27, 2014, the court proceeded, with its third sentence of the opinion, to explain that it had already rejected a common-law cause of action in *Ritchie*.

The length of the opinion, five pages, also suggests that it felt no need to rehash its opinion as expressed in *Ritchie*. The court reversed in part, and affirmed in part, the judgment of the appellate court.[44]

The element of the case that was affirmed was that grievances warranted the case being remanded back to trial court.

The court reversed the appellate and trial court's remedy of a buyout. In articulating its opinion, the Texas Supreme Court began by noting that Texas law does not authorize the buy-out order as a remedy. In *Ritchie*, the court determined that a claim for shareholder oppression is only available under section

"... will federal court rulings in Texas continue to mirror those of prior Texas appellate court decisions, or will they conform to the Texas Supreme Court decisions?"

11.404 of the Texas Business Organizations Code as relates to rehabilitative receivership, and that a common-law claim for shareholder oppression is not valid.[45]

The court did acknowledge that transgressions had occurred, but that the choice of law was faulty. The court remanded the matter to the trial court.[46] As the court wrote in Ritchie, there are "other existing legal protections" that could be pursued other than a common-law cause of action.[47] One such statute suggested by the court as more appropriate is a derivative action for breach of fiduciary duties under Section 21.563(c) of the Business Corporations Code.[48]

## On the Heels of *Hughes* and *Ritchie*, How Will Federal Courts in Texas Rule?

In prior federal court cases in Texas, the federal courts have largely followed the lead of the state appellate courts.[49] These decisions were *In re Rosenbaum* and *Bulacher v. Enowa*, both in 2010.[50] *Bulacher* relied on *Willis*[51] and *Davis*[52] in considering a two-part definition of shareholder oppression.

In the future, will federal court rulings in Texas continue to mirror those of prior Texas appellate court decisions, or will they conform to the Texas Supreme Court decisions?

## Conclusion

Absent the enactment of a shareholder oppression statute by the Texas legislature, it is apparent that relief to allegedly oppressed shareholders is confined largely to the receivership statute or a derivative action. In *Hughes*, even the trial jury determined that no fiduciary relationship existed. A derivative action is not necessarily a bad option.

Typically, in a shareholder derivative suit, the suit is brought by a shareholder on behalf of a shareholder, and the damages are awarded to the corporation. However, in Texas, a shareholder of a closely held corporation may seek damages for oneself.[53]

In conclusion, the following features of *Hughes* may serve as words to the wise when entering into a securities transaction:

- Hughes signed a bad buy/sell agreement. The price inscribed by contract was book value, not even a multiple of book value as is typically the method for a going-concern company with a value based on expected future cash flow exceeds break-up value.

  Furthermore, valuations based on book value are ordinarily applied only to companies within the financial sector, notably banks, because they engage in the carry trade. Also, certain real estate holding companies may be valued by adjusted net asset value, reflecting the current market value of the underlying assets.

  CPS was not a financial company. If Hughes and Joubran had disagreed on a valuation method when inking the contract, they could have stipulated that an independent valuation analyst would determine fair market value when the buy/sell agreement was triggered.

- A buy/sell agreement based on book value invites manipulation of cash flow by unscrupulous, controlling shareholders. It is conceivable, to use an extreme example for illustrative purposes, that a company could generate nearly zero growth in book value over 10 years, while generating robust growth in revenue and free cash flow.

  Conceivably and mathematically, a company could have a book value of only $1 million while generating over $100 million in revenue (a real world example with similar proportions is General Motors over the last 100 years).

  This result could be achieved simply through paying exorbitant salaries to the controlling shareholders who serve in management positions.

  Under that scenario, if the company, hypothetically, would fetch a valuation of 1x revenue to a willing buyer, it could be valued at $100 million under the guideline publicly traded company valuation method (the market approach), while being valued at $1 million if valued at 1x book value (the asset-based approach).

- The very nature of the buy/sell agreement, that the firing of Hughes would trigger the mandatory purchase by Joubran at book value, gave Joubran an incentive to fire

Joubran when the fair market value of CPS greatly exceeded its book value. Essentially, the buy/sell agreement was akin to a free stock option given to Joubran, with no expiration date.

The longer CPS remained in business and generating profits, the more compelling was the arbitrage opportunity for Joubran, which he could exercise simply by firing Hughes and immediately capturing the difference between book value and fair market value, multiplied by the percentage ownership of Hughes.

Notes:

1. Cabell v. Markham, 148 F.2d 737, 739 (CA. 2d, 1945).
2. Texas Business Organizations Code Section 11.404.
3. Ritchie v. Rupe, 339 S.W.3d 275 (Tex. App. 2011); Cardiac Perfusion Services v. Hughes, 380 S.W.3d 198 (Tex. App. 2012).
4. Ritchie v. Rupe, 339 S.W.3d 275.
5. Ritchie v. Rupe, 443 S.W.3d 856, 861 (Tex. 2014).
6. Id. at 862.
7. Ritchie v. Rupe, 339 S.W.3d at 294.
8. Davis v. Sheerin, 754 S.W.2d 375, 381-82 (Tex. App. 1988).
9. Ritchie v. Rupe, 339 S.W.3d at 289 (citing Willis v. Bydalek, 997 S.W.2d 798, 801; Redmon v. Griffith, 202 S.W.3d 225, 234; Pinnacle Data Servs., Inc. v. Gillen, 104 S.W.3d 188, 196).
10. Ritchie v. Rupe, 339 S.W.3d at 285.
11. Texas Business Corporation Act, Article 7.05, later amended to Section 11.404 of Texas Statutes – "Appointment of Receiver to Rehabilitate Domestic Entity."
12. Ritchie v. Rupe, 443 S.W.3d at 863.
13. Ritchie v. Rupe, 339 S.W.3d at 301.
14. Davis v. Sheerin, 754 S.W.2d 375.
15. Davis v. Sheerin, 754 S.W.2d at 380.
16. http://www.statutes.legis.state.tx.us/?link=BO.
17. Ritchie v. Rupe, 443 S.W.3d at 866.
18. 141 T.C. No. 5 (2013).
19. Ritchie v. Rupe, 443 S.W.3d at 871.
20. Id.
21. Id. at 892.
22. Id. at 878.
23. Id. at 879.
24. Id. at 880.
25. Id. at 897.
26. Cardiac Perfusion Services v. Hughes, 380 S.W.3d 198.
27. Id. at 204.
28. Id. at 200.
29. Id.
30. Cardiac Perfusion Services v. Hughes, 436 S.W.3d 790, 791 (Tex. 2014).
31. Cardiac Perfusion Services v. Hughes, 380 S.W.3d 198.
32. Fortis Benefits v. Cantu, 234 S.W.3d 642 (Tex. 2007).
33. Fortune Production Co. v. Conoco, Inc., 52 S.W.3d 671 (Tex. 2000).
34. City of the Colony v. North Texas Municipal Water District, 272 S.W.3d 699 (Tex. App. 2008).
35. Hayes v. Olmsted & Associates, Inc., 173 Or.App. 259, 21 P.3d 178 (2001).
36. Cardiac Perfusion Services v. Hughes, 380 S.W.3d at 204.
37. Id.
38. Id. at 205.
39. Id.
40. Id.
41. Id.
42. Id. at 207.
43. Id. at 198.
44. Cardiac Perfusion Services v. Hughes, 436 S.W.3d 790.
45. Id. at 791.
46. Id.
47. Id.
48. Id.
49. Paul R. Genender, "Minority Shareholder Oppression in Texas: Current Developments and Considerations," presentation to the 2014 Conference on Securities Regulation and Business Law, February 13–14, 2014, Dallas, Texas: 13.
50. Ibid.: 13–15.
51. Willis v. Bydalek, 997 S.W. 2d (Tex. App. 1999).
52. Davis v. Sheerin, 754 S.W.2d 375.
53. Texas Business Corporation Act, Article 5.14 (Derivative Proceedings), section L.

*Sam Nicholls is a senior associate in our Atlanta practice office. Sam can be reached at (404) 475-2311 or at ssnicholls@willamette.com.*