# SHAREHOLDER OPPRESSION: IS IT A CAUSE OF ACTION?

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**UNITED STATES MARINE CORPS OFFICER CANDIDATE SCHOOL**, QUANTICO, VIRGINIA—2009

- Screened and evaluated on leadership ability by Marine Officers and NCOs.

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**U.S. ATTORNEY'S OFFICE, SOUTHERN DISTRICT OF TEXAS—LAW CLERK (Spring 2013)**

- Assisted in investigations and prosecutions of international drug cartels.

**TRANSCANADA CORPORATION—LEGAL INTERN (Summer 2012)**

- Researched legal issues with regulatory compliance and pipeline operations.

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## I. SCOPE OF THE ARTICLE

In troubled economic times, the temptation to exercise power over business partners can be overwhelming—whether borne out of greed, a sense of entitlement, or even a perceived need for self preservation. This article deals with the rights of individual shareholders in closely held corporations. This is an area that is poorly developed in Texas law and plagued with apparent contradictions in the dicta. The most common case arising out of the abuse of corporate powers has to do with officers or directors using their power to steal from the corporation (and thus from the shareholders as a group). Shareholders often bring these cases, and a very common result is the dismissal of the lawsuit because the duties violated are owed to the corporation and not to the shareholders individually. Several Texas cases seem to suggest that there are no (or at least very few) duties owed to shareholders individually. In recent years, individual shareholders have been prevailing in lawsuits asserting claims for shareholder oppression—claims based on duties owed to the shareholders individually. In this article, we will explore the basis of these claims. We will not deal with the closely related issue of derivative suits or with duties owed by officers and directors to corporations.

## II. SHAREHOLDER RIGHTS AND DUTIES

### A. Choice of Law

1. Texas Statutory Law

The Texas Business Organizations Code is the primary statute regulating the operation of corporations in Texas. Additionally, Texas Revised Civil Statute Article 1302 *et seq*. contains various provisions regulating corporations. The Texas Business Organizations Code was adopted in 2003 with an effective date of January 1, 2006.[1] The Texas Business Organizations Code applies to all domestic corporations formed or converted from another type of business organization on or after January 1, 2006,[2] to all foreign entities not registered with the Secretary of State prior to January 1, 2006,[3] and to all domestic and foreign corporations electing early adoption of the Code.[4] The Business Organizations Code applies to all corporations as of January 1, 2010.[5]

2. Choice of Law

Texas has codified the internal affairs doctrine.[6] The internal affairs doctrine provides that the internal affairs of a foreign corporation, including but not limited to the rights, powers, and duties of its board of directors and shareholders and matters relating to its shares, shall be governed solely by the laws of its jurisdiction of incorporation.[7]

### B. Structure and Relationship of the Corporation to Shareholders

1. Nature of the Corporation

The corporate structure allows the owners of a business to shield themselves from liability for debts incurred by the business, to document and securitize their ownership, to separate the ownership and control of a business so as to allow the existence of owners who are purely investors and are not required to manage the affairs of the business actively, and to make the business structure permanent and not subject to the whims of each of the participants. "A principal economic function of corporate organization is separation of ownership from control, so that entrepreneurs need not supply all the capital, and those who supply capital may diversify their investments and need not furnish managerial skills." [8] Because ownership is split up into shares, it is also usually the case that certain shareholders will have minority ownership interests in the corporation.

2. Principle of Majority Rule

Texas corporate law provides for centralized control of corporate affairs through directors elected by the shareholders and for majority rule on elections and most matters submitted to a shareholder vote. The business corporations statute states that "the business and affairs of a corporation shall be managed under the direction of the board of directors of the corporation."[9] These directors are elected by the holders of a majority of the shares of the corporation and may be removed at any time, with or without cause, by a vote of the majority of the shares of the company.[10] Therefore, whoever controls the majority of the shares, controls who runs the company. In most smaller corporations, a shareholder may only own 51% of the shares, but

[1] TEX. BUS. ORGS. CODE ANN. § 1.02(20) (West 2011).
[2] *Id*. § 402.001(a)(1), (2).
[3] *Id*. § 401.001(a)(3).
[4] *Id*. §§ 402.002, 402.003.
[5] *Id*. § 4.02.005.
[6] *See id*. §§ 1.101. 1.102, 1.105; Sommers Drug Stores Co. Emp. Profit Sharing Trust v. Corrigan, 883 F.2d 345, 353–54 (5th Cir. 1989); *see also* RESTATEMENT (SECOND) OF CONFLICTS OF LAW § 302(2) (1971).
[7] *Corrigan*, 883 F.2d at 353.
[8] Hoagland *ex rel.* Midwest Transit, Inc. v. Sandberg, Phoenix & von Gontard, P.C., 385 F.3d 737, 747 (7th Cir. 2004).
[9] TEX. BUS. ORGS. CODE ANN. §§ 3.101, 21.401, 21.402. (West 2011).
[10] *Id*. §§ 21.301, 21.302, 21.303, 21.405, 21.409.

because of the doctrine of majority rule, that shareholder can place himself in 100% control of 100% of the corporate assets.

### C. Shareholder Duties

1. Controlling Shareholders

Shareholders who exercise control over the corporation, either directly as an officer, director or through a majority vote or indirectly through control and influence over the officers and directors, is generally held to be a corporate fiduciary.[11] "[T]he peculiar duty of a controlling stockholder to deal fairly with the corporation, its stockholders, and creditors is broader than the trust-fund doctrine. It rests on his inside knowledge of the corporation's affairs and his opportunity to manipulate them for his personal advantage."[12]

2. Other Shareholders

In all other regards, however, share ownership does not ordinarily involve any duties to the corporation or to other shareholders.[13] A minority shareholder, for example, may compete in business against his own corporation.[14]

### D. Shareholder Rights

1. Legal Relationship of Corporation to Shareholders

Historically in Texas law, the relationship between a corporation and its shareholders has been seen as a particular species of trust.[15] The corporation holds legal title to its assets and business.[16] But that legal title is held for the benefit of the shareholders, who are the equitable and beneficial owners of the corporation's assets.[17] The Texas Supreme Court has held that a corporation "is a trustee for the interests of it shareholders in its property, and is under the obligation to observe its trust for their benefit. Its possession is friendly, and not adverse, and the shareholder is entitled to rely upon its not attempting to

[11] Schautteet v. Chester State Bank, 707 F. Supp. 885, 889 (E.D. Tex. 1988) (stating that officers, directors, and controlling shareholders owe fiduciary duties of utmost good faith, scrupulous honesty, and loyalty to the corporation and to its shareholders); C.H. Leavell & Co. v. Leavell Co., 676 S.W.2d 693, 697 (Tex. App.—El Paso 1984, writ dism'd by agr.); *see also* Lewis v. Knutson, 699 F.2d 230, 235 (5th Cir. 1983) (applying Delaware law).

[12] Tigrett v. Pointer, 580 S.W.2d 375, 379 (Tex. App.—Dallas 1978, writ ref'd n.r.e.); *see also* Pepper v. Litton, 308 U.S. 295, 306 (1939) ("A director is a fiduciary. So is a dominant or controlling stockholder or group of stockholders. Their powers are powers in trust. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein."); S. Pac. Co. v. Bogert, 250 U.S. 483, 487–88 (1919) ("The rule of corporation law and of equity invoked is well settled and has been often applied. The majority has the right to control; but when it does so, it occupies a fiduciary relation toward the minority, as much so as the corporation itself or its officers and directors.").

[13] *See* Hoggett v. Brown, 971 S.W.2d 472, 488 (Tex. App.—Houston [14th Dist.] 1997, writ denied).

[14] *See* Witmer v. Ark. Dailies, Inc. 151 S.W.2d 971, 974 (Ark. 1941); Bennett v. Mack's Supermarkets, Inc., 602 S.W.2d 143, 147 (Ky. 1979) ("Mere stock ownership without management and control does not prevent a stockholder from competing with his corporation."); Singer v. Carlisle, 26 N.Y.S. 172, 181 (N.Y. Sup. 1940); *see also* US Airways Grp., Inc. v. British Airways PLC, 989 F. Supp. 482, 494 (S.D.N.Y. 1997) ("It is well-settled under Delaware law that a shareholder does not owe a fiduciary duty to the corporation unless it owns a majority interest in or exercises control over the business affairs of the corporation."); Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987) ("Under Delaware law a shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation.").

[15] *See* Yeaman v. Galveston City Co., 167 S.W. 710, 723 (Tex. 1914); Disco Machine of Liberal Co. v. Payton, 900 S.W.2d 124, 126 n.2 (Tex. App.—Amarillo 1995, writ denied); Hinds v. Sw. Savings Ass'n, 562 S.W.2d 4, 5 (Tex. Civ. App.—Beaumont 1977, writ ref'd n.r.e.); Graham v. Turner, 472 S.W.2d 831, 836 (Tex. Civ. App.—Waco 1971, no writ); Rex Ref. Co. v. Morris, 72 S.W.2d 687, 691 (Tex. Civ. App.—Dallas 1934, no writ).

[16] Rapp v. Felsenthal, 628 S.W.2d 258, 260 (Tex. App.—Fort Worth 1982, writ ref'd n.r.e.).

[17] McAlister v. Eclipse Oil Co., 98 S.W.2d 171, 176 (Tex. 1936); *In re* Estate of Trevino, 195 S.W.3d 223, 230 (Tex. App.—San Antonio 2006, no pet.); Cotten v. Weatherford Bancshares, Inc., 187 S.W.3d 687, 697 (Tex. App.—Fort Worth 2006, pet. denied); Martin v. Martin, Martin & Richards, Inc., 12 S.W.3d 120, 124 (Tex. App.—Fort Worth 1999, no pet.); Rapp, 628 S.W.2d at 260; Gossett v. State, 417 S.W.2d 730 (Tex. Civ. App.—Eastland 1967, writ ref'd. n.r.e.).

impair his interest."[18] The court further characterized the "trusteeship of a corporation for its shareholders" as "an acknowledged and continuing trust."[19] "It cannot be regarded of a different character. It arises out of the contractual relation whereby the corporation acquires and holds the stockholder's investment under express recognition of his right and for a specific purpose. It has all the nature of a direct trust . . . ."[20]

The shareholders' rights and interests derive "from the nature of the organization, and the relation of the stockholders to the corporation and its property."[21] However, the fiduciary duty owed directly to minority shareholders under Texas law is "narrow."[22] The duty of the corporation to its shareholders concerns and is limited to those interests and expectations that flow from the nature of share ownership and the relationship between the corporation and its shareholders. Within that context, however, the corporation as trustee is held to a strict duty of loyalty. A trustee owes a trust beneficiary an unwavering duty of good faith, fair dealing, loyalty and fidelity over the trust's affairs and its corpus.[23] The Texas Supreme Court has written:

> When persons enter into fiduciary relations, each consents, as a matter of law, to have his conduct towards the other measured by the standards of the finer loyalties exacted by courts of equity. That is a sound rule and should not be whittled down by exceptions. The rule is general in its use and is fundamental. It is for the benefit of the cestui que trust and undertakes to enforce the duty of loyalty on the part of the trustee by prohibiting him from using the advantage of his position to gain any benefit for himself at the expense of his cestui que trust and from placing himself in any position where his self interest will or may conflict with his obligations as trustee.[24]

2. Corporate Duties Owed Directly to Shareholders

Texas law has long recognized that actions for wrongful conduct in the management or control of a corporation may not be asserted directly by the shareholders.[25] However there has always been a recognized exception "where the wrongdoer violates a duty arising from contract or otherwise, and owing directly by him to the stockholder."[26] In the landmark case of *Cates v. Sparkman*,[27] the Texas Supreme Court upheld the dismissal of a minority shareholder lawsuit against the directors and majority shareholders of the corporation. In that case, the plaintiff owned lands with coal deposits. The plaintiff entered into an agreement with the defendants to develop the coal deposits. The defendants formed a corporation, and the plaintiff exchanged his title to the land for stock in the corporation. The defendants began development of the mining project, but apparently ran out of money and shut it down—thus leaving the plaintiff with no land and near worthless stock in a company that was out of business. The plaintiff filed suit claiming that the defendants breached duties owed to him as a shareholder. The Texas Supreme Court upheld the dismissal of the action on the basis of the business judgment rule:

> The breach of duty authorizing a suit by an individual stockholder for damage in the depreciation of his stock does not refer to mere mismanagement or neglect of the officers or directors in the control of the corporate affairs, or the abuse of discretion lodged in them in the conduct of the company's business. On this ground the courts do not interfere. . . . If the acts or things [challenged by a plaintiff shareholder] are or may be that which the majority of the company have a right to do, or if they have been done irregularly, negligently, or imprudently, or are within the exercise of their discretion and judgment in the development or prosecution of the enterprise in which their interests are involved, these would not constitute such breach of duty, however unwise or inexpedient such acts

[18] *Yeaman*, 167 S.W. at 723.
[19] *Id*.
[20] *Id*. at 723–24.
[21] Moroney v. Moroney, 286 S.W. 167, 169 (Tex. Comm. App. 1926, judgm't adopted).
[22] *See Reibe*, 828 F. Supp. at 456.
[23] Hersbach v. City of Corpus Christi, 883 S.W.2d 720, 735 (Tex. App.—Corpus Christi 1994, writ denied); Ames v. Ames, 757 S.W.2d 468, 476 (Tex. App.—Beaumont 1988), *aff'd and modified*, 776 S.W.2d 154 (Tex. 1989).
[24] Slay v. Burnett Trust, 187 S.W.2d 377, 377–78 (Tex. 1945).
[25] *See* Commonwealth of Massachusetts v. Davis, 168 S.W.2d 216, 221 (Tex. 1943) ("Ordinarily, the cause of action for injury to the property of a corporation. or the impairment or destruction of its business, is vested in the corporation, as distinguished from its stockholders, even though it may result indirectly in loss of earnings to the stockholders. Generally, the individual stockholders have no separate and independent right of action for injuries suffered by the corporation which merely result in the depreciation of the value of their stock.").
[26] *Id*. at 222.
[27] 11 S.W. 846 (Tex. 1889).

> might be, as would authorize the interference by the courts at the suit of a stockholder.[28]

This ruling continues to be cited as the classic statement of the business judgment rule in Texas jurisprudence.[29]

In describing the limits of the business judgment rule, the Texas Supreme Court also shed light on the nature of the duties owed directly to shareholders:

> The breach of duty or conduct of officers and directors which would authorize, in a proper case, the court's interference in suits of this character is that which is characterized by ultra vires, fraudulent, and injurious practices, abuse of power, and oppression on the part of the company or its controlling agency clearly subversive of the rights of the minority, or of a shareholder, and which, without such interference, would leave the latter remediless.[30]

For our purposes, it is important to note that the Texas Supreme Court's holding contemplates two distinct kinds of claims: First, the conduct of directors is not shielded from judicial interference when their actions are ultra vires, fraudulent, or an abuse of power. These descriptions contemplate breaches of duties owed to the corporation and could be asserted only by the corporation or by a shareholder in a derivative suit. However, the Court also contemplates a class of claims for "oppression on the part of the company or its controlling agency clearly subversive to the rights of the minority, or of a shareholder." This class of claims for conduct that the Court describes as "oppression" must be based on the individual rights of minority shareholders as against the company and those in control of the company.

Texas courts have long recognized that minority shareholders have rights and interests that the law will protect and that those rights and interests belong to the shareholders individually by virtue of their legal status as shareholders. In *Patton v. Nicholas,*[31] the Texas Supreme Court cited the *Cates v. Sparkman* opinion as authority for the contention that minority stock interests involve valuable legal rights which the law will protect and are far from merely "change left on the counter" as the majority shareholders had contended. In Patton, the Supreme Court held that a minority shareholder, individually, has a remedy both against the corporation and against those in control of the corporation for malicious suppression of dividends, where the controlling shareholder had retained significant earnings in the corporation, had taken an unreasonably high salary, had declared no dividends for six years, and had evidenced a malicious state of mind toward the minority shareholders.[32] The court held that "in the more extreme cases of the general type of the instant one," cases involving "gross or fraudulent mismanagement," minority shareholders may seek the appointment of a receiver for even solvent corporations.[33] However, the court also held that "[w]isdom would seem to counsel tailoring the remedy to fit the particular case," which in that particular case was an injunction on the corporation and the majority shareholder to declare dividends under the supervision of the trial court.[34] The Supreme Court held that courts of equity should use their powers to protect minority shareholders from "recurrent mismanagement or oppression on the part of a dominant and perverse majority stockholder or stockholder group."[35]

In *Moroney v. Moroney,*[36] a guardian had been appointed to manage the estates of his minor nephews, a large part of which was the stock in a closely held corporation. The nephews' estate controlled all but one share of stock in the corporation; the guardian owned the remaining share individually. Additionally, the guardian ran and controlled the corporation. The dispute concerned the guardian's misappropriation of certain cash and merchandise from the corporation, which the district court had charged to the guardian in favor of the estate. The guardian argued that the award was incorrect because the estate, as a shareholder, did not have a claim against him for misappropriating the corporation's assets. The Commission of Appeals upheld the award. This case is usually cited as an example of shareholders being allowed to sue corporate officers directly as a result of a duty owed by the corporate officer to the individual shareholder independent from the ownership of stock and in a capacity unrelated to the corporation.[37] However, the

[28] *Id*. at 849.

[29] *See* TTT Hope, Inc. v. Hill, Civil Action No. H-07-3373, 2008 WL 4155465 (S.D. Tex. 2008); FDIC v. Benson, 867 F. Supp. 512, 516 n.2 (S.D. Tex. 1994); Pace v. Jordan, 999 S.W.2d 615, 623 (Tex. App—Houston [1st Dist.] 1999, pet. denied); Langston v. Eagle Pub. Co., 719 S.W.2d 612, 617 (Tex. App.—Waco 1986, writ ref'd n.r.e.); Gearhart Indus., Inc. v. Smith Int'l, Inc., 741 F.2d 707, 721 (5th Cir. 1984).

[30] *Cates*, 11 S.W. at 849.

[31] 279 S.W.2d 848, 854 (Tex. 1955).

[32] *Id*. at 857–58.

[33] *Id*.

[34] *Id*.

[35] *Id*.

[36] 286 S.W. 167 (Tex. Comm. App. 1926, judgm't adopted).

[37] *See, e.g.*, Schoellkopf v. Pledger, 739 S.W.2d 914, (Tex. App.—Dallas 1987) (characterizing holding as "guardian who manages a corporation

*Maroney* opinion does not turn on this ground. The court, relying on duties owed to the plaintiffs as shareholders, characterizes the illegal payments to the guardian as constructive dividends to the controlling shareholder and only then holds that the defendant must account to the estate for his receipt of the dividends based on his duties to the plaintiffs as guardian.[38] The court stated its reasoning:

> The stockholder does own, however, his shares, stock, or interest whatsoever in the corporation, and this carries with it certain legal rights, but they are not the rights of a legal owner of the corporation's assets in whole or in part. This distinction holds good even though all the stock may be held by a single individual. It does not follow from this, however, that the rights of a stockholder in a corporation are not of judicial cognizance. Indeed, in every profitable corporate venture, the rights of the stockholder are of great importance, and at all times will be properly protected, whether in a court of law or equity, according to the exigencies of the situation. The chief value of corporate stock is its right to receive dividends. So important is this right that courts of equity will, in a proper case, compel a payment of dividends. And where a stockholder is entitled to force payment of a dividend, the right does not arise from any actual contract between the corporation and its stockholders, but rather from the nature of the organization, and the relation of the stockholders to the corporation and its property.[39]

In *Morrison v. St. Anthony Hotel*,[40] the minority shareholder sued the majority shareholder claiming malicious suppression of dividends. Further, the minority shareholder alleged that the majority shareholder: 1) took out significant fees and salaries; 2) paid off loans it had made to the corporation early; 3) paid out dividends far less than the earnings of the corporation; and 4) had maliciously mismanaged the corporation for the wrongful purpose of reducing the minority's earnings and to suppress their dividends. The court held: "Generally, it is the corporation and not the stockholders which must redress wrongs which weaken corporate values."[41] The court, however, continued on to hold that "in a proper case, where a majority stockholder has abused its discretion and has maliciously suppressed the payment of dividends, a stockholder may assert a cause of action for damages and may compel the declaration of dividends."[42]

Further, "[m]anagement of the corporation by those in control, for their own interest or profit, to the exclusion of minority stockholders, is ground for relief."[43] Additionally, "[m]ismanagement of the corporation, by those in charge, for the purpose of depressing the value of the stock of minority stockholders, so as to cause them to either surrender the stock or sell it at a sacrifice, is actionable."[44] "[W]hile a majority of the stockholders may legally control the corporation's business, they assume the correlative duty of good faith, and cannot manipulate such business in their own interest to the injury of minority stockholders."[45] The court reversed the dismissal of the minority shareholder's action and held that the minority shareholder had stated a claim to recover the dividends that had been withheld.[46]

3. Contrary Analysis

Conceptualizing the rights of shareholders as duties owed by the corporation arising from the legal relationship between corporation and its owners is not free from difficulty, primarily because the corporation does not act except as a result of decisions made by humans in control of the corporation and except through human agency. Some other jurisdictions have resisted the notion that the liability should rest with the corporation for wrongdoing initiated by and executed through officers, directors or other shareholders.[47] The Sixth Circuit has stated:

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in which his ward's estate is the principal shareholder may be directly liable to the ward for mismanagement resulting in depreciation in the value of the estate's shares, as breach of the duty of a guardian to his ward"), *rev'd on other grounds*, Pledger v. Schoellkopf, 762 S.W.2d 145 (Tex. 1988).

[38] *See* 268 S.W. at 170.

[39] *Id*. at 169.

[40] 295 S.W.2d 246, 252 (Tex. Civ. App.—San Antonio 1956, writ ref'd n.r.e.).

[41] *Id*. at 250.

[42] *Id*.

[43] Id.

[44] *Id*. at 250–51.

[45] *Id*. at 251.

[46] *Id*. at 253.

[47] Many jurisdictions have held that there is no respondeat superior liability on a corporation for a breach of fiduciary duty by its directors. *See* CCBN.Com, Inc. v. Thomson Fin., Inc., 270 F. Supp.2d 146, 151–52 (D. Mass. 2003); U.S. Airways Grp., Inc. v. British Airways PLC, 989 F. Supp. 482, 494 (S.D.N.Y. 1997) ("[T]he imposition of respondeat superior liability on a corporation for breach of fiduciary duty by its directors on the board of another corporation would completely undermine Delaware corporate law, which limits such fiduciary duty to majority

> Liability for breach of the directors' fiduciary obligation could not possibly run against the corporation itself, for this would create the absurdity of satisfying the shareholders' claims against the directors from the corporation, which is owned by the shareholders. There is not, and could not conceptually be any authority that a corporation as an entity has a fiduciary duty to its shareholders.[48]

Of course, these cases presuppose that the state law recognizes fiduciary duties running from the officers and directors to the individual shareholders—otherwise, there would be no question of holding the corporation liable for violations by the officers and directors of duties to the shareholders. Under Texas law, however, officers and directors owe "a fiduciary

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and controlling shareholders."); *cf.* Med. Self Care, Inc. v. Nat'l Broad. Co., Inc., 01-CIV-4191, 2003 WL 1622181, *7 (S.D.N.Y. March 28, 2003) (citing *US Airways Group* and rejecting theory under California law); *see also* RESTATEMENT (SECOND) OF AGENCY §§ 140, 212 (1958). *But see In re* Papercraft Corp., 165 B.R. 980, 991 (Bankr. W.D. Pa. 1994) (accepting theory in case applying Pennsylvania law), *vacated on other grounds*, 187 B.R. 486 (Bankr. W.D. Pa. 1995), *rev'd on other grounds*, 211 B.R. 813 (W.D. Pa. 1997).

[48] Radol v. Thomas, 772 F.2d 244, 258 (6th Cir. 1985); Jordan v. Global Natural Res., Inc., 564 F. Supp. 59, 68 (S.D. Ohio 1983) ("We conclude, however, that a corporation as an entity has no fiduciary duty to its shareholders as a matter of law. We have engaged in extensive research and have found nothing to indicate that a fiduciary relationship exists between a corporation and its shareholders. Rather, a corporation is a legal entity created and regulated by statute in derogation of the common law. The rights and obligations of a corporation and its shareholders are defined by statute and remedies are provided for breach of statutory duties. We can find no authority that would allow this Court to impose a common law fiduciary duty on the part of Global to its shareholders and we, therefore, decline to do so. . . . A corporation, because of its nature, may act only through its officers and agents. It may, therefore, be held vicariously liable for the acts of its officers and agents acting within the scope of their actual or apparent authority under the doctrine of respondeat superior.") (citations omitted); *see also* Holloway v. Howerdd, 536 F.2d 690, 695 (6th Cir. 1976); 10 FLETCHER, CYCLOPEDIA CORPORATIONS § 4886 (1978). It is a well-recognized principle that directors of a corporation have a fiduciary duty to the corporation, and it is often found that the obligation extends to the shareholders as well. *E.g.*, Ohio Drill & Tool Co. v. Johnson, 625 F.2d 738, 742 (6th Cir. 1980). It is conceivable, therefore, that plaintiff could recover against the corporation if he could establish that the directors, acting within their actual or apparent authority, breached a duty owing to plaintiff and the class. Under New York law, a corporation does not owe fiduciary duties to its members or shareholders. Hyman v. N.Y. Stock Exch., Inc., 848 N.Y.S.2d 51, 53 (N.Y.A.D. 2007). Kansas law does not recognize a fiduciary duty between a corporation and its stockholders. *See* Litton v. Maverick Paper Co., 388 F. Supp.2d 1261, 1296 (D. Kan. 2005). *Litton* relied on *Burcham v. Unison Bancorp, Inc.*, 77 P.3d 130, 416 (Kan. 2003), which holds that it is the directors who owe fiduciary duties to the shareholders, and not the corporation, and that the corporation is not liable for the breach of the directors' fiduciary duties to the shareholders because the directors control the corporation and are therefore not its agents and concludes that it would be unjust to shift responsibility from the directors to the corporation for the directors' breach of duty to shareholders." Under Alaska law, officers, directors and controlling shareholders owe fiduciary duties to corporation and possibly to shareholders, but corporation does not owe fiduciary duties to hits shareholders. *See* Meidinger v. Koniag, Inc., 31 P.3d 77, 87 (Alaska 2001). Under Illinois law, individuals who control corporations owe fiduciary duties to their corporations and their shareholders, but the corporation, as distinct from its officers and directors, does not owe fiduciary duties to shareholders. *See* Small v. Sussman, 713 N.E.2d 1216, 1221 (Ill. App. 1999); Doherty v. Kahn, 682 N.E.2d 163, 174 (Ill. App. 1997); Wencordic Enters., Inc. v. Berenson, 511 N.E.2d 907, 918 (Ill. App. 1987). However, *Holmes v. Birtman Elec. Co.*, 159 N.E.2d 272 (Ill. App. 1959), *rev'd on other grounds*, 165 N.E.2d 261 (Ill. 1960), held: "In Illinois a corporation and its agents are trustees with respect to the registration of transfers of its securities and are liable for injuries resulting from their failure to discharge such fiduciary responsibilities." *Allmon v. Salem Bldg. & Loan Ass'n*, 114 N.E. 170, 170 (Ill. 1916), held: "But a corporation is by law the custodian of the shares of its stock and clothed with power sufficient to protect the rights of every one interested therein from unauthorized transfers, and, like every other trustee, it is bound to execute the trust with proper diligence and care, and is responsible for an injury sustained by its negligence or misconduct in making transfers or cancellations of such stock." *Small v. Sussman* distinguishes these cases as limited to situations of transfer of shares. *See* 713 N.E.2d at 1221.

duty to the shareholders collectively, i.e., the corporation," but not to the individual shareholders.[49]

### E. Contract

A corporation may also owe a duty directly to an individual shareholder as a result of a contractual obligation—either an express contract or an implied contract. An implied contract arises when circumstances disclose that, according to the ordinary course of dealing and the common understanding, there was a mutual intent to contract.[50] Express language is not essential to a promise; conduct may convey an objective assent. The only difference between express contracts and implied contracts is the character and manner of proof required to establish mutual assent, and whether mutual assent existed is a question of fact for the jury.[51]

## III. DUTIES TO SHAREHOLDERS IN THE PURCHASE AND SALE OF SHARES

### A. Repurchase of Minority Shares by Corporation

In *In re Fawcett*, the widow of a shareholder in a closely held corporation entered into an agreement with the corporation providing for the corporation to repurchase her shares.[52] She later sued the corporation for fraud and breach of fiduciary duties because the corporation and the other shareholders failed to disclose the existence of a significant business opportunity that the corporation commenced within days after signing the agreement, and which would have greatly increased the value of her shares. The court of appeals held that there was a fact issue as to the existence of fiduciary duties owed to the individual shareholder under the circumstances.[53] "An officer or director of a closely held corporation, as well as the corporation itself, may become fiduciaries to a shareholder when the corporation, officer, or director repurchases the shareholder's stock." [54] Subsequent cases have cited *In re Fawcett* for the proposition that fiduciary relationships may be created by contract, through the repurchase of a shareholder's stock in a closely held corporation.[55] However, it is clear from the opinion that the contract itself did not create fiduciary duties; rather it was the occasion of entering into the contract that resulted in the application of fiduciary duties that already existed in the relationship between the corporation and its shareholder.

In *Ward v. Succession of Freeman*,[56] the Fifth Circuit reversed a securities fraud judgment in favor of former minority shareholders of a Louisiana Coke-bottling corporation. A group of shareholders who together controlled twenty percent of the outstanding shares and who had control of the corporation's management, caused the corporation to make a series of tender offers to repurchase minority shares after attending a 1979 convention at which they learned that the Coca-Cola Corporation intended to initiate a restructuring program whereby it would "actively participate" in changes to the ownership of the affiliated bottling companies. In 1980, 1982, and 1983, the corporation made nonbinding offers to retain minority shares at prices ranging from $321 per share to $850 per share. The plaintiffs sold their shares in the 1982 tender offer. In the 1982 tender offer document, the defendants mentioned to the possibility of a future reverse stock split (which would cash out a minority shareholder positions) but also represented at the company had no current plans for such a reverse split. As a result of the various tender offers, the defendants increase their share position from 20% to 80%. In 1984, the defendants sold the bottling company to Big Coke for $148 million. Thereafter, the plaintiffs sued, claiming that the series of tender offers or fraudulent and constituted part of the defendants' plans to "squeeze out" and "freeze out" the minority shareholders. The case was tried to a jury, and the plaintiffs perceived a favorable judgment.[57]

With respect to the securities fraud claim, the Court held that there must be a misrepresentation or

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[49] Ritchie v. Rupe, 339 S.W.3d 275 (Tex. App.—Dallas 2011, pet. granted); Redmon v. Griffith, 202 S.W.3d at 233; *see* Hoggett v. Brown, 971 S.W.2d 472, 488 (Tex. App.—Houston [14th Dist.] 1997, writ denied); Faour v. Faour, 789 S.W.2d 620, 621–22 (Tex. App—Texarkana 1990, writ denied); Kaspar v. Thorne, 755 S.W.2d 151, 155 (Tex. App.—Dallas 1988, no writ); Schoellkopf v. Pledger, 739 S.W.2d 914, 918 (Tex. App.—Dallas 1987), *rev'd on other grounds*, 762 S.W.2d 145 (Tex. 1988); Gearhart Indus., Inc. v. Smith Int'l Inc., 741 F.2d 707, 721 (5th Cir. 1984); Schautteet v. Chester State Bank, 707 F. Supp. 885, 888 (E.D. Tex. 1988).

[50] City of Houston v. First City, 827 S.W.2d 462, 473 (Tex. App.—Houston [1st Dist.] 1992, writ denied).

[51] Estate of Townes v. Townes, 867 S.W.2d 414, 419 (Tex. App.—Houston [14th Dist.] 1993, writ denied).

[52] 55 S.W.3d 214, 216 (Tex. App.—Eastland 2001, pet. denied).

[53] *Id*. at 220.

[54] *Id*. (citing Miller v. Miller, 700 S.W.2d 941, 945–46 (Tex. App.—Dallas 1985, writ ref'd n.r.e.)); WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5811.05 (perm. ed., rev. vol. 2000).

[55] *See In re* Rosenbaum, 08-43029, 2010 WL 1856344, at *7 (Bankr. E.D. Tex. May 7, 2010) *aff'd*, 08-43029, 2011 WL 4553440 (E.D. Tex. Sept. 29, 2011); *see also* Redmon, 202 S.W.3d at 237; *accord Willis*, 118 S.W.3d at 31, 33.

[56] 854 F.2d 780 (5th Cir. 1988).

[57] *Id*. at 782–83.

omission of a material fact.[58] The Court held that the plaintiffs' contention that the defendants had failed to disclose their "secret plan" or "true purpose" to "squeeze out or freeze out" the minority shareholders in order to sell to Big Coke did not state a claim for securities fraud. Federal securities laws do not provide a cause of action for breach of fiduciary duties unless there is an element of deception or fraudulent manipulation.[59] Therefore, the defendants' good faith or subjective motivation in entering into the transaction is not a "material fact."[60] The mere possibility of a future sale to Big Coke also did not need to be disclosed because there was no offer, and negotiations did not begin until more than a year after the tender offer.[61] The breach of fiduciary duties claim was brought under Louisiana law. The Court held that the jury charge had applied the incorrect standard because the tender offers were not self-dealing transactions because the benefit to the defendant shareholders from those transactions was no different from the benefit that devolved upon the corporation or all shareholders generally.[62]

### B. Purchase of Minority Shares by Controlling Shareholder

In *Miller v. Miller*,[63] the court addressed duties of controlling shareholders in purchasing shares from minority shareholders. Certain aspects of the case are unusual, and the case probably could have been resolved without reference to the corporate law issues. The case arose out of a divorce between a husband and wife. The husband had started a corporation with three other engineers, each of whom were issued 25% of the shares.[64] The husband was an officer and director. None of the shares were in the wife's name; her interests were purely as a result of community property. At the time that the corporation was organized, the husband and wife were already separated. The purpose of the corporation was to develop and market some extremely promising telephone switching technology. A subsidiary of Exxon had agreed to provide venture capital and to take a significant equity stake.

Exxon required, as a condition of its investment, that the shareholders enter into a shareholders' agreement restricting the sale of their shares. One of the provisions required any divorcing spouse of the shareholders to sell any shares owned by them back to the shareholder spouse, to the corporation or to the other shareholders at a price determined by a formula that was guaranteed to result in a fairly low price.[65] All of the spouses were required to sign. The husband presented the agreement to the wife, and explained that it was an agreement between Exxon and the founders and was necessary to get the company started. He did not explain the agreement and did not disclose the facts he knew about the prospects of the company, the size of Exxon's investment or the price per share paid by Exxon, or the potential value of the enterprise. The wife read the agreement and signed it and later testified that she had believed that she was already bound by it.

The husband's 700,000 shares apparently were not dealt with in the divorce, but were treated as his separate property, and he never demanded that she sell the shares or offered her the consideration under the agreement, which he contended was $2500. Two years later, the wife later learned that the corporation was worth far more than she had believed. She sued to rescind the agreement and partition the shares.[66]

The case was tried to a jury, which found the affirmative representations made by the husband were false and material and that the husband had failed to disclose that Exxon had purchased 1.5 million shares at $1 per share, that the wife would be required to sell in the event of a divorce, that the stock had a fair market cash value, and that the corporation was developing technology that would be in great demand. However, the jury also found that the husband did not act with the intent to deceive. With regard to breach of fiduciary duties, the jury found that the husband had acted in good faith, that the agreement had a reasonable business purpose, but that the agreement was unfair to the wife.[67] On the basis of these findings,

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[58] *Id*. at 790.

[59] *Id*. at 791 (citing Santa Fe Indus. v. Green, 430 U.S. 462 (1977)).

[60] *Id*. (citing Biesenbach v. Guenther, 588 F.2d 400 (3d Cir.1978)) (determining that directors' failure to disclose "the true purpose behind" their activities to gain control of a corporation failed to state a claim); Vaughn v. Teledyne, Inc., 628 F.2d 1214 (9th Cir. 1980) (stating that undisclosed plan to increase control over corporation not fraud); Coronet Ins. Co. v. Seyfarth, 665 F. Supp. 661 (N.D. Ill. 1987) (holding that failure to disclose plan to entrench management not fraud). In part, these opinions are influenced by the fact that any person with even an elementary knowledge of the corporate structure would realize that an offer to repurchase stock would increase the ownership of the remaining shareholders and that the offer was probably made for that purpose. *See* Ala. Farm Bureau Mut. Cas. Co., Inc. v. Am. Fid. Life Ins. Co., 606 F.2d 602, 611 (5th Cir. 1979).

[61] *Id*. at 792.

[62] *Id*. at 74 (citing Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

[63] 700 S.W.2d 941 (Tex. App.—Dallas 1985, writ ref'd n.r.e.).

[64] *Id*. at 943.

[65] *Id*.

[66] *Id*. at 944.

[67] *Id*.

the trial court denied rescission of the shareholder's agreement and ordered that the wife be paid the amount due under the shareholders' agreement.

The wife appealed only the breach of fiduciary duties. The jury had found a confidential relationship, and certain fiduciary duties would have existed as a matter of law by virtue of the marriage relationship. However, the court of appeals' analysis places primary emphasis on the husband's power over the wife's stock rights as a result of his controlling position in the corporation:

> The record shows that as a founder, officer, and director of InteCom, Howard had an insider's knowledge of the affairs and prospects of the corporation. . . . Recognition of a fiduciary duty in this case is based not only on the personal relationship between Howard and Judy but also on Howard's position as a founder, officer, and director of InteCom."[68]

The court noted that no Texas case had address the issue of whether an officer and director of a corporation has a duty to disclose to a stockholder his knowledge of information affecting the value of the stock before purchasing it from the stockholder.[69] The court noted that majority rule was that a director or officer does not stand in a fiduciary relation to a stockholder in respect to his stock and, therefore, has the same right as any other stockholder to trade freely in the corporation's stock.[70]

However, some jurisdictions had held that officers and directors have a fiduciary duty to individual stockholders, as well as to the corporation itself and, thus, cannot properly purchase stock from a stockholder without giving him the benefit of any official knowledge they have of information that may increase the value of the stock.[71] Still other courts had followed the majority rule, but recognized an exception when "special facts" impose on the officer or director a limited fiduciary duty to disclose any knowledge of special matters relating to the corporate business—e.g., merger, assured sale, etc.—that may affect the value of the stock.[72] The court declined to rule whether Texas would follow the "majority" or "minority" rule, but held that even under the majority rule the "special facts" of this case were sufficient to bring it within the exception.[73] The "special facts" critical to the court's decision were that the husband knew that "Exxon was purchasing 1,500,000 shares at one dollar per share and that if IBX was developed, it would be in great demand" and that the husband therefore had a fiduciary duty to disclose those facts prior to contracting with the wife regarding the ownership of her shares.[74]

In *Westwood v. Continental Can Co.*,[75] the Fifth Circuit decided a case involving a shareholder and managing director of a Texas corporation who negotiated a deal sell the stock of his corporation, and then negotiated option agreements with all the stockholders that would permit him to buy their stock and resell it at a premium. Ultimately, the buyer refused to consummate the transaction, and the shareholder sued for breach of contract. The buyer successfully defended the action on the grounds that the contract was unenforceable because it constituted a breach of the shareholder's fiduciary duties to the corporation and its shareholders.

The Fifth Circuit held that the contract was unenforceable because "when directors or other officers step aside from the duty of managing the corporate business under the charter for the benefit of stockholders, and enter upon schemes among themselves or with others to dispose of the corporate business and to reap a personal profit at the expense of the stockholders by buying up their shares without full disclosure and at an inadequate price, there is a breach of duty."[76] "If a favorable opportunity arises to sell out, the stockholders and not the managing officers are entitled to have the benefit of it. If an agreement cannot be reached by the stockholders, no doubt one faction may buy out the other."[77] Any shareholder, even though an officer and director, could legally buy up the stock of the other shareholders with the purpose of

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[68] *Id*.
[69] *Id*.
[70] *Id*. at 945–56 (citing Seitz v. Frey, 188 N.W. 266, 268 (1922)); Schuur v. Berry, 281 N.W. 393 (1938).
[71] *Id*. at 946 (citing Dawson v. Nat'l Life Ins. Co. of U.S., 157 N.W. 929 (1916)); *see* Jacobson v. Yaschik, 155 S.E.2d 601 (1967); *cf.* Harris v. Mack, SA:11-CV-00622-DAE, 2013 WL 416299, at *4 (W.D. Tex. Jan. 31, 2013) (affirming summary judgment for majority shareholder on minority shareholder's fraud by nondisclosure claim because majority shareholder did not owe a fiduciary duty to disclose information to minority shareholder); *Jones v. Sherman*, 857 S.W.2d 468 (Mo. Ct. App. 1993) ("Neither closely held corporation nor majority shareholder had duty to disclose financial information to minority shareholder while negotiating to buy out minority shareholder.").
[72] *Id*. (citing Strong v. Repide, 213 U.S. 419 (1909)); Hobart v. Hobart Estate Co., 159 P.2d 958 (1945); FLETCHER, *supra* note 54 § 1171, at 293–94.
[73] *Id*. at 946.
[74] *Id*.
[75] 80 F.2d 494, 498 (5th Cir. 1935).
[76] *Id*.
[77] *Id*.

reselling at a profit, but only on full disclosure.[78] The shareholder had disclosed to the other shareholders in a letter "the state of the business, the want of harmony among the stockholders, and the wisdom of acting promptly to save the investment.

In making his offer for the stock, he stated that he proposed to resell it as an entirety, and if unable to do so, to dissolve the corporation and dispose of the assets, hoping to make a profit as the reward of his risk and efforts."[79] He had even disclosed that he was in the process of carrying on negotiations for a possible sale.[80] However, in the lawsuit, the shareholder contended that he in fact had a contract with the buyer; and the court held that, if so, "the plan as a whole was thus one for the managing officer to deceive the stockholders and acquire the corporate assets for his own and another's profit."[81]

Both *Miller* and *Westwood* involved shareholders who were also officers and directors, and both opinions emphasize their duties as officer and directors. However, those duties run only to the corporation—in Miller, the plaintiff was suing individually, and in Westwood the corporation was not involved in the transaction. These cases are best understood as flowing from the defendants' duties to the shareholders arising from their control of the corporation. If a corporation could not enter into a transaction or purchase shares from a shareholder because the transaction would be unfair or because the corporation is in possession of undisclosed, material information, then a shareholder, officer or director who is in the same position of advantage over the shareholder as a result of his control over a corporation is subjected to the same duties of loyalty, good faith, full disclosure and fairness.

*Allen v. Devon Energy Holdings, L.L.C.* concerned the redemption of Allen's minority interest in an LLC involved in natural gas exploration and development.[82] The LLC redeemed Allen's interest in 2004 based on a 2003 $138.5 million appraisal of the LLC.[83] In 2004, however, the LLC sold for $2.6 billion—almost twenty times the value used to calculate the redemption price.[84] Allen sued, claiming that the majority shareholder and the LLC made misrepresentations, failed to disclose facts regarding the LLC's future prospects, and that Allen would not have sold his interest in 2004 if he had known these material facts.[85] For instance, the majority shareholder withheld information concerning the LLC's technological advances in horizontal drilling and significant lease acquisitions in an existing natural gas field, both of which occurred after the redemption offer but before the redemption.[86]

The appellate court determined that a majority shareholder owed a fiduciary duty to a minority shareholder in the context of a redemption agreement. The court based its decision on majority shareholder's operating control over the affairs of the company and intimate knowledge of the company's daily affairs and future plans.[87] Further, the purchase of a minority owner's interest benefitted the majority owner.[88] Although *Allen* was remanded by agreement, its holding demonstrates that majority shareholders may owe minority shareholders a fiduciary duty based on factors such as superior knowledge and in the context of redemption agreements.

### C. Sales to Third Parties

*Thompson v. Hambrick*[89] dealt with the sale of shares in a bank. At one point, the shareholders got together and entered into a buy–sell agreement with the expressed purpose of maintaining ownership of the bank among the current shareholders. However, the agreement was poorly written and seemed to bind only the minority shareholders to a right of first refusal in favor of the majority shareholders. Some time later, a group of investors attempted to purchase the bank, offering to pay $45/share to all the shareholders. All of the shareholders jointly refused the offer. Immediately thereafter, the two shareholders who owned a majority interest secretly negotiated to sell their controlling share to the investors for $55/share. This opportunity to sell was not offered to the other shareholders. The minority shareholders sued the majority shareholders and lost on summary judgment. The Dallas Court of Appeals reversed. The court held that the contract was ambiguous and there was a fact issue as to whether it precluded the sale. Independently, however, the court also held that there were fact issues regarding whether the transaction violated fiduciary duties owed by the

[78] *Id*.
[79] *Id*.
[80] *Id*.
[81] *Id*.
[82] Allen v. Devon Energy Holdings, L.L.C., 367 S.W.3d 355 (Tex. App.—Houston [1st Dist.] 2012, pet. granted judgm't vacated w.r.m.).
[83] *Id*. at 365.
[84] *Id*.
[85] *Id*.
[86] *Id*.
[87] *Id*. at 392.
[88] *Id*. at 395; *see* Transeo S.A.R.L. v. Bessemer Venture Partners VI L.P., 11-CV-5331, 2013 WL 1285453, at *14 (S.D.N.Y. Mar. 29, 2013) (internal citations omitted) (stating majority shareholders owe fiduciary duties to minority shareholders but the duty is narrow and breached when majority shareholders exploit the minority shareholders).
[89] 508 S.W.2d 949 (Tex. App.—Dallas 1974, writ ref'd n.r.e.).

majority shareholders directly to the minority shareholders.[90]

In *Harris v. Carter*, the buyer misrepresented to majority shareholders that it owned stock in certain companies and subsidiaries throughout negotiations for a stock exchange agreement. The buyer also presented unaudited financial statements and a fictitious draft financial statement to the majority shareholders.[91] The corporation's chief financial officer analyzed the buyer's financial statements and questioned the accuracy of the buyer's reporting.[92] Despite these red flags, the majority shareholders sold their controlling shares to the buyer in a transaction that contemplated a future merger and resigned as directors, allowing the buyer to control the board of directors.

The buyer owned worthless stock and lacked financial stability. After the sale, the buyer looted the corporation after gaining control. As a result, minority shareholders' proportionate ownership of the corporation reduced from 48% to 12% under the successor directors.[93] A minority shareholder sued the former majority shareholders and directors, arguing that they breached a duty of care to the corporation and minority shareholders by failing to investigate the buyer before selling their controlling shares and resigning as directors. The defendants filed a motion to dismiss, arguing that selling their personal stock did not constitute a directorial act for which they could be liable to a shareholder.[94]

The court, however, found that the plaintiff alleged "more than simply a sale of stock by directors," but rather that the defendants negligently transferred corporate control to the buyer.[95] The court acknowledged that when a majority shareholder presumes to exercise control over a corporation and directs its actions, that shareholder assumes fiduciary duty of the same kind as that owed by director to corporation. Further, a controlling shareholder has a duty to "take such steps as a reasonable person would take to ascertain that the buyer does not intend or is unlikely to plan any depredations of the corporation" when transferring control of a corporation to another under Delaware law especially when the buyer has raised red flags.[96] As a result, the court held that the defendants' sale of controlling interests in the corporation, coupled with their agreement to resign from the board of directors to ensure that buyer's designees assume the board of directors, implicates duty of care and inquiry on part of majority shareholders when circumstances would alert reasonably prudent person to risk that his buyer is dishonest or in some material respect not truthful.[97]

During the sale or change of control of a corporation, directors satisfy their fiduciary duties to shareholders when their conduct facilitates "the maximization of the company's value at a sale for the stockholders' benefit."[98] At the same time, controlling stockholders do not have a "duty to engage in self-sacrifice for the benefit of minority shareholders" when selling their shares.[99] In *In re Synthes, Inc. Shareholder Litigation*, a Delaware court considered whether the CEO, a controlling stockholder breached his fiduciary duties by not considering an offer that would have cashed out minority stockholders but forced him to remain in the privately held surviving company with reduced voting rights. In that case, minority shareholders contended that as the CEO and majority shareholder of Synthes, Inc. reached retirement age, he wanted to divest his shares and use the money to achieve certain estate planning and tax goals.[100] For two years, the company contacted nine strategic buyers capable of purchasing the company and six private equity firms.[101]

A private equity consortium offered a bid that would have cashed out the minority stockholders. Although the highest bid at the time, the private equity consortium's bid would require the CEO to "roll substantially all of his equity" into equity of the surviving company where he would no longer have the same voting or exit power.[102] The board of directors viewed the bid as riskier because the private equity

[90] *Id*. (fact issues existed as to whether the agreement was for exclusive benefit of majority stockholders and gave them right to sell their stock without giving other stockholders an opportunity to buy and whether majority stockholders' alleged conduct in secretly agreeing to sell their stock at $55 per share shortly after joining in rejection of buyer's offer to all stockholders of $45 per share constituted breach of fiduciary duty, thus precluding summary judgment.).

[91] Harris v. Carter, 582 A.2d 222, 225 (Del. Ch. 1990).

[92] *Id*.

[93] *Id*. at 226.

[94] *Id*. at 232.

[95] *Id*.

[96] *Id*. at 233.

[97] *Id*. at 235.

[98] Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986); *see also* Shenker v. Laureate Educ., Inc., 983 A.2d 408, 422–23 (Md. 2009) ("[I]n a cash-out merger transaction where the decision to sell the corporation already has been made, shareholders may pursue direct claims against directors for breach of their fiduciary duties of candor and maximization of shareholder value.").

[99] *In re* Synthes, Inc. S'holder Litig., 50 A.3d 1022, 1040–41 (Del. Ch. 2012).

[100] *Id*. at 1025.

[101] *Id*. at 1027.

[102] *Id*. at 1028.

consortium revealed it could not raise its CHF (Swiss Franc) 151 per share cash bid any higher during negotiations.[103] Market giant Johnson & Johnson then offered Synthes, Inc. a lower bid of CHF 145–150 per share, with more than 60% consideration paid in Johnson & Johnson stock. Johnson & Johnson later increased its offer to CHF 159 per share and its $21.3 billion acquisition of Syntheses that represented 65% stock and 35% cash for all of Synthes' outstanding shares was approved.

Minority shareholders of Synthes sued the CEO and board of directors, alleging that the CEO breached his fiduciary duties by not considering the private equity bid, which at the time presented the highest value proposal for Synthes' minority stockholders. The court stated flatly that plaintiffs' complaint was essentially that the CEO "refused to consider an all-cash offer that might have delivered a better deal for the minority shareholders at [the CEO's] expense."[104]

In dismissing plaintiff's claims with prejudice, the court held that a majority shareholder's duty to put the "best interest of the corporation and its shareholders" above "any interest... not shared by the stockholders generally" does not mean that the majority shareholder must "subrogate his own interests so that the minority stockholders can get the deal that they want."[105] While majority shareholders cannot use their control to exploit minority shareholders, they are not required "to act altruistically towards [minority shareholders]."[106] Thus, the CEO did not breach his fiduciary duties when he opposed a deal that "required him to subsidize a better deal for the minority stockholders by subjecting him to a different and worse form of consideration."[107]

*Ritchie v. Rupe*,[108] which is currently under review by the Texas Supreme Court, involved a minority shareholder that wanted to sell her stock, but the majority shareholders refused to meet with any prospective purchasers or to cooperate with purchasers' due diligence efforts. The minority shareholder sued, claiming that this lack of cooperation was oppressive conduct that precluded her from selling her shares. A jury agreed, awarding her $7.3 million for the fair value of her stock.[109] The Dallas Court of Appeals affirmed.

The appellate court discussed the "fair dealing" standard for oppression with respect to the owner of unrestricted stock, holding that directors or "those in control" must act fairly and reasonably in connection with a shareholder's efforts to sell that stock to a third party.[110] The court continued to hold that directors or majority shareholders cannot adopt policies that unreasonably restrain or prohibit the sale or transfer of the stock or deprive the owner of its fair market value. Applying this standard, the court held that the majority shareholders' refusal to meet with potential purchasers of the minority shareholder's stock was oppressive because it was "a visible departure from the standards of fair dealing and a violation of fair play on which each shareholder is entitled to rely."[111] The court opined that a corporation's management may place reasonable limitations on the corporation's cooperation, including limiting the time spent with potential investors and requiring them to sign confidentiality agreements that protect the company's interests while permitting reasonable due diligence. However, they cannot act in such a way as to substantially defeat the minority shareholder's right to sell her stock to a third party.

### D. Remedies for Squeeze-Outs

A "squeeze out" occurs when controlling shareholders of closely held corporations use a variety of tactics to effectively deny minority shareholders a return on their investment in an effort to force minority shareholders to sell their shares back for less than the fair market value of their minority shares.[112] For instance, these tactics may include wrongfully withholding dividends, and termination of employment.[113] A squeeze-out may constitute a breach

[103] *Id*. at 1928–29.

[104] *Id*. at 1039 ("[I]n other words, [the plaintiffs] complain that [the CEO] refused to facilitate a potentially better deal for the minority because he was not willing to roll a "substantial" part of his equity stake into the post-merger entity and thereby accept a different, less liquid, and less value-certain form of consideration than that offered to the minority stockholders.").

[105] *Id*. at 1041 (internal citations omitted).

[106] *Id*.

[107] *Id*.

[108] 339 S.W.3d 275 (Tex. App.—Dallas 2011, pet. granted).

[109] *Id*. at 283.

[110] *Id*. at 294.

[111] *Id*. at 297 (citing *Willis*, 997 S.W.2d at 801).

[112] *See* Keating v. Keating, 2003 WL 23213143, at *17 (Mass. Super. Ct. Oct. 3, 2003) (holding that majority shareholder's offer to buy minority shareholder's shares at far less than the fair market value for his shares evidences a freeze-out); Donahue v. Rodd Electrotype Co. of New England, Inc., 328 N.E.2d 505, 515 (1975) (holding that "[m]ajority 'freeze-out' schemes which withhold dividends are designed to compel the minority to relinquish stock at inadequate prices" and "when the minority stockholder agrees to sell out at less than fair value, the majority has won.") (citations omitted).

[113] Davis, 754 S.W.2d at 382; Balvik v. Sylvester, 411 N.W.2d 383, 388 (N.D. 1987).

of fiduciary duty by the majority shareholder.[114] But minority shareholders may not be successful in bringing breach of fiduciary duty claims against majority shareholders after they sign a binding agreement to sell their shares at a squeeze-out price to the majority shareholders. Courts may find that the oppressive acts of the majority shareholder demonstrate that the minority shareholder had no reason to trust or place confidence in the majority shareholder.[115] Further, there is no duty or implied covenant of good faith and fair dealing to repurchase a shareholder's shares at a price reasonable to the shareholder.[116] A minority shareholder that voluntarily quits and sells his shares to majority shareholders after a squeeze-out may face difficulty in suing for shareholder oppression because "an employee who voluntarily leaves the employment of the corporation presents a less persuasive case for concluding the majority shareholders oppressed him."[117]

*Kilpatrick v. Kilpatrick* involved a minority shareholder's attempt to sue majority shareholders for breach of fiduciary duty after he sold his shares after a squeeze-out and signed a settlement agreement based on the majority shareholder's misrepresentations as to the amount of money they received from the sale of the corporation.[118] In that case, Kelly, a minority shareholder, sold his shares to his brothers, the majority shareholders of their family-owned closely held corporation, in 1997 after his brothers squeezed him out by changing the locks on Kelly's office door, piling his office furniture in the middle of a company warehouse, threatening him and physically assaulting him.[119] As part of the sale, he signed a purchase agreement and a severance and release agreement; both agreements contained language releasing his brothers from future claims. The purchase agreement also contained a provision granting him a proportionate share of the sale proceeds if his brothers sold the corporation within twelve months of the agreement.

After Kelly learned that his brothers had sold the company without giving him his share of the proceeds, he sued his brothers for fraudulent inducement, fraud, breach of fiduciary duty, and shareholder oppression in 2001. Kelly met with his brothers to discuss settling the lawsuit in 2001.[120] His brothers told Kelly that they each received only $1,000,000 in the $25,000,000 sale because most of the proceeds had been used to pay the corporation's debts. Kelly signed a settlement agreement in 2001 that released his brothers from all present and future claims and disclaimed any reliance by Kelly on his brothers' prior representations. The court granted Kelly's motion to dismiss his claims with prejudice.

In 2010, Kelly discovered that his brothers had misrepresented and underreported the amount of money that they had received from the sale of the company during negotiations for the 2001 settlement agreement.[121] Kelly sued his brothers alleging fraud and minority shareholder oppression as to the 1997 sale.[122] Additionally, he also sued for fraudulent concealment as to the 2001 settlement agreement; and common law fraud, breach of fiduciary duty, fraudulent inducement, and duress as to both the 1997 sale and the 2001 settlement agreement.[123]

The appellate court held that because Kelly ended his business relationship with his brothers in 1997, no fiduciary relationship existed at the time that he negotiated the 2001 settlement agreement with his brothers.[124] Further, the court determined that Kelly's brothers' outrageous actions and Kelly's 2001 lawsuit undermined his breach of fiduciary duty claim and contention that he trusted his brothers during the 2001 settlement.[125] Therefore, the appellate court affirmed

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[114] *See* Cook v. Wallot, 2011-CA-01056-COA, 2013 WL 1883533, at *6 (Miss. Ct. App. May 7, 2013) (holding that when a majority of shareholders attempt to unfairly control a minority, the "attempt to squeeze out a minority shareholder must be viewed as a breach of his fiduciary duty."); Bair v. Purcell, 500 F. Supp. 2d 468, 484 (M.D. Pa. 2007) (holding that "an attempt by a majority shareholder to "freeze-out" or "squeeze-out" a minority shareholder constitutes a breach of fiduciary duty).

[115] *See* Kilpatrick v. Kilpatrick, 02-12-00206-CV, 2013 WL 3874767, at *6 (Tex. App.—Fort Worth July 25, 2013, no. pet. h.).

[116] Blaustein v. Lord Balt. Capital Corp., CIV.A. 6685-VCN, 2013 WL 1810956, at *17 (Del. Ch. Apr. 30, 2013) (rejecting minority shareholder's breach of fiduciary duty claim against the majority shareholder, the court stated that "in seeking to have her shares repurchased at a reasonable price, [the minority shareholder] is attempting to acquire—through fiduciary principles—an additional right that she was unable to obtain through an arms-length negotiation" and "there is no . . . implied covenant of good faith and fair dealing to accept minority shareholder's 'reasonable' repurchase proposals" in a shareholder's agreement with the corporation), *aff'd in part, rev'd in part* CIV.A. 6685-VCN, 2012 WL 2126111 (Del. Ch. May 31, 2012).

[117] Allchin v. Chemic, Inc., 14-01-00433-CV, 2002 WL 1608616, at *9 (Tex. App.—Houston [14th Dist.] July 18, 2002, no pet.).

[118] Kilpatrick, 2013 WL 3874767, at *6.

[119] *Id.*

[120] *Id.* at *1.

[121] *Id.*

[122] *Id.* at *2.

[123] *Id.*

[124] *Id.* at *5.

[125] *Id.* at *6.

summary judgment on Kelly's breach of fiduciary duty and fraud claims on the 2001 settlement agreement in favor of the brothers.

Although courts may not always find majority shareholders liable for breach of fiduciary duty in a squeeze-out, they may uphold minority shareholders' claims for unjust enrichment. The Delaware Court of Chancery recently denied motions to dismiss a minority shareholder's unjust enrichment claim against majority shareholders in *Frank v. Elgamal* based on a merger where all minority shareholders were cashed out at a lower price and the controlling shareholders retained an interest in the surviving entity.[126] The court held that a merger involving a controlling group of stockholders that received an interest in the surviving entity received the entire fairness standard, rather than the business judgment rule because appropriate procedural protections were not in place to protect the minority stockholders.[127]

The court held that the minority shareholder properly stated a claim for unjust enrichment.[128] The plaintiff stated that the merger allowed the members of the control group to continue to benefit from the company's ongoing success, but that minority shareholders cannot participate in the company's ongoing success because they were cashed out—at an unfairly low price—in the merger.[129] Thus, the majority shareholders enrichment and the minority shareholders' impoverishment were related because the merger both cashed out the minority shareholders at an unfair price, and gave majority shareholders control in the new company.

### E. Presumptions

When persons enter into fiduciary relations, each consents as a matter of law to have his conduct measured by "the standards of the finer loyalties exacted by courts of equity."[130] Even in the case of a gift between parties with a fiduciary relationship, "equity indulges the presumption of unfairness and invalidity, and requires proof at the hand of the party claiming validity . . . of the transaction that it is fair and reasonable."[131] The fiduciary must show that the transaction was "fair, honest, and equitable."[132] In establishing the fairness of a transaction involving a fiduciary, some of the most important factors are:

(1) whether there was full disclosure regarding the transaction,
(2) whether the consideration (if any) was adequate, and
(3) whether the beneficiary had the benefit of independent advice.[133]

Another crucial inquiry is whether the fiduciary has benefited at the expense of the beneficiary.[134] The transaction is unfair if the fiduciary significantly benefits from it as viewed in light of circumstances existing at the time of the transaction.[135] Proof of "good faith" is necessary to sustain the transaction,[136] but good faith alone does not establish fairness under Texas law.[137]

The leading Texas case on this question is *Johnson v. Peckham*,[138] which concerned a partner's duty to disclose to a copartner, whose interest he was purchasing, facts affecting the value of the partnership property. The supreme court held that because of the fiduciary relationship, the purchasing partner had the "absolute duty" to disclose to the selling partner material facts within his knowledge and that such a sale would be sustained "only when it is made in good faith, for a fair consideration and as full and complete disclosure of all important information as to value."[139] Accordingly, the court held that the selling partner did not have the burden to establish reliance on the purchasing partner to make such disclosure and that the trial court had properly refused a requested issue inquiring whether the purchaser relied on the seller to make such disclosure. Following this decision, Texas

[126] Frank v. Elgamal, CIV.A. 6120-VCN, 2012 WL 1096090 at *9 (Del. Ch. Mar. 30, 2012).
[127] *Id*. at *10.
[128] *Id*. at *10 (stating that to plead a claim for unjust enrichment under Delaware law, the plaintiff must allege (1) an enrichment, (2) an impoverishment, (3) a relation between the enrichment and impoverishment, (4) the absence of justification, and (5) the absence of a remedy provided by law).
[129] *Id*.
[130] Johnson v. Peckham, 132 Tex. 148, 120 S.W.2d 786, 788 (1938); *see* Estate of Townes v. Townes, 867 S.W.2d 414, 417 (Tex. App.—Houston [14th Dist.] 1993, writ denied); Sorrell v. Elsey, 748 S.W.2d 584, 585 (Tex .App.—San Antonio 1988, writ denied).
[131] *Sorrell*, 748 S.W.2d at 585.
[132] Miller v. Miller, 700 S.W.2d 941, 947 (Tex. App.—Dallas 1985, writ ref'd n.r.e.); *Archer*, 390 S.W.2d at 740.
[133] *Id*. *See Townes*, 867 S.W.2d at 417.
[134] *Id*.
[135] *Id*.
[136] *Peckham*, 120 S.W.2d at 788.
[137] *See* Brooks, Tarlton, Gilber, Douglas & Kressler v. U.S. Fire Ins. Co., 832 F.2d 1358, 1369 (5th Cir. 1987); *see also Johnson*, 120 S.W.2d at 788; *accord Archer*, 390 S.W.2d at 740; Cartwright v. Minton, 318 S.W.2d 449, 452–53 (Tex. Civ. App.—Eastland 1958, writ ref'd n.r.e.) (quoting Murphy v. Cartwright, 202 F.2d 71, 73 (5th Cir.1953)); *Miller*, 700 S.W.2d at 947.
[138] Peckham, 120 S.W.2d at 787–88.
[139] *Id*. at 788.

courts have applied a presumption of unfairness to transactions between a fiduciary and a party to whom he owes a duty of disclosure, thus casting on the fiduciary the burden to establish fairness.[140] Similarly, since the adoption of the Texas Uniform Partnership Act, the Texas partnership statutes have expressly imposed on partners the duty to render information concerning the partnership "on demand" of a partner or a partner's legal representative.[141] As the *Miller* court held:

> Since this duty has been established, we must determine where the burden of proof lies concerning the fairness or unfairness of the shareholders' agreement as between Judy and Howard and whether that burden has been discharged. Accordingly, we conclude that Howard had the burden of proving the fairness of the shareholders agreement to Judy. In determining whether Howard has met this burden of proving the fairness of the agreement, we note that what constitutes the required fairness has been variously stated, depending on the facts in the particular case.[142]

Further, in *Stephens County Museum, Inc. v. Swenson*,[143] the ultimate issues were held to be whether the fiduciary "had made reasonable use of the confidence placed in him and whether the transactions were ultimately fair and equitable." Another crucial inquiry bearing on the issue of fairness is whether the fiduciary has benefited or profited at the expense of the beneficiary.[144] The transaction is unfair if the fiduciary significantly benefits from it at the expense of the beneficiary as viewed in the light of circumstances existing at the time of the transaction.[145]

## IV. SHAREHOLDERS' RIGHT TO INFORMATION

### A. Introduction

The shareholders own the corporation and are the equitable or beneficial owners of all property possessed by the corporation, including all the information and all the records.[146] Those in charge of the corporation are merely the agents of the stockholders who are the real owners, and the owners are entitled to information as to the manner in which the corporate business is conducted.[147]

> "While the corporation holds the legal title to its property, the stockholders are deemed the real and beneficial owners thereof and, as such, are entitled to information concerning the management of the property and business they have confided to the officers and directors of the corporation as their agents. A stockholder's assertion of right to inspect the corporation's books and records is sometimes said to be one merely for the inspection of what is his own."[148]
>
> "A minority shareholder has very few rights. By definition, those shareholders who, along with their allies, are in the majority, have sufficient votes to nullify the minority's right of franchise. In such instance, about the only thing left to a dissatisfied minority stockholder is his right to inspect, coupled with his right to denounce any matters disclosed by his inspection."[149]

### B. Nature of Shareholder's Right to Inspect Corporate Records

1. Fundamental Shareholder Right

The shareholder's right to examine the books and records of the corporation "is a privilege . . . incident to his ownership of stock."[150] The right to inspect corporate books and records exists so that the shareholder may "ascertain whether the affairs of the

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[140] Tex. Bank & Trust Co. v. Moore, 595 S.W.2d 502, 509 (Tex. 1980); Archer v. Griffith, 390 S.W.2d 735, 740 (Tex. 1964); Ginther v. Taub, 570 S.W. 516, 525 (Tex. Civ. App.—Waco 1978, writ ref'd n.r.e.); Miller, 700 S.W.2d at 946

[141] *See* TEX. BUS. ORGS. CODE ANN. § 152.213 (West 2011).

[142] *Miller*, 700 S.W.2d at 946.

[143] 517 S.W.2d 257, 261 (Tex. 1974).

[144] *Miller*, 700 S.W.2d at 947; International Bankers Life Insurance Co. v. Holloway, 368 S.W.2d 567, 576 (Tex. 1963); Cole v. McCanlies, 620 S.W.2d 713, 715 (Tex. Civ. App.—Dallas 1981, writ ref'd n.r.e.).

[145] *Miller*, 700 S.W.2d at 947; Archer, 390 S.W.2d at 740.

[146] *See* Cotten v. Weatherford Bancshares, Inc., 187 S.W.3d 687, 697 (Tex. App.—Fort Worth 2006, pet. filed).

[147] Johnson Ranch Royalty Co. v. Hickey, 31 S.W.2d 150, 153 (Tex. App.—Amarillo 1930, writ ref'd).

[148] State *ex rel.* G.M. Gustafson Co. v. Crookston Trust Co., 22 N.W.2d 911, 915–16 (Minn. 1946); *accord* Guthrie v. Harkness, 199 U.S. 148, 155 (1905).

[149] Perry v. Perry Bros., Inc., 753 S.W.2d 773, 777 (Tex. App.—Dallas 1988, no writ) (Howell, J., dissenting).

[150] Johnson Ranch Royalty Co. v. Hickey, 31 S.W.2d 150, 153 (Tex. App.—Amarillo 1930, writ ref'd).

corporation are properly conducted and that he may vote intelligently on questions of corporate policy and management."[151] "The predisposition of the law is in favor of allowing reasonable inspections of corporate books and records."[152]

2. Not Absolute, But Important

The "right to inspect the books and records of a corporation, is not an absolute right, regardless of the stockholders' motive."[153] In *Guthrie v. Harkness*,[154] the United States Supreme Court noted that courts will not compel the inspection of a bank's books under all circumstances. "In issuing the writ of mandamus the court will exercise a sound discretion, and grant the right under proper safeguards to protect the interests of all concerned. The writ should not be granted for speculative purposes, or to gratify idle curiosity, or to aid a blackmailer, but it may not be denied to the stockholder who seeks the information for legitimate purposes."[155] However, the "right of a stockholder as conferred by statute to examine the corporate records, although not absolute, is a valuable right."[156]

3. Who Has the Right?

a. Current Shareholders

The statutory right of inspection in Texas is limited to current shareholders who have held their shares for at least six months or who hold at least five percent of all the outstanding shares of the corporation. [157] However, all shareholders have a common law right of inspection if the inspection is made in good faith for a proper purpose.[158] "There can be no question that the decisive weight of American authority recognizes the common-law right of the shareholder, for proper purposes and under reasonable regulations as to place and time, to inspect the books of the corporation of which he is a member."[159]

Texas courts have held that the passage of a legislative right of inspection does not negate the preexisting common law right. [160] Similarly, the inspection statute makes clear that, while the statutory remedies are limited to certain shareholders, the statute is not intended to limit the common law rights of all shareholders:

> This [statute] does not impair the power of a court, on the presentation of proof of a proper purpose by a beneficial or record holder of shares, to compel production for examination by the holder of the books and records . . . regardless of the period during which the holder was a beneficial holder or record holder and regardless of the number of shares.[161]

The right of inspection extends to both common and preferred shareholders.[162]

b. Record Owner

A shareholder of record is entitled to inspect even if not the beneficial owner of the shares. Texas courts have not addressed this issue, but the Delaware courts have held a record owner is entitled to inspect the stock ledger even if only a nominee.[163]

c. Beneficial Owner

A holder of a beneficial interest in a voting trust is regarded as a holder of the shares represented by such beneficial interest for the purposes of statutory inspection rights.[164]

d. Contractual Right to Shares

An individual who is entitled to be issued shares under a subscription agreement or other contract has rights of inspection, even if the shares have not been issued.[165]

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[151] Id.

[152] Citizens Ass'n for Sound Energy v. Boltz, 886 S.W.2d 283, 291 (Tex. App.—Amarillo 1994, writ denied).

[153] Guar. Old Line Life Co. v. McCallum, 97 S.W.2d 966, 967 (Tex. Civ. App.—Dallas 1936, no writ).

[154] 199 U.S. 148 (1905).

[155] *Id.* at 156.

[156] Chavco Inv. Co., Inc. v. Pybus, 613 S.W.2d 806, 810 (Tex. Civ. App.—Houston [14th Dist.] 1981, writ ref'd n.r.e.).

[157] TEX. BUS. ORGS. CODE ANN. § 21.218(b) (West 2011).

[158] Williams v. Freeport Sulphur Co., 40 S.W.2d 817, 825 (Tex. Civ. App.—Galveston 1930, no writ) (holding that the right of inspection is provided "both by the common law and the statutes of this state"); *see also* Palacios v. Corbett, 172 S.W. 777, 782 (Tex. Civ. App.—San Antonio 1915, writ ref'd) (finding a common law right to inspect county records).

[159] *Guthrie*, 199 U.S. at 153.

[160] Tex. Infra-Red Radiant Co. v. Erwin, 397 S.W.2d 491, 493 (Tex. Civ. App.—Eastland 1965, writ ref'd n.r.e.).

[161] BUS. ORGS. § 21.218(c).

[162] *See* Cotten v. Weatherford Bancshares, Inc., 187 S.W.3d 687, 697 (Tex. App.—Fort Worth 2006, pet. denied).

[163] State *ex rel.* Healy v. Superior Oil Corp., 13 A.2d 453 (Del. Super. Ct. 1940).

[164] BUS. ORGS. § 21.218(a).

[165] Horton v. Robinson, 776 S.W.2d 260, 267 (Tex. App.—El Paso 1989, no writ).

e. Applies To Pledged Shares

Shareholders who have pledged their shares as collateral for a debt retain their inspection rights.[166]

## C. Exercising the Right of Inspection

1. Written Demand

The demand for inspection must be in writing.[167] There is no requirement that the demand be sworn or notarized. Typically, a certified letter delivers written demand to an officer of the corporation or to its registered agent; however, neither the statute nor the common law prescribes any particular format or method of delivery. Presumably, email to an officer or director would be just as effective.

2. Statement of Purpose

The Texas statute provides that the demand must state the purpose of the inspection, and the purpose must be a proper purpose.[168] In order to exercise his statutory rights, the shareholder need not demonstrate, show proof, or otherwise convince the corporation of a proper purpose. He is required merely to "state" the purpose.[169] The statement of purpose is important because the corporation's duty to permit inspection is limited to records reasonably related to the stated purpose.[170] However, the shareholder does not forfeit the right of inspection by failure to state a proper purpose. If the corporation refuses to allow inspection, then the shareholder is still entitled to enforce his common law inspection rights in court, but will be required to introduce proof of a proper purpose.[171]

3. Description of Documents Requested

The statute does not require the shareholder to describe the documents sought; rather the shareholder is entitled to review all its books and records of account, minutes, and share transfer records that are relevant to the purpose stated in the demand.[172] Typically, demands for inspection do give a list of documents requested. This practice probably stems from the fact that attorneys preparing these demands are familiar and comfortable with the requests for production of documents in civil litigation. Also the description of documents demanded assists in demonstrating the relationship between the purpose and the documents if there is a question. Description of documents also assists the corporation in gathering the documents and placing them in a specific place for inspection, for the convenience of corporation and to prevent disrupting business operations. However, exercising the right of inspection is very different from serving a discovery request. Describing categories of documents puts the burden on the shareholder of predicting what kinds of documents the corporation keeps and tends to allow the corporation to take a rather restrictive view of what documents it will make available for inspection. A shareholder would be completely justified stating only that he intended to inspect all books and records relevant to the purpose described and attempting to inspect those records as they are kept in the files. Probably the best practice is to state the purpose, demand inspection of all relevant books and records, and provide a nonexclusive list as a starting point.

4. Timing of the Inspection

A shareholder is entitled to conduct the inspection at any reasonable time or times.[173] There is no requirement of any period of prior notice to the corporation. Conceivably, a shareholder could show up at the corporation's place of business, hand over the written demand, and begin the inspection immediately. However, the corporation might justifiably claim that immediate inspection was not "reasonable." There is no requirement that the shareholder state in the demand when the inspection is to occur, but doing so increases the odds that the corporation will voluntarily comply.

5. Place of Inspection

The statute does not specify where the inspection must take place. Texas Business Organizations Code requires the corporation to keep certain records and to make them available for inspection.[174] Therefore, the logical conclusion is that the inspection is to be made where the records are kept. Typically, the demand will state that the shareholder intends to be at a certain location, e.g. the corporate headquarters, during normal business hours on a certain day to begin the inspection.

A question arises as to corporations with records in many different places or out of state. Nothing in the Texas case law or statute suggests that there is any duty on a Texas corporation to do anything other than to make the records available to the shareholder—in other words, the shareholder must go to the records, not the other way around. One commentator has suggested that a Texas corporation may have an

[166] Fort Worth KJIM, Inc. v. Walke, 604 S.W.2d 362, 363 (Tex. Civ. App.—Fort Worth 1980, writ ref'd n.r.e.).

[167] BUS. ORGS. § 21.218(b).

[168] BUS. ORGS. § 21.218(b). What constitutes a "proper purpose" is dealt with at length below. *See infra* Part 4.V.

[169] Tex. Infra-Red Radiant Co. v. Erwin, 397 S.W.2d 491, 493 (Tex. Civ. App.—Eastland 1965, writ ref'd n.r.e.).

[170] *See* Kaufman v. CA, Inc., 905 A.2d 749, 753 (Del. Ch. 2006).

[171] Tex. Infra-Red Radiant Co., 397 S.W.2d at 493.

[172] BUS. ORGS. § 21.218(b).

[173] *Id.* § 21.218(b).

[174] *Id.* §§ 3.151, 21.218(b).

obligation to bring out-of-state records back into Texas to accommodate an inspection demand by a Texas shareholder.[175] However, nothing in the statute suggests any requirement to keep or produce records within the state. Texas corporations are not required to maintain their headquarters in the state. Therefore, it is difficult to conceive of any legal requirement for Texas corporations to maintain or produce their business records for inspection within the state.

6. Who Participates in the Inspection?

Shareholders are permitted to conduct the inspection in person or by agent, accountant, or attorney.[176] There is no requirement to disclose who will do the inspection in the written demand; nor is there any requirement to execute or provide the corporation with a written appointment or power of attorney. However, if the shareholder does not intend to be present, the best practice would be at least to identify the agent who will conduct the inspection in the written demand or prior to the commencement of inspection.

**D. Scope of Documents Subject to Inspection**

1. Shareholder Lists

A qualified shareholder enjoys a near-absolute right to inspect a corporation's "stock ledger" or "list of stockholders."[177]

2. Other Books and Records

The right to inspect applies to all books, records of account, minutes and share transfer records.[178] The phrase "books and records of account" is not defined, but there is no support in the case law or commentary for limiting the right of inspection to financial records alone. "Books and records of account" should include all documentary or electronic information in the possession of the corporation.[179] "The property of a corporation, in the last analysis is that of the stockholder, and when one seeks an inspection of its books, records or property, he is in reality but seeking an inspection of his own and that this should be accorded fully, freely and at all times when such inspection will not unreasonably inconvenience others who have a like interest in and rights to the property and that the attempt unreasonably to hamper such inspection by officers, managers or others is an unjust exercise of power and one which courts should not sanction."[180]

Courts in other jurisdictions have consistently favored a broad application of the scope of inspection rights. In *Otis-Hidden Co. v. Sheirich*,[181] a minority shareholder was permitted to inspect correspondence involving internal affairs of the corporation that passed between its nonresident president, who was the majority shareholder, and its active manager. The court held that the common law right of inspection included all documents, contracts, and papers relating to the business affairs of the corporation.[182] Similarly, in *Cain v. Merck & Co., Inc.*, the court held that the term "minutes" in the New Jersey inspection statute referred to minutes of the proceedings of shareholders, the board, and the executive committee, and not simply the shareholder-meeting minutes as the defendant-corporation contended.[183] However, in *Master Mortgage Corporation v. Craven*,[184] the court

[175] HAMILTON, MILLER & RAGAZZO, 20A TEXAS PRACTICE: BUSINESS ORGANIZATIONS § 34.6, at 35 (2004) ("Presumably, a corporation that maintains an out-of-state location for its records would be required to produce those records in Texas if a suit for inspection of records is brought in Texas by a Texas shareholder.").

[176] BUS. ORGS. § 21.218(b).

[177] *In re* LTV Sec. Litig., 89 F.R.D. 595, 609 (N.D. Tex. 1981); *see also* NVF Co. v. Sharon Steel Corp., 294 F. Supp. 1091, 1093 (W.D. Pa. 1969); Goldman v. Trans-United Indus. Inc., 171 A.2d 788 (Pa. 1961).

[178] BUS. ORGS. § 21.218(b).

[179] *See* HAMILTON ET AL., *supra* note 175, § 34.6, at 36 ("[T]he right of inspection should generally extend to all relevant records necessary to inform the shareholder about corporate matters in which has a legitimate interest.").

[180] Johnson Ranch Royalty Co. v. Hickey, 31 S.W.2d 150, 153 (Tex. App.—Amarillo 1930, writ ref'd).

[181] 219 S.W. 191 (Kan. 1920).

[182] *Id.* at 193–94; *see also* Friedman v. Altoona Pipe & Steel Supply Co., 460 F.2d 1212 (3d Cir. 1972) (upholding the right to inspect corporate tax returns); Bank of Heflin v. Miles 318 So.2d 697 (Ala. 1975) (endorsing a broad interpretation of "books and records"); Smith v. Flynn, 155 So.2d 497 (Ala. 1963) (holding that a shareholder is entitled to inspect president's expense account); Tucson Gas & Elec. Co. v. Schantz, 428 P.2d 686 (Ariz. Ct. App. 1967) (finding that inspection includes all the books of account, minute book, and all papers of every kind and nature); Meyer v. Ford Indus., Inc., 538 P.2d 353 (Or. 1975) (the term "book as and records of account" was not limited to any ordinary, literal or limited sense, but was subject to a broad and liberal construction so as to extend to all records, contracts, papers and correspondence); State *ex rel.* Anderson v. Frederickson, 233 P. 291 (Wash. 1925) (allowing inspection of "all the books of account, minute book, and stock book, and all papers of every kind and nature, including income tax reports of the corporation . . . .").

[183] Cain v. Merck & Co., Inc., 1 A.3d 834, 841 (N.J. Sup. Ct. App. Div. 2010).

[184] 193 S.E.2d 567 (Ga. App. 1972).

considered the scope of a shareholder's right of inspection under both common law and the Georgia statute, holding that the catch-all clause, "all other corporate books, records, and files pertaining in any way to business or the financial status of the corporation at any time since the inception of the corporation" was too broad and not encompassed within either the common law or statutory rights of inspection, in the absence of a showing or relevancy by the shareholder.

3. Subsidiaries' Records

A shareholder of a corporation has the right to inspect the books and records of all subsidiaries of that corporation.[185]

4. Proprietary, Confidential, Trade Secret Documents

Most private corporations view all of their internal documents, particularly financial records, as proprietary and are reluctant to share them with shareholders not actively involved in the business. While these concerns can be (and frequently are) overblown, corporations do have some very legitimate concerns about information provided to shareholders. There are also frequent concerns about the public release of nonpublic information or the breaching of duties of confidentiality to clients of the corporation. While these concerns are real and legitimate, it can generally be said that a shareholder who acts in good faith and for a proper purpose may inspect even those documents that the corporation wishes to keep secret.[186]

There is no blanket trade secret or confidentiality privilege to shareholder inspection. Nonetheless, courts have acknowledged "that the need to protect certain confidential information from dissemination to others may exist *even when* a statutory right to inspection by the shareholder is invoked."[187] The Fort Worth Court of Appeals struck the proper balance between a shareholder's right of inspection and the corporation's interest in protecting proprietary information in *Professional Microfilming, Inc. v. Houston*.[188] There, the court upheld a discovery order requiring production of customer and supplier lists and pricing and discount information to a plaintiff who was employed by the corporation's chief competitor on the grounds that the plaintiff was a shareholder and would be entitled to inspect those documents under the TBCA for the proper purpose of determining the validity of his derivative claims against the directors for mismanagement, excessive compensation, and misappropriation.[189] However, the court imposed a protective order that prohibited dissemination of any information in the documents to third parties, and required pre-inspection review of the documents by the trial court.[190]

Courts in other jurisdictions have generally held that shareholders acting in good faith and for a proper purpose are entitled even to confidential information.[191] In *State ex rel. G.M. Gustafson Co. v. Crookston Trust Co.*,[192] the Minnesota Supreme Court held that the shareholders of a bank had the common law right of inspection of the banks records, notwithstanding the bank's objection that the shareholder would have access to information regarding depositors' business that the bank had an obligation to keep confidential. Furthermore, the mere fact that a shareholder is a competitor, without more, does not defeat the shareholder's right of inspection.[193]

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[185] Cotton v. Weatherford Bancshares, Inc., 187 S.W.3d 687, 697 (Tex. App.—Fort Worth 2006, pet. denied).

[186] *See* Moore v. Rock Creek Oil Corp., 59 S.W.2d 815, 818 (Tex. Comm'n App. 1933, jdgm't adopted). The issue of an improper purpose and reasonable restrictions on the use of certain information is dealt with separately.

[187] Gaughan v. Nat'l Cutting Horse Ass'n, 351 S.W.3d 408, 417 (Tex. App.—Fort Worth 2011, no pet.) (holding that a member of a nonprofit corporation's right of inspection was subject to a trial court's protective order preventing disclosure of documents designated "confidential" by the corporation).

[188] Prof. Microfilming, Inc. v. Houston, 661 S.W.2d 767 (Tex. App.—Fort Worth 1983, orig. proceeding).

[189] *Id.* at 769–70 (citing the Texas Business Corporation Act, the predecessor to the current Texas Business Organizations Code).

[190] Id.

[191] *See* Bank of Heflin v. Miles, 318 So.2d 697, 701 (Ala. 1975) (resolving that"the fact of mere confidentiality of the books and records sought" will not defeat the right of inspection); Apple v. Careerco, Inc., 370 N.Y.S.2d 289, 291 (N.Y. Sup. Ct. 1974) ("The financial condition of a corporation cannot be considered confidential when a stockholder is concerned. It is when the stockholder attempts to misuse the financial information to the detriment of the corporation that his actions will be limited."); Fears v. Cattlemen's Inv. Co., 483 P.2d 724, 730 (Okla. 1971). ("[The] fact that the information sought by a stockholder under the statute involved is of a confidential nature is not enough, in itself, to deny the statutory right of examination of records and making extracts or abstracts therefrom.").

[192] 22 N.W.2d 911, 916–17 (Minn. 1946).

[193] *See* BBC Acquis. Corp. v. Durr-Fillauer Med., Inc., 623 A.2d 85, 90 (Del. Ch. 1992); E.L. Bruce Co. v. State, 144 A.2d 533, 534 (Del. 1958). *See also* Kortum v. Webaso Sunroofs, Inc., 769 A.2d 113, 124 (Del. Ch. 2000) ("[A] stockholder's

Obviously, corporations have no obligation to allow inspection of sensitive or confidential records if the inspection is not germane to the shareholder's legitimate interests and proper purpose.[194] In *News-Journal v. State ex rel. Gore*,[195] the Florida Supreme Court held that a shareholder "is entitled to any information affecting the financial status of the corporation but he is not entitled to be placed in possession of its trade secrets and confidential communications unless they affect the financial status or the value of his stock in some way." It is important to remember that shareholders may lawfully compete with their corporation; therefore, conceivably, highly sensitive competitive information might be made available to a competitor through the ruse of a shareholder inspection. Courts enforcing inspection rights courts are sensitive to the possibility that a shareholder may have an improper purpose in seeking confidential records.[196] The danger, however, must be real. Courts have universally rejected the argument that the common law right of inspection must be limited merely because the shareholder might make improper use of the information. "Many legal rights may be the subjects of abuse, but cannot be denied for that reason. . . . The possibility of the abuse of a legal right affords no ground for its denial."[197]

5. Preliminary or Interim Records of Account

Although not yet addressed by Texas courts, some courts in other jurisdictions have restricted the right of inspection by holding that corporations are not required to permit inspection of draft or tentative documents such as preliminary interim financial statements.[198]

6. Attorney–Client Privilege

An attorney representing a corporate client does not owe any duty directly to the shareholders.[199] Therefore, shareholders are outside the privilege between the corporation and its attorneys, and the right of inspection does not extend to documents subject to the attorney–client privilege.[200] In *Burton v. Cravey*,[201]

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status as a competitor may limit the scope of, or require imposing conditions upon, inspection relief, but that status does not defeat the shareholder's legal entitlement to relief."); Nationwide Corp. v. Nw. Nat'l Life Ins. Co., 87 N.W.2d 671, 679 (Minn. 1958) ("The fact that the stockholder is interested as a stockholder or otherwise in rival corporations is not of itself enough to deny the right of inspection. . . . It ordinarily is not enough to deny the right that the information sought is of a confidential nature."); Uldrich v. Datasport, Inc. 349 N.W.2d 286, 288–89 (Minn. App. 1984) (ordering inspection of what corporation contended was "confidential business information" even though shareholders owned a competing business, although court also enjoined competitive use of information).

[194] *See* Garner v. Wolfinbarger, 430 F.2d 1093, 1104 n.21 (5th Cir. 1970).

[195] News-Journal Corp. v. State *ex rel.* Gore, 187 So. 271, 272 (Fla. 1939).

[196] *See* Uvalde Rock Asphalt Co. v. Loughridge, 425 S.W.2d 818, 819–20 (Tex. 1968) (holding that inspection may be denied when the purpose is to obtain "competitive advantage" over the corporation); *see also* State *ex rel.* Beaty v. Guarantee Mfg. Co., 174 P. 459, 460 (Wash. 1918) (competitor was not entitled to inspect minutes of board of directors). *But see News-Journal Corp.*, 187 So. At 272 (finding that a shareholder who owned competing company was "entitled to any information affecting the financial status of the corporation but he is not entitled to be placed in possession of its trade secrets and confidential communications unless they affect the financial status or the value of his stock in some way").

[197] Guthrie v. Harkness, 199 U.S. 148, 155–56 (1905).

[198] *See, e.g.*, State *ex rel.* Jones v. Ralston Purina Co., 358 S.W.2d 772 (Mo. 1962) (holding confidential interoffice communications, such as preliminary profit and loss statements, monthly profit analysis reports, and monthly tentative balance sheets, that were tentative studies prepared purely for the information of the management, were not comprehended within the meaning of "books" with respect to which shareholders enjoy statutory inspection rights); Bitters v. Milcut, Inc., 343 N.W.2d 418, 419 (Wis. 1983) (holding that interim corporate financial statements were not within the phrase "books and records of account").

[199] Gamboa v. Shaw, 956 S.W.2d 662, 664–65 (Tex. App.—San Antonio 1997, no writ). *See also* Brennan v. Ruffner, 640 So.2d 143, 146 (Fla. App. 1994) ("The duty of an attorney for the corporation is first and foremost to the corporation, even though legal advice rendered to the corporation may affect the shareholders. Cases in other jurisdictions have similarly held."); Felty v. Harweg, 523 N.E.2d 555, 555 (Ill. App. 1988) ("A shareholder in an ordinary corporation does not thereby become a beneficiary of an attorney-client relationship between a lawyer and the corporation in which he owns shares. The lawyer for the corporation does not, thereby, owe a fiduciary duty to the shareholder."); Pelletier v. Zweifel, 921 F.2d 1465, 1491 n.60 (11th Cir. 1991) ("[A] corporation's attorney owes no such fiduciary duty to the corporation's shareholders.").

[200] Courts in other jurisdictions uniformly deny shareholders the right to inspect attorney–client privileged documents. *See In re* LTV Sec. Litig., 89 F.R.D. 595, 610–11 (N.D. Tex. 1981); Henshaw v. Am. Cement Corp., 252 A.2d 125

the Houston First Court of Appeals suggested in dicta that the attorney–client privilege must be balanced against the right of inspection. The Texas Supreme Court specifically disapproved of this dicta in *Huie v. DeShazo*,[202] in the course of holding that a trustee has an attorney–client privilege even against the beneficiary of the trust:

> [T]o the extent that the court held that the owners' statutory right of inspection somehow trumped the privilege for confidential attorney-client communications, we disapprove of its holding, for the reasons previously discussed. We also disapprove of the court's dicta that the trial court could, in its discretion, decline to apply the attorney-client privilege even if all the elements of Rule 503 were met.[203]

However, the Texas Supreme Court also held that corporate records do not become shielded from inspection by the attorney–client privilege merely because they are in the possession of the corporation's attorney.[204]

7. Work Product

Although not addressed yet by Texas courts, the rule excluding attorney–client privileged documents from shareholder inspection should also apply to the work product of the corporation's attorney and consulting experts.[205]

8. Fifth Amendment

Corporations are not entitled to refuse shareholder inspection on Fifth Amendment grounds.[206]

9. Documents Not Otherwise Discoverable in Litigation

Lawyers representing corporations sometimes object to a requested inspection on bases drawn from the rules of civil procedure, such as that the description of the documents in vague or ambiguous, or that the request is overly broad and unduly burdensome, or is irrelevant to the subject matter of the ongoing dispute with the shareholder. These types of objections are completely inappropriate in the context of a shareholder's exercise of inspection rights. The substantive rights to inspect corporate documents and the procedures for demanding an inspection are completely independent from the discovery rules in civil litigation.[207] In *Burton v. Cravey*,[208] the court held that objections under the rules of discovery do not apply to a request for inspection, so that a corporation may not complain that a demand is "overly broad, unduly burdensome, and requires the production of irrelevant information." Likewise, restrictions and procedural requirements on a shareholder's right of inspection do not apply to or affect a shareholder's discovery requests in ongoing litigation, and a shareholder who is in litigation with the corporation is free to use either or both methods of discovery.[209] A shareholder engaged in litigation with the corporation may very well be entitled to inspect corporate records that would otherwise not be discoverable in the lawsuit. Conversely, a shareholder may be able to obtain some records in discovery that he would not otherwise be entitled to inspect, that the fact that a document might be "discoverable" in litigation does not establish a shareholder's right to inspect it.[210] Nevertheless, some courts have restricted a shareholder's right of inspection when the shareholder was actively engaged in litigation against the corporation and the court viewed the inspection demand as nothing more than "back-door discovery."[211]

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(Del. Ch. 1969); Riser v. Genuine Parts Co., 258 S.E.2d 184 (Ga. App. 1979).

[201] 759 S.W.2d 160, 162 (Tex. App.—Houston [1st Dist.] 1988, no writ).

[202] 922 S.W.2d 920 (Tex. 1996).

[203] *Id.* at 924; *see also* Riser v. Genuine Parts Co., 258 S.E.2d 184, 186 (Ga. App. 1979) (affirming denial of request for attorney's opinions); Schein v. N. Rio Arriba Elec. Co-op, Inc., 932 P.2d 490, 495 (N.M. 1997) ("Corporate documents that are subject to the attorney-client privilege may be withheld from shareholders."). In *Cox v. Boudreaux Civic Ass'n, Inc.*, No. 01-90-00657-CV, 1991 WL 35026 (Tex. App.—Houston [1st Dist.] Mar. 14, 1991, writ denied), the court rejected a member of a nonprofit corporation's argument that he had the statutory right to inspect all the nonprofit's records and therefore none of the nonprofit's records could be withheld from discovery in a civil suit on the grounds of attorney–client privilege.

[204] 922 S.W.2d at 924.

[205] *See* Barnett v. Barnett Enters., Inc., 182 So.2d 728 (La. App. 1966) (holding that shareholder inspection rights did not extend to valuation estimates prepared by the corporations experts for use in the appraisal proceeding).

[206] *See* Stone v. Martin, 289 S.E.2d 898 (N.C App. 1982).

[207] San Antonio Models, Inc. v. Peeples, 686 S.W.2d 666, 670 (Tex. App.—San Antonio 1985, no writ).

[208] 759 S.W.2d 160, 162 (Tex. App.—Houston [1st Dist.] 1988, no writ).

[209] See San Antonio Models, Inc., 686 S.W.2d at 670.

[210] *See* Kaufman v. CA, Inc., 905 A.2d at 754.

[211] *In re* LTV Sec. Litig., 89 F.R.D. 595, 610 (N.D. Tex. 1981) (quoting Henshaw v. Am. Cement Co., 252 A.2d 125, 130 (Del. Ch. 1969). In *Stasan Inc. v. Logal*, 48 Fed. App'x 917 (5th

## E. Proper Purpose

1. Statement of a Proper Purpose

The statutory requirement on the shareholder seeking inspection is to state a proper purpose.[212] The shareholder is not required to state every purpose that he has, that the purpose identified is the only purpose, or that he represent that he does not have an improper purpose. However, if the purpose stated is not proper, then the corporation will have an easy time resisting any effort to enforce the shareholder's inspection rights. Therefore, care should be taken to state purposes in the demand that are recognized as proper.

2. What Constitutes a Proper Purpose?

The principal limitation on a shareholder's inspection rights is that the shareholder must act with a "proper purpose." Generally, a proper purpose is one that is reasonably related to the protection of stockholder's interest as a shareholder (including protection of the corporation's interests that affect the shareholder indirectly); conversely an improper purpose is one that seeks to injure the corporation or the shareholders.[213] "[A] proper purpose is one that bears upon the protection of the shareholder's interest and that of other shareholders in the corporation."[214]

a. Ascertain Value of Shares

Probably the most common reason for a shareholder's wanting to inspect corporate records is to determine the financial performance of the company and other information that bears ultimately on the value of the shareholder's ownership interest. The stated purpose of "ascertaining the value of his shares" is a "clearly proper and legitimate" purpose for inspection.[215]

b. Investigate Wrongdoing by Management

Under the common law, both shareholder litigation against the corporation or its directors, and shareholder investigation of improper corporate management are deemed proper purposes.[216] In *Chavco Investment Company, Inc. v. Pybus*, the court held that the stated purpose "[of] determin[ing] whether the rental on a building, the principal asset of the corporation, was a reasonable rental or whether the rental was so unreasonably low as to result in corporate waste," and "examining expenditures, determining whether there was excessive compensation being paid to officers and directors, whether corporate funds were used for personal purposes, and whether there was corporate mismanagement . . . . were clearly proper and legitimate reasons for wanting to inspect the books of the corporation."[217]

In addition, the Delaware Supreme Court expressly held that in the context of a shareholder-derivative action, "it is a proper purpose . . . to inspect books and records that would aid the plaintiff in pleading demand futility" even if the inspection suit was filed during the derivative action, so long as the court granted leave to amend.[218] Nonetheless, courts encourage plaintiffs to seek inspection of corporate records first because of "the additional burden that a post-complaint bo0ks and

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Cir. 2002), the Fifth Circuit found that a shareholder's attempt to obtain mandamus to enforce inspection rights as a method to compel the corporation to produce documents requested in discovery in litigation with the corporation "expands [the inspection statute] beyond its purpose." *Accord* Bezirdian v. O'Reilly, 107 Cal. Rptr. 3d 384, 395–96 (Cal. Ct. App. 2010) ("Plaintiff does not cite to any authority for the proposition that section 1601 authorizes discovery in an ongoing lawsuit.").

[212] TEX. BUS. ORGS. CODE ANN. § 21.222(b) (West 2011).

[213] *See* Guar. Old Line Life Co. v. McCallum, 97 S.W.2d 966, 967 (Tex. Civ. App.—Dallas 1936, no writ); *see also In re* Occidental Petrol. Corp., 217 F.3d 293, 298 (5th Cir. 2000) (inspection demand "must be germane to his interest as stockholder").

[214] HAMILTON ET AL., *supra* note 175, § 34.6, at 34 (2004); *see also* Tatko v. Tatko Bros. Slate Co., Inc., 569 N.Y.S.2d 783, 918 (N.Y.A.D. 1991). ("[P]roper purposes are those reasonably related to the shareholder's interest in the corporation. They include, among others, efforts to ascertain the financial condition of the corporation, to learn the propriety of dividend distribution, to calculate the value of stock, to investigate management's conduct, and to obtain information in aid of legitimate litigation.").

[215] Chavco Inv. Co., Inc. v. Pybus, 613 S.W.2d 806, 808 (Tex. Civ. App.—Houston [14th Dist.] 1981, writ ref'd n.r.e.).

[216] *See In re* LTV Sec. Litig., 89 F.R.D. 595. 610 (N.D. Tex. 1981); Nodana Petrol. Corp. v. State, 123 A.2d 243, 246 (Del. 1956); Skoglund v. Ormand Indus., Inc., 372 A.2d 204, 207 (Del. Ch. 1976); Taylor v. Eden Cemetery Co., 10 A.2d 573 (Pa. 1940); *see generally* Annot., 15 A.L.R.2d 11 (1951).

[217] 613 S.W.2d 806, 808 (Tex. Civ. App.—Houston [14th Dist.] 1981, writ ref'd n.r.e.); *accord* Boehringer v. Konkel, 404 S.W.3d 18, 27 (Tex. App.—Houston [1st Dist.] 2013, no pet.) ("Konkel's statement that he had a vested interest in seeing how the company's money was being spent constitutes a statement of a proper purpose for which the request was made.").

[218] King v. VeriFone Holdings, Inc., 12 A.3d 1140, 1150 (Del. 2011).

records action may place on a defendant-corporation . . . ."[219]

c. Communication with Other Shareholders

Inspection of shareholder lists for the purpose of obtaining the names and addresses of other stockholders to inform them of grievances or concerns is per se a proper purpose.[220] Because the right to communicate with other shareholders regarding matters of common interest is central to corporate democracy, the law looks more favorably upon shareholder requests for the stock register than for other company records.[221] As one Texas court noted:

> We can see no good reason why a stockholder in a corporation who is dissatisfied with the internal management of the corporate affairs should not have the right to call to the attention of his fellow stockholders conditions in the corporate management with which he is dissatisfied and in good faith regards as prejudicial to the best interest of the corporation and its stockholders. In our opinion, stockholders have such right.[222]

Another court described the shareholder's list as a corporate record possessing "a sacred character . . . which shareholders may inspect as a matter of right."[223]

Inspection of these documents will be bridled only upon a showing by the corporation that the shareholder's purpose is improper.[224] However, the Delaware Supreme Court has held that the stated purpose of communicating with other shareholders was not sufficient if the nature of intended communication not disclosed.[225] Other courts have recognized similar limits on the right to shareholder lists. In *Retail Property Investors, Inc. v. Skeens*,[226] the request for the shareholders list was not allowed for purpose of contacting other shareholders regarding possible lawsuit against corporation. In *Shabshelowitz v. Fall River Gas Co.*,[227] the Massachusetts Supreme Court held that a shareholder's request to inspect and copy the stock ledger for the purpose of contacting other shareholders and soliciting the purchase of their shares was not proper.[228]

3. True Purpose

The problem arises when the corporation believes that the purpose stated is not the true purpose or that there is another purpose that is improper. "And it is very easy for controlling shareholders to view any request to inspect with suspicion that easily could lead to the rejection of a request on the ground that a claimed 'proper purpose' was in fact 'improper.'"[229] The issue of what is the true purpose and whether that purpose is improper must be resolved through the courts once the corporation refuses to allow inspection. That issue will be dealt with in a separate article on the enforcement of inspection rights. What is important here is to determine what constitutes the statement of a proper purpose.

## F. Compliance

1. Furnishing a Substitute Is Insufficient

A corporation may not satisfy its obligation to permit shareholder inspection by offering a substitute, such as an annual statement. "The fact that the defendant had its books audited annually and furnished its officers copies thereof is no defense in this

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[219] *In re* Johnson & Johnson Derivative Litig., 865 F. Supp. 2d 545, 580 (D.N.J. 2011); *see also King*, 12 A.3d at 1150–51 ("[I]t is wasteful of the court's and the litigant's resources to have a regime that could require a corporation to litigate repeatedly the issue of futility.").

[220] *See In re LTV Sec. Litig.*, 89 F.R.D. at 609–10.

[221] *Id.* at 609; *see also* NVF Co. v. Sharon Steel Corp., 294 F. Supp. 1091, 1093 (W.D. Penn. 1969); Goldman v. Trans-United Indus. Inc., 171 A.2d 788 (Pa. 1961); HAMILTON ET AL., *supra* note 175, § 34.10, at 41 (2004) ("Courts probably tend to be more lenient in granting access to shareholders lists than to other books and records.").

[222] Grayburg Oil Co. v. Jarratt, 16 S.W.2d 319, 320 (Tex. Civ. App.—El Paso 1929, no writ); *see also* Conserv. Caucus Research Analysis & Educ. Found., Inc. v. Chevron Corp., 525 A.2d 569 (Del. 1987) (stating that a desire to communicate with other shareholders, particularly regarding matters of concern in advance of a shareholder's meeting, is proper as a matter of law).

[223] *In re LTV Sec. Litig.*, 89 F.R.D. at 611.

[224] *See* Skoglund v. Ormand Indus., Inc., 372 A.2d 204, 207 (Del. Ch. 1976).

[225] Nw. Indus. Inc. v. B.F. Goodrich Co., 260 A.2d 428, 429 (Del. 1969).

[226] 471 S.E.2d 181, 183 (Va. 1996).

[227] 588 N.E.2d 630, 632–33 (Mass. 1992).

[228] The Maine Supreme Court reached the same result in *Chas. A. Day & Co., Inc. v. Booth*, 123 A. 557, 558–59 (Me. 1942). However, in *Madison Liquidity Investors 103 LLC v. Carey*, 739 N.Y.S.2d 18 (N.Y. App. Div. 2002), a New York appellate court permitted inspection of stockholder list where avowed purpose was to solicit purchases and where there was no evidence of wrongful intent or that anything other than market would dictate price.

[229] HAMILTON ET AL., *supra* note 175, §34.6, at 35 (2004).

proceeding. . . . The right [of shareholder inspection] cannot be defeated by an audit of the company's business and furnishing the stockholder with the auditor's report."[230]

2. Conditions

A corporation may require some reasonable conditions on the inspection so as to protect the rights of other shareholders and avoid harm to the corporation, and courts frequently impose some reasonable limitations or conditions that result in the shareholder receiving something less than "unfettered access" to the books and records.[231] For instance, in *Ritchie v. Rupe*, the corporation would only permit the original corporate stock and minute books to be inspected and copied on the corporate premises.[232] The minority-shareholder plaintiff argued that this was an unreasonable restriction on her statutory right to inspect the books and records of the corporation.[233] The appellate court rejected this argument, holding that a corporation is "entitled to impose reasonable restrictions for the protection and integrity of its books and records. [Plaintiff] has not shown that requiring some of [corporation's] original books remain on its premises to be copied was an unreasonable restriction . . . ."[234]

However, the courts tend to be skeptical about such conditions and will not permit the corporation to substantially abridge the shareholder's right. In *Johnson Ranch Royalty Co. v. Hickey*,[235] the corporation agreed to allow inspection and audit of the books and records but imposed a number of onerous conditions. The shareholders agreed to some but not all of the conditions, and the corporation refused to allow the inspection. The trial court ordered the corporation to permit the inspection and audit and imposed following conditions on the shareholders in the order: That the shareholders bear all expenses and not unnecessarily interfere with the conduct of the business; that no valuable deeds or other instruments, contracts, or any of the books or papers from the defendants' office; that the plaintiffs post a $10,000 bond for the safe redelivery to the corporation of all documents; that plaintiffs use a Texas CPA; and that the examination and audit be conducted continuously and diligently. The plaintiffs did not challenge the conditions imposed by the district court, and the court of appeals affirmed the judgment. The court of appeals seemed to accept the notion that some reasonable conditions might be imposed by the corporation or ordered by the court; however, the court of appeals stated in dicta: "We think the court's judgment and the conditions imposed upon plaintiffs are even more liberal than defendants could insist upon under the law."[236] The key is the "reasonableness" of the conditions or limitations. Any unreasonable restrictions imposed by the corporation constitute a "constructive" refusal to permit inspection.[237]

a. Bond

The corporation may not require shareholders to post a bond to guaranty the safety or redelivery of documents, "unless it had been shown that the plaintiffs had threatened or would likely take possession of valuable records, deeds, etc."[238]

b. Designation of Agent or Agent's Qualifications

A shareholder is entitled to conduct an inspection personally or through an agent, and the corporation has no right to dictate who the agent may be or to limit the plaintiff's choice of agent by, for example, requiring the agent to have particular qualifications. In *Johnson Ranch Royalty Co. v. Hickey*,[239] the court of appeals held that the corporation was not entitled to specify that the shareholders' agent conducting the inspection be a Texas CPA.

c. Limitations on Time or Deadlines for Completion

In *Johnson Ranch Royalty Co. v. Hickey*,[240] the court of appeals held that the trial court's requirement that the examination, once commenced by plaintiffs, be conducted continuously and diligently until finished" is

[230] Johnson Ranch Royalty Co. v. Hickey, 31 S.W.2d 150, 153 (Tex. App.—Amarillo 1930, writ ref'd); *see also* Citizens Ass'n for Sound Energy v. Boltz, 886 S.W.2d 283, 290 (Tex. App.—Amarillo 1994, writ denied) (The furnishing of a financial statement of the corporation in lieu of the original financial records is not sufficient to satisfy a right to inspect the corporate books); Moore v. Rock Creek Oil Corp., 59 S.W.2d 815, 819 (Tex. Comm'n App. 1933, judgm't adopted) ("Defendants in error are not entitled to defeat plaintiffs in error's statutory right of inspection by offering them the substitute of financial statements issued by the company or an auditor's report made at its instance. . . . The right thus granted by the statute cannot be bartered away by the officers of the corporation.").

[231] *See In re* LTV Sec. Litig., 89 F.R.D. 595, 609–10 (N.D. Tex. 1981).

[232] Ritchie v. Rupe, 339 S.W.3d 275, 304–05 (Tex. App.—Dallas 2011, pet. granted).

[233] Id.

[234] *Id.* at 305.

[235] Johnson Ranch Royalty Co., 31 S.W.2d at 151.

[236] *Id.* at 152.

[237] *See* Stasan Inc. v. Logal, 48 Fed. App'x 917 (5th Cir. 2002) (citing *Johnson Ranch Royalty Co.*, 31 S.W.2d at 152).

[238] Johnson Ranch Royalty Co., 31 S.W.2d at 152.

[239] Id.

[240] *Id.* at 153.

"more favorable to them than the law justifies." The court held that the law requires that a "corporation's books and records shall at all reasonable times be open to the inspection of the stockholder, and does not limit them to any particular hours or any period or periods of time which may be reasonable."[241] Nevertheless, courts are sensitive to the reality that the corporation's primary business is not the facilitation of shareholder inspection and that inspection can sometimes be disruptive. Corporations will be allowed to take reasonable efforts to schedule the inspection with the shareholder and will not be held to have refused the inspection merely because of scheduling difficulties.[242]

d. Confidentiality Agreement

A common condition, generally approved by the courts, is a reasonable confidentiality agreement preventing the shareholder from using the information obtained to compete against the corporation or otherwise injure the corporation, particularly if the shareholder works for a competitor or there is some other reasonable basis for concern.[243] A shareholder otherwise entitled to inspection "may be limited in its use of any information where the information is confidential and release would harm the company."[244] "[I]t is customary for any final order [in a § 220 action] to be conditioned upon a [reasonable] confidentiality [agreement]."[245] In *Ihrig v. Frontier Equity Exchange Association*,[246] the court held that the corporation may limit disclosure to those records reasonably related to the proper purpose, and may prescribe limitations or conditions on disclosure as deemed just and proper, including prohibiting on any publication of information contained in records.

3. Delay

"The law does not sanction an indefinite delay in granting the right to inspect. The right of inspection is a present right when the demand is made at a reasonable time and an indefinite delay in according this right is equivalent to a denial of it."[247] Similarly, one Texas court has held that a four-month delay in responding to a request was a refusal.[248] However, the Dallas court of appeals held in *Watson v. Homeowners Association of Heritage Ranch, Inc.* that a reasonable delay for the purpose of determining a policy for payment of the costs associated with inspection and copying of records does not constitute a refusal.[249]

4. Right to Photocopy

In addition to inspecting the books and records, the shareholder has the right to make photocopies.[250]

5. Expenses of Inspection

No Texas case has addressed whether a corporation has a right to charge the shareholder for the right to conduct the inspection. The Corpus Christi court of appeals recently decided a case involving inspection rights of a member of a nonprofit corporation and rejected the member's argument that a nonprofit corporation could not charge an "inspection fee."[251] The court held that the nonprofit corporation could charge the member for the reasonable expenses incurred in the inspection, including not only the cost of copies, but the hourly rate for the corporation's bookkeeper to assemble the records and "oversee" the

[241] Id.

[242] *See Stasan Inc.*, 48 Fed. App'x 917. In *Shioleno v. Sandpiper Condo. Council of Owners, Inc.*, 2008 WL 2764530 (Tex. App.—Corpus Christi, July 17, 2008, orig. proceeding), a case involving inspection rights in a nonprofit corporation, the court held that the corporation had failed to comply with the member's inspection rights, where the corporation delayed for four months and then granted access on only three days, one of which it knew that the member would only be available for one hour in the morning.

[243] Gaughan v. Nat'l Cutting Horse Ass'n, 351 S.W.3d 408, 417 (Tex. App.—Fort Worth 2011, no pet.) (requiring a member of a nonprofit corporation to abide by the corporation's confidentiality terms as a condition to inspection).

[244] Pershing Square, LP v. Ceridian Corp., 923 A.2d 810, 816 (Del. Ch. 2007).

[245] *Id.* at 820; *see also* CM&M Group, Inc. v. Carroll, 453 A.2d 788 (Del. 1982) (holding that shareholder's "secondary purpose" to get financial information that might be helpful to a third party did not preclude inspection, but conditioned inspection on an agreement of nondisclosure).

[246] 128 P.3d 993, 999 (Kan. App. 2006),

[247] Johnson Ranch Royalty Co. v. Hickey, 31 S.W.2d 150, 153 (Tex. App.—Amarillo 1930, writ ref'd).

[248] Shioleno v. Sandpiper Condo. Council of Owners, Inc., No. 13-07-00312-CV, 2008 WL 2764530 (Tex. App.—Corpus Christi-Edinburg, July 17, 2008, orig. proceeding).

[249] Watson v. Homeowners Ass'n of Heritage Ranch, Inc., 346 S.W.3d 258, 260–61 (Tex. App.—Dallas 2011, no pet.) (finding a two-month delay reasonable after the entity made clear to the member that he would be entitled inspect the books and records once the cost of inspection was determined).

[250] Cotton v. Weatherford Bancshares, Inc., 187 S.W.3d 687, 698 (Tex. App.—Fort Worth 2006, pet. denied).

[251] Shioleno v. Sandpiper Condo. Council of Owners, Inc., 2008 WL 2764530 (Tex. App.—Corpus Christi, July 17, 2008, orig. proceeding).

inspection.[252] The court's reasoning, however, was based largely on the language in the Non-Profit Corporation Act that the inspection of books and records be conducted "at the expense of the member"[253] and on the member's attorney's stipulation in the trial court that the member would pay for necessary expenses.

The statutory language governing inspection in for-profit corporations does not include the "at expense of the member" language.[254] Given that the keeping of the books and records at the corporation's principal place of business is a statutory obligation of the corporation,[255] as is the making of those documents available for inspection, it would seem odd that a corporation would be permitted to charge a shareholder for complying with its own legal obligations. Obviously, if the corporation incurs any expense accommodating the requests of the shareholder beyond its bare legal obligations, such as making photocopies, then it would only be fair for the shareholder making the request to bear the expense. Most likely courts will examine this issue based on the rule of "reasonableness."[256] Corporations must act reasonably under the circumstances and may not use charges to the shareholder of expenses as a method to substantially abridge the shareholder's rights or to punish the shareholder for the exercise of those rights.

### G. Other Statutory Rights To Corporate Records

1. Shareholder Lists

In addition to the general right of inspection, there is also a statutory right to inspect a shareholders list before the any meeting of the shareholders.[257] Not less than ten days before the meeting, the corporation is required to make available for inspection at its principal place of business (or post on the internet) a complete, alphabetical list of the shareholders entitled to vote at the meeting, with the address of and the number of shares held by each. The corporation does not have to provide telephone numbers or email addresses. The list must be continuously available during normal business hours for a period of at least ten days. Shareholders are entitled to inspect and copy the list without a written demand, proper purpose or prior notice.

2. Voting Trust Agreements

Copies of voting trusts and voting agreements must be deposited with the corporation and be kept available for inspection by shareholders, but the shareholder must follow the same procedures as with other books and records.[258]

3. Annual Reports

In addition, a corporation must mail its most recent annual and interim financial statements to any shareholder who requests them in writing.[259]

4. State and Federal Tax Returns

A shareholder of record who owns at least 1% of the corporation's outstanding stock has the right to inspect the corporation's federal income tax returns.[260] Any shareholder has the right to inspect Texas franchise annual reports.[261]

5. Notice of Indemnification

If the corporation has agreed to indemnify or advance expenses to any director, the corporation must report that fact to the shareholders in writing with or before the notice of the next shareholders' meeting, and in any case within twelve months of the indemnification or advance.[262]

6. Director's Right of Inspection

In disputes and litigation among shareholders of closely held corporations, the shareholder excluded from access to corporate records and information is often also a director. When this situation arises, the withholding of information takes on an entirely different dimension. The management of Texas corporations is entrusted to the directors. Implicit in that idea is that the directors must have access to all information within the corporation. Whatever rights there may be for management to withhold information from a shareholder, those rights vanish when the shareholder is also a director.

a. Right of Inspection is Absolute

The right of a director of a corporation to inspect the corporate books and records is absolute.[263] Because directors of a corporation are charged with managing the business and affairs of the corporation,[264]

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[252] Id.
[253] TEX. REV. CIV. STAT. art. 1396-2.22(B).
[254] Tex. Bus. Orgs. Code Ann. § 21.218 (West 2011).
[255] *Id.* §§ 3.151, 21.173.
[256] Johnson Ranch Royalty Co. v. Hickey, 31 S.W.2d 150, 151–52 (Tex. App.—Amarillo 1930, writ ref'd).
[257] BUS. ORGS. §§ 21.354, 21.372.
[258] *Id.* §§ 6.251–6.252.
[259] *Id.* § 21.219.
[260] 26 U.S.C. § 6103(e)(1)(D)(iii) (2012).
[261] TEX. TAX CODE ANN. § 171.209 (West 2011).
[262] Bus. Orgs. § 8.152.
[263] Chavco Inv. Co., Inc. v. Pybus, 613 S.W.2d 806, 810 (Tex. Civ. App.—Houston [14th Dist.] 1981, writ ref'd n.r.e.).
[264] BUS. ORGS. § 21.401.

> It would seem to be axiomatic that the individual director cannot make his full contribution to the management of the corporate business unless given access to the corporation's books and records. The information therein contained is ordinarily requisite to the exercise of the judgment required of directors in the performance of their fiduciary duty so much so that the directors' right of inspection has been termed absolute, during their continuance in office at all reasonable times.[265]

At the time *Chavco Investment Co., Inc. v. Pybus* was decided the Texas Business Corporation Act did not specifically confer upon directors the right to inspect the corporate books, however, the court of appeals held that this right existed by common law.[266] The Texas Business Organizations Code specifically provides directors the right of inspection and a remedy for violation of that right.[267] The director does not have to have a "proper" purpose to inspect, so long as his purpose is "reasonably related to his service as a director"; however, the director is not required to state his purpose or even to make a written demand.

b. Attorney–Client Privilege

Frequently, when there is a dispute among shareholders, the attorney paid by the corporation will consult with one side or the other, typically with the side aligned with the controlling shareholder. In this instance, in all likelihood, the communications with the corporation's attorney are not privileged as to another director. Texas courts have not confronted this issue, although the statement in *Chavco Inv. Co., Inc. v. Pybus*,[268] that the director's right to information is "absolute" would certainly seem to imply that result. Delaware courts have confronted this issue in a number of contexts and have uniformly held that the attorney–client privilege between the corporation and the corporate counsel does not shield communications from a director. When a corporation employs legal counsel, each of the members of the board of directors has a status co-equal with the corporation as "client."

The issue is not whether the documents are privileged or whether plaintiffs have shown sufficient cause to override the privilege. Rather, the issue is whether the directors, collectively, were the client at the time the legal advice was given. Defendants offer no basis on which to find otherwise, and I am aware of none. The directors are all responsible for the proper management of the corporation, and it seems consistent with their joint obligations that they be treated as the 'joint client' when legal advice is rendered to the corporation through one of its officers or directors.[269]

As a matter of law, communications made during the tenure of any director could not have been intended to be kept confidential from that director. "Absent a governance agreement to the contrary, each director is entitled to receive the same information furnished to his or her fellow board members."[270]

Furthermore, even after a director's tenure expires or the director is removed, that director continues to be entitled to discovery all communications with the corporation's counsel that occurred during his tenure—for the obvious reason that such communications were not privileged when made, and there is no legal principle that would create a privilege ex post facto. In *Kirby v. Kirby*,[271] the Delaware Chancellor held that, as to attorney–client communications that occurred during the tenure of former directors, it is not possible for any privilege to have been created for those communications, and therefore, there is no basis for the invocation of the attorney–client privilege at a later date.

Independently, Delaware courts have held that the corporation is prohibited from asserting the attorney–client privilege as to information to which a director is entitled. A corporation may not "assert the privilege to deny a director access to legal advice furnished to the board during the director's tenure."[272]

In a situation where there is a dispute with one of the directors, where the board or management has a good faith reason for consulting with counsel without the participation of that director, the law does provide mechanisms for preserving the privilege. As the Chancellor held in *Moore Business Forms, Inc. v. Cordant Holdings Corp.*:

> Holdings had alternative means to enable its directors (other than Mr. Rogers) to receive confidential attorney advice not discoverable by Moore. Holdings could have bargained for such protections in the Stockholders Agreement. Alternatively, and independent of the Stockholders Agreement, the Holdings

[265] Chavco Inv. Co., Inc. v. Pybus, 613 S.W.2d at 810 (quoting FLETCHER, *supra* note 54, at § 2235).
[266] Id.
[267] BUS. ORGS. § 3.152(a).
[268] 613 S.W.2d at 810.
[269] Kirby v. Kirby, 1987 WL 14862, at *7 (Del. Ch. July 29, 1987).
[270] Intrieri v. Avatex, No. C.A. 16335-NC, 1998 WL 326608 (Del. Ch. June 12, 1998). Each director is as much the "client" as any other member of the board.
[271] *Kirby*, 1987 WL 14862.
[272] Moore Bus. Forms, Inc. v. Cordant Holdings Corp., Civ. A. Nos. 13911, 14595, 1996 WL 307444, at *4 (Del. Ch. June 4, 1996).

> board could have acted, pursuant to 8 Del.C. § 141(c) and openly with the knowledge of Moore and Rogers, to appoint a special committee empowered to address in confidence those same matters. Under either scenario the special committee would have been free to retain separate legal counsel, and its communications with that counsel would have been properly protected from disclosure to Moore and its director designee. Neither approach was followed here.[273]

## H. Enforcement of Inspection Rights

Lack of information to shareholders is probably the most common violation of shareholder rights and almost always a component of a campaign of shareholder oppression. In and of itself, the restriction of information is rarely enough to constitute a pattern of oppression sufficient to invoke more extreme equitable remedies, such as a forced buyout or dissolution. A shareholder faced with a cutoff of information and a refusal to allow inspection must first seek judicial remedies designed explicitly to enforce these rights. Unfortunately, as demonstrated below, Texas law does not provide a procedural mechanism for expedited enforcement of these important rights. An aggrieved shareholder must file a lawsuit seeking a writ of mandamus to compel production. If the corporation is able to raise a fact issue as to whether the plaintiff has a proper purpose, then the corporation is entitled to a jury trial, and the shareholder is faced with a long and expensive battle just to get information. With most civil dockets in the state requiring years to move a case from Original Petition to jury trial, even an unsuccessful bid by a corporation to refuse inspection can effectively deny the shareholder's rights for a long period of time. However, the court may certainly take into consideration whether this type of gamesmanship by a corporation is motivated by bad faith on the part of the controlling shareholders, which may ultimately set the stage for a claim of oppression.

## I. Causes of Action for Refusal to Permit Inspection.

A shareholder seeking to enforce inspection rights must sue for a writ of mandamus to compel the inspection.[274] The writ may be issued to enforce either the shareholder's common law or statutory rights of inspection—the difference being that the statutory rights are narrower, but provide the shareholder with the benefit of certain presumptions and allow for the recovery of attorneys fees.

### 1. Elements of Common Law Cause of Action

#### a. Common Law

To obtain a writ of mandamus enforcing a common law right of inspection, the plaintiff shareholder must prove the following: (1) that he is a record or beneficial shareholder (regardless of number of shares or length of time held); (2) that he made a demand on the corporation for inspection of documents (not necessarily in writing); (3) that his purpose for inspecting the records is proper (need not have been stated in demand) and that he is acting in good faith; and (4) that the corporation refused.[275] Some courts have suggested that if the shareholder seeks only inspection of the shareholders list, then a proper purpose is presumed; whereas the burden to prove proper purpose shifts to the shareholder with regard to all other books and records.[276]

When the corporation refuses to comply with the director's demand for inspection, the director need only show that (1) he is a director, (2) that he demanded to inspect the corporate books and records (need not be in writing or state a purpose), and (3) the right to inspection was refused by the corporation.[277] "The unqualified right of appellee as director to inspect the books of the corporation must be distinguished from the right of shareholders, which is not absolute."[278]

#### b. Statutory Cause of Action

To obtain mandamus relief under the statutory inspection rights, the plaintiff shareholder must prove the following:

(1) that he is a shareholder or holder of a beneficial interest in a voting trust;
(2) that he has owned his shares for at least six months or holds at least five percent of all the outstanding shares of the company;

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[273] *Moore Bus. Forms, Inc.*, 1996 WL 307444, at *6.

[274] *See* Uvalde Rock Asphalt Co. v. Loughridge, 425 S.W.2d 818, 820 (Tex. 1968); Moore v. Rock Creek Oil Corp., 59 S.W.2d 815, 817–18 (Tex. Comm'n App. 1933, judgm't adopted); *In re* Dyer Custom Installation, Inc., 133 S.W.3d 878, 881 (Tex. App.—Dallas 2004, orig. proceeding); Yelverton v. Brown, 412 S.W.2d 325, 330 (Tex. Civ. App.—Tyler 1967, no writ).

[275] *See* TEX. BUS. ORGS. CODE ANN. § 21.218(c) (West 2012); *Moore*, 59 S.W.2d at 818; Tex. Infra-Red Radiant Co. v. Erwin, 397 S.W.2d 491, 493 (Tex. Civ. App.—Eastland 1965, writ ref'd n.r.e.).

[276] *See In re* LTV Sec. Litig., 89 F.R.D. 595, 609 (N.D. Tex. 1981).

[277] Chavco Inv. Co., Inc. v. Pybus, 613 S.W.2d 806, 810 (Tex. Civ. App.—Houston [14th Dist.] 1981, writ ref'd n.r.e.).

[278] Id.

(3) that he has made a written demand for inspection;
(4) that the demand stated a proper purpose; and
(5) that the demand was refused.[279]

The "proper purpose" requirement seems to place the burden on the shareholder to establish that the purpose stated is proper; however, the corporation retains the burden to prove that the shareholder is motivated by some other improper purpose.

A governing person may enforce his right of access to corporate records by showing the following:

(1) that he is a governing person;
(2) that he demanded to inspect the corporate books and records (need not be in writing);
(3) that his purpose for inspecting the corporate books and records was reasonably related to his service as a director (need not have been stated in the demand); and
(4) the corporation refused his good faith demand to inspect the books and records.[280]

c. Absence of Adequate Remedy at Law

The remedies of mandamus and injunction are governed by equitable principles and therefore the plaintiff must also plead and prove the absence of an adequate remedy at law.[281]

d. Attorneys' Fees

A shareholder who prevails on the statutory claim is entitled to recover all costs and expenses, including attorney's fees, incurred in enforcing his rights, in addition to any other damages or remedy afforded him by law.[282] For a director, the court may also award him his attorneys' fees and any other relief that the court deems proper.[283] The trial court's award of attorneys' fees under the statute was affirmed in *Chavco Investment Company, Inc. v. Pybus*,[284] and in *Bayoud v. Bayoud*.[285] The shareholder or director must also establish that the attorneys' fees were reasonable and necessary.[286] In *Dobson v. Poor*, the San Antonio court of appeals upheld an award of attorney' fees to a shareholder and director from whom the books and records were withheld until the suit was filed, although the case was remanded for the plaintiff to properly segregate the attorneys fees incurred as a result of refusing inspection.[287]

e. Award Against Individuals

One court has permitted an award of attorney's fees for refusal to allow inspection directly against the majority shareholders/directors who were responsible for the refusal, although the court noted that the individuals could escape liability if their refusal was based on the advice of counsel under the safe harbor provisions.[288]

2. Issue of Proper Purpose

a. Defining the Issue

The single issue in dispute in virtually every case is whether or not the plaintiff shareholder had a "proper purpose." The inspection statute permits a corporation to assert the affirmative defense that the shareholder "was not acting in good faith or for a proper purpose in making [his demand]" [289] The corporation may seek to prove that the shareholder's stated purpose is not "proper" in that it is unrelated to his status as a shareholder. In that case, it would be immaterial whether the purpose was "improper" in the sense of harmful to the interests of the corporation. For example, the shareholder might be seeking information that is useful to him only in another capacity. Courts in other jurisdictions have generally held that a purpose that serves the personal interests of the shareholder, unrelated to his share ownership is not "proper," even if it is not otherwise wrongful or harmful to the corporation. For example, in *Lynn v. EnviroSource, Inc.*, the Delaware court held that a shareholder did not have a proper purpose where his sole purpose was to gather evidence for use in an administrative appeal regarding his pension benefits.[290]

Assuming that the shareholder has met his burden to state a purpose and to establish that the stated purpose is proper, what then must the corporation prove? Logically there are two alternatives: (1) the shareholder is not actually motivated by the stated

[279] BUS. ORGS. § 21.218.
[280] BUS. ORGS. § 3.152(b).
[281] Salgo v. Matthews, 497 S.W.2d 620, 625 (Tex. Civ. App.—Dallas 1973, writ ref'd n.r.e.); *see also* Callahan v. Giles, 137 Tex. 571, 155 S.W.2d 793 (1941); Poten v. Lockhart, 131 Tex. 181, 114 S.W.2d 219 (1938).
[282] BUS. ORGS. § 21.222.
[283] *Id.* § 3.152.
[284] 613 S.W.2d 806, 810 (Tex. Civ. App.—Houston [14th Dist.] 1981, writ ref'd n.r.e.).
[285] 797 S.W.2d 304, 315 (Tex. App.—Dallas 1990, writ denied).
[286] Arthur Anderson & Co. v. Perry Equip. Corp., 945 S.W.2d 812, 818–19 (Tex. 1997).
[287] Dobson v. Poor, No. 04-96-00920-CV, 1998 WL300530, at *7 (Tex. App.—San Antonio June 10, 1998, no pet.).
[288] *Id.* at *7 (citing TEX. BUS. CORP. ACT ANN. art. 2.41(D) (Vernon Supp. 1998), now codified at BUS. ORGS. § 3.102).
[289] Tex. Bus. Orgs. Code Ann. § 21.222 (West 2012).
[290] Lynn v. EnviroSource, Inc., Civ. A. No. 11770, 1991 WL 80242, at *2–3 (Del. Ch. May 13, 1991), *aff'd* 608 A.2d 728 (Del. 1991).

proper purpose;[291] (2) whether or not the shareholder is motivated by the stated purpose, he also has an improper purpose. The statutory language, requiring that the corporation prove that the shareholder "was not acting in good faith or for a proper purpose" seems to point only to the first alternative. As a practical matter, however, negating the fact that the shareholder is acting for a proper purpose is essentially impossible. How can a corporation possibly prove that the shareholder does not want to know what his shares are worth? The second alternative may be easier to prove, but it raises the question of why a shareholder who is asserting a valid right (inspection for a proper purpose) should be denied that right because he has other purposes. Does the improper purpose have to be the "real" or primary purpose? Does the potential harm to the corporation from the improper purpose have to outweigh the shareholder's rights arising from the proper purpose? Or does the mere existence of an improper purpose disqualify the shareholder from exercising his rights?

b. Problem of Mixed Motives

Frequently, the shareholder's motives are mixed. A shareholder may have a truly proper purpose, but also a secondary purpose that is unrelated to his status as a shareholder or that is "improper" and harmful to the corporation. For example, a shareholder might wish to obtain information for purposes that are proper, such as ascertaining the value of his shares, but also for purposes that are more questionable, such as harassment of management for purposes of attempting to force a settlement of private litigation. In such a case, the question will be whether a finding of any proper purpose will be sufficient to uphold the right of inspection, or whether the finding of any improper purpose will defeat the right of inspection, or whether the Court must make a finding of what the true or principal purpose really is. In *Citizens Association for Sound Energy v. Boltz*, [292] the court termed the defendant's burden as one of proving the "lack of a proper purpose." This language would seem to indicate that the existence of a proper purpose ("I want to know what my stock is worth") would permit inspection despite the existence of other highly improper motives. Some Delaware decisions seem to indicate that this may be the standard.[293]

While Texas courts have not squarely addressed this issue, the language of most of the cases seems to suggest that the court must determine whether the shareholder's "real" or primary purpose is improper:

> [W]hen the corporation pleads, and is able to establish by proof, a state of facts sufficient to convince the court that the stockholder is not seeking the information which might be revealed by the desired inspection for the protection of his interest as a stockholder, or that of the corporation, but that he is actuated by corrupt or unlawful motives, the court will not, by the issuance of its writ of mandamus, aid him to consummate such corrupt and unlawful purposes.[294]

"Obviously, substantial and difficult factual issues may arise as to a shareholder's true purpose. The issue may come down to predominant motive and intent."[295]

c. Burden of Proof

A shareholder enforcing his common law rights has the burden to plead and prove that he has a proper purpose. [296] Under the statutory rights, however, a shareholder need only prove that he has stated a proper purpose in his written demand.[297] "Section B contains no requirement that such a shareholder of record must prove a 'proper' purpose, merely that he must 'state' his purpose." [298] The corporation resisting inspection has the burden to prove the absence of a proper purpose.[299] The statute makes clear that absence of a

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[291] Presumably, the defendant would only be required to negate the plaintiff's stated purpose and not negate the universe of other possible proper purposes.

[292] 886 S.W.2d 283, 289 (Tex. App.—Amarillo 1994, writ denied).

[293] *See, e.g.*, CM&M Group, Inc. v. Carroll, 453 A.2d 788 (Del. 1982) (finding the desire to value ones shareholdings is a proper purpose, even though the shareholder might have a "secondary purpose" to get financial information that might be helpful to a third party); Skoglund v. Ormand Indus., Inc. 372 A.2d 204 (Del. Ch. 1976) (holding that, if a proper purpose is established, it is no defense that the shareholder had a secondary purpose which might be improper, such as gaining control of the corporation).

[294] Moore v. Rock Creek Oil Corp., 59 S.W.2d 815, 818 (Tex. Comm'n App. 1933, judgm't adopted).

[295] HAMILTON ET AL., *supra* note 175, § 34.6, at 35 (2004).

[296] *See* TEX. BUS. ORGS. CODE ANN. § 21.218(c) (2012); *Moore*, 59 S.W.2d 815 at 818; Tex. Infra-Red Radiant Co. v. Erwin, 397 S.W.2d 491, 493 (Tex. Civ. App.—Eastland 1965, writ ref'd n.r.e.).

[297] BUS. ORGS. § 21.218(b).

[298] Citizens Ass'n for Sound Energy v. Boltz, 886 S.W.2d at 291 (citing the TBCA). The current statute reads: "Subject to the governing documents and on written demand stating a proper purpose . . . ." BUS. ORGS. § 21.218(b).

[299] Burton v. Cravey, 759 S.W.2d 160, 162 (Tex. App.—Houston [1st Dist.] 1988, no writ).

proper purpose or bad faith on the part of the shareholder are affirmative defenses that must be pleaded and proved by the corporation.[300]

The situation is somewhat different with respect to directors. It seems that under the common law, the purpose of the inspection is either irrelevant.[301] However, the corporation must certainly be able to raise this issue in the affirmative defense of unclean hands. Under the statute, on the other hand, the director has the burden of proving that his purpose is "reasonably related" to his service as a director[302] and that the demand was made in good faith.[303]

This issue of a purpose being "reasonably related" to service as a director would seem to be a lower standard than a "proper" purpose, and conceivably a director's improper purpose might still be "reasonably related."

3. Defense of Improper Purpose

In every case, the ultimate factual issue will come down to the corporation's evidence that the shareholder's true purpose is improper. This is true even when the plaintiff has the burden of proving a proper purpose because it will always be relatively easy for the plaintiff to introduce proof of a proper purpose. The plaintiff shareholder can always testify, "I want to ascertain the value of my shares."[304] And the courts have made clear that the subjective testimony of the shareholder is sufficient.[305] Therefore, regardless of which party has the ultimate burden, the case will always turn on what proof the corporation is able to introduce evidencing that the plaintiff's true purpose is improper.

a. Improper Purposes Generally

Generally, a proper purpose is one that is reasonably related to the protection of stockholder's interest as a shareholder (including protection of the corporation's interests that affect the shareholder indirectly); conversely an improper purpose is one that seeks to injure to the corporation or the shareholders.[306] As one New York court summarized:

> Improper purposes are those which are inimical to the corporation, for example, to discover business secrets to aid a competitor of the corporation, to secure prospects for personal business, to find technical defects in corporate transactions to institute 'strike suits,' and to locate information to pursue one's own social or political goals.[307]

b. Bad Faith

The inspection statute explicitly states that proof of the failure of the plaintiff to make the request in good faith is a defense.[308] Several courts have noted the absence of good faith on the part of the plaintiff as one reason for denial of inspection rights.[309] However, the motives of a nonshareholder with a close relationship to the plaintiff-shareholder "should not prevent [plaintiff] from exercising its right as a shareholder to inspect the corporation's books and records."[310]

c. Fishing Expedition

A frequent claim is that the shareholder's purposes are entirely speculative, that he is on a "fishing expedition" to "dig up dirt." In *Citizens Association for Sound Energy v. Boltz,*[311] the Court rejected the argument that inspection should not be allowed for a speculative purpose. *Johnson Ranch*

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[300] BUS. ORGS. § 21.222(c)–(d).

[301] Chavco Inv. Co., Inc. v. Pybus, 613 S.W.2d 806, 810 (Tex. Civ. App.—Houston [14th Dist.] 1981, writ ref'd n.r.e.).

[302] Bus. Orgs. § 3.152.

[303] *Id.* § 3.152.

[304] *Chavco Inv. Co., Inc.*, 613 S.W.2d at 808 ("[A]scertaining the value of his shares [is a] clearly proper and legitimate [purpose for inspection].").

[305] Citizens Ass'n for Sound Energy v. Boltz, 886 S.W.2d at 291 ("[T]he subjective nature of parts of the [shareholders'] affidavits does not make them incompetent to establish a proper purpose.").

[306] *See* Guar. Old Line Life Co. v. McCallum, 97 S.W.2d 966, 967 (Tex. Civ. App.—Dallas 1936, no writ).

[307] Tatko v. Tatko Bros. Slate Co., Inc., 569 N.Y.S.2d 783, 917–18 (N.Y.A.D. 1991); *see also* Keenland Ass'n v. Pessin, 484 S.W.2d 849, 852 (Ky. App. 1972) (finding examples of improper purpose to include intent to destroy a corporation, to bring vexatious suits, or to take unfair advantage for competition reasons).

[308] BUS. ORGS. § 21.222.

[309] *See In re* Dyer Custom Installation, Inc., 133 S.W.3d 878, 881–82 (Tex. App.—Dallas 2004, orig. proceeding); *Guar. Old Line Life Co.*, 97 S.W.2d at 966.

[310] Biolustre' Inc. v. Hair Ventures, LLC, No. 04-10-00360-CV, 2011 WL 540574, at *3 (Tex. App.—San Antonio Feb. 16, 2011) (holding that the plaintiff-shareholder's boyfriend's contact with other shareholders would not prevent inspection of the corporation's records); *accord* Moore v. Rock Creek Oil Corp., 59 S.W.2d 815, 819 (Tex. Comm'n App. 1933, judgm't adopted).

[311] 886 S.W.2d 283, 289 (Tex. App.—Amarillo 1994, writ denied).

*Royalty Co. v. Hickey*,[312] held: "It is not necessary that the stock holder should first show that there is mismanagement where he wishes to make the examination in good faith for the purpose of seeing whether the affairs of the corporation are properly managed." However, the court in *Grayburg Oil Co. v. Jarratt*, noted the correctness of the following "abstract propositions of law":

> A stockholder under the guise of a statutory right should not be permitted to examine the books of a corporation for speculative purposes, or to gratify curiosity, or for the purpose of obtaining a list of stockholders with their addresses so that he might communicate with such stockholders making false and untrue charges against the officers of the company, or relative to the management of the affairs of the company, based upon rumors, without any investigation whatsoever on the part of such stockholder as to the truth and correctness of such rumors, thereby injuring the business and being detrimental to the interests of other stockholders, and the extraordinary remedy of mandamus should be denied. [313]

d. Information Is Not Needed

The corporation will frequently assert that the shareholder has no legitimate need for the information sought. Typically, the shareholder will have a different perspective, especially where the information sought will help shed light on the financial condition of the company and the competence of its management. In *Fownes v. Hubbard Broadcasting Inc.*, [314] the court held refusal could not be justified on the ground that the information was available form other sources or was not needed.

e. Obtaining Competitive Advantage

Courts have been extremely sensitive to risk that shareholders who own competing businesses will use their inspection rights to conduct industrial espionage. In *Uvalde Rock Asphalt Co. v. Loughridge*, [315] the Texas Supreme Court held that the corporation's allegation that the shareholder was a competitor of the corporation and sought by its inspection to obtain a competitive advantage in the area in which the shareholder and the corporation competed raised an issue as to whether the shareholder acted with an improper purpose.[316]

However, proof of this improper purpose requires more than merely establishing that the information sought is confidential or that the shareholder is affiliated with a competitor. There is no blanket trade secrets or confidentiality privilege to shareholder inspection. The Fort Worth court of appeals upheld a discovery order requiring production of customer and supplier lists and pricing and discount information to a plaintiff who was employed by the corporation's chief competitor on the grounds that the plaintiff was a shareholder and would be entitled to inspect those documents under the TBCA.[317] In *State ex rel. G.M. Gustafson Co. v. Crookston Trust Co.*, [318] the Minnesota Supreme Court held that the shareholders of a bank had the common law right of inspection of the banks records, notwithstanding the bank's objection that the shareholder would have access to information regarding depositors' business that the bank had an obligation to keep confidential. "Furthermore, the mere fact that a shareholder is a competitor, without more, does not defeat the shareholder's right of inspection."[319]

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[312] 31 S.W.2d 150, 153 (Tex. App.—Amarillo 1930, writ ref'd).

[313] 16 S.W.2d 319, 320 (Tex. Civ. App.—El Paso 1929, no writ).

[314] 225 N.W.2d 534 (Minn. 1975).

[315] 425 S.W.2d 818, 819–20 (Tex. 1968).

[316] *Accord In re* Dyer Custom Installation, Inc., 133 S.W.3d 878, 881 (Tex. App.—Dallas 2004, orig. proceeding).

[317] Prof'l Microfilming, Inc. v. Houston, 661 S.W.2d 767, 769–70 (Tex. App.—Fort Worth 1983, orig. proceeding) (citing Texas Business Organizations Code's predecessor, the Texas Business Corporations Act).

[318] 22 N.W.2d 911, 916–17 (Minn. 1946).

[319] *Id. See* BBC Acquis. Corp. v. Durr-Fillauer Med., Inc., 623 A.2d 85, 90 (Del. Ch. 1992); E.L. Bruce Co. v. State, 144 A.2d 533, 534 (Del. Sup. Ct. 1958). *See also* Kortum v. Webaso Sunroofs, Inc., 769 A.2d 113, 124 (Del. Ch. 2000) ("[S]tockholder's status as a competitor may limit the scope of, or require imposing conditions upon, inspection relief, but that status does not defeat the shareholder's legal entitlement to relief."); Nationwide Corp. v. Nw. Nat'l Life Ins. Co., 87 N.W.2d 671, 679 (Minn. 1958) ("The fact that the stockholder is interested as a stockholder or otherwise in rival corporations is not of itself enough to deny the right of inspection. . . . It ordinarily is not enough to deny the right that the information sought is of a confidential nature."); Uldrich v. Datasport, Inc. 349 N.W.2d 286, 288–89 (Minn. App. 1984) (ordering inspection of what corporation contended was "confidential business information" even though shareholders owned a competing business, although court also enjoined competitive use of information).

f. Destroy the Company

A corporation will not be required to assist a disaffected shareholder whose true purpose is to destroy the company. The Dallas court of appeals dealt with a dispute in which a shareholder, who had served as president, resigned in the course of a heated dispute with the other shareholders. The corporation later refused the former president's inspection demand, in part, on the grounds that his true intent was to destroy the company. The court held that testimony of specific instances of the plaintiff's improper cash payments to himself and others, of his failure to maintain financial records, of conduct detrimental to the company, and of threats to put the company out of business were sufficient to raise a fact issue as to plaintiff's proper purpose.[320]

g. Campaign of Harassment or Extortion

Those in control of corporations tend to view every request for information from shareholders as "harassment." However, the courts have recognized that inspection rights can be misused to harass, particularly when the shareholder's inspection demands are combined with an effort to force the purchase of his shares at a grossly inflated price. In *Uvalde Rock Asphalt Co. v. Loughridge*,[321] the Texas Supreme Court held that evidence that the shareholder's demand for inspection was a means to continue a program of studied harassment of the corporation in order to force the corporation to purchase the shareholder's stock at a grossly inflated price or to sell to the shareholder significant assets of the corporation at a grossly inadequate price raised a fact issue as to whether the shareholder acted with an improper purpose.[322]

In *Perry v. Perry Brothers, Inc.*,[323] the court held the following facts were sufficient to support the jury finding of an improper purpose: that plaintiff had previously filed, and then dismissed, a lawsuit to prevent the company from destroying records based on an employee's conversation which he overheard; that he had made repetitious and disruptive inspections—eleven separate requests over a period of nine months; that he formed a group of "concerned stockholders" that made additional requests during the same period; that he gave about seventy-five people one share of stock apiece, which cost the corporation additional money and labor transferring, preparing and mailing four quarterly dividend payments; that he sent out false and misleading information to many shareholders that indicated the company was overdrawn by one-and-one-half million dollars; and that he offered to sell his stock (8 to 8 1/2 % of the total outstanding stock) to the company for $30.00 per share as a way "to put an end to all these problems," even though he believed the book value of the stock was around $20.00 and had acquired much of it six months earlier for $7.70 per share.

h. Evidence of Animosity Is Not Sufficient

In *Citizens Association for Sound Energy v. Boltz*,[324] the court held that a demonstration of hostility between the officers of a nonprofit corporation and certain members requesting inspection of documents was not "indicative of an improper purpose." The Court relied on a Texas Commission of Appeals case, *Moore v. Rock Creek Oil Corp.*,[325] which upheld the inspection rights of a shareholder in a for-profit corporation, and rejected a corporation's argument that the animosity between the corporation and the stockholders seeking the right of inspection was a ground for denying an examination of the corporate books.[326] In *Johnson Ranch Royalty Co. v. Hickey*,[327] the court held it irrelevant to the right of inspection that there was a "great deal of evidence in the record which shows a want of harmony and in some cases open hostility and antagonism" among the parties and noted the fact that the controlling shareholder "bitterly opposes a thorough examination and inspection of the books would naturally tend to increase the suspicions which plaintiffs assert they already have."

i. Repeated Requests

While an excessive number of prior inspection requests was a factor in Perry, repeated requests are not necessarily evidence of improper motive. The statute does not limit or specify the number of times a shareholder may inspect corporate records. "In the absence of a showing that the right of inspection has been used by a member for harassment or to impede the management of the corporation, the right of inspection is not limited in number and certainly not to

[320] *In re* Dyer Custom Installation, Inc., 133 S.W.3d at 882–83.

[321] 425 S.W.2d 818, 819–20 (Tex. 1968).

[322] *Accord In re* Dyer Custom Installation, Inc., 133 S.W.3d at 882.

[323] 753 S.W.2d 773, 775 (Tex. App.—Dallas 1988, no writ).

[324] 886 S.W.2d 283, 289 (Tex. App.—Amarillo 1994, writ denied).

[325] 59 S.W.2d 815 (Tex. Comm'n App. 1933, judgm't adopted).

[326] *Id.* at 818.

[327] 31 S.W.2d 150, 154 (Tex. App.—Amarillo 1930, writ ref'd); *accord* Boehringer v. Konkel, 404 S.W.3d 18, 27 (Tex. App.—Houston [1st Dist.] 2013, no pet.) ("[T]he admitted ill-will between Boehringer and Konkel does not automatically establish ill-will in regard to Konkel's requests for EEF's records.").

only one inspection."[328] As one Texas appellate court noted:

> The right of inspection . . . is not limited to one occasion; it may be exercised at any reasonable time so long as the relation of the stockholder exists. The mere fact that appellant had, about twenty days prior to the demand here under consideration, made some sort of inspection of the books, and that opportunity to continue the same was at that time afforded and not used, does not of itself show that this demand was, as to time, unreasonable.[329]

j. Improper Communications With Shareholders

Corporations are frequently especially concerned about shareholders obtaining access to shareholder records for the purpose of communicating with other shareholders. However, communications regarding the corporation, particularly truthful communications critical of management, are far from improper:

> Nor is it any reason for denying such examination that plaintiffs in error hope to find something alarming in the affairs of the company, which they intend to communicate to other stockholders. If in truth and in fact no alarming condition exists, presumably it will not be found through any examination made by plaintiffs in error. If there is existent anything in the financial affairs of the company which would be reasonably calculated to alarm the stockholders in general, we see no reason why plaintiffs in error could not properly communicate such fact to other stockholders. The stockholders of a corporation are the beneficial owners of the corporate property, and are therefore vitally interested in knowing the true condition of its affairs. If a condition exists which is calculated to alarm the stockholders, they are legitimately entitled to know such fact, and there would be nothing improper should plaintiffs in error communicate the information thus obtained to other stockholders.[330]

But communications with shareholders for other purposes tend to be found to be improper purposes. In *State ex rel. Pilsbury v. Honeywell, Inc.*,[331] the Minnesota Supreme Court held the plaintiff's purpose in inspecting the share ledger to be improper where shareholder motivated by political, social interests rather than financial interests and was seeking to communicate with other shareholders to promote his political views that management should stop producing napalm used in Vietnam War. In *Retail Property Investors, Inc. v. Skeens*,[332] the court held that a request for shareholders list is not allowed for purpose of contacting other shareholders regarding possible lawsuit against corporation. In *Shabshelowitz v. Fall River Gas Co.*,[333] the Massachusetts Supreme Court held that a shareholder's request to inspect and copy the stock ledger for the purpose of contacting other shareholders and soliciting the purchase of their shares was improper. The same result was reached by the Supreme Court of Maine in *Chas. A. Day & Co. v. Booth*.[334] However, in *Madison Liquidity Investors 103 LLC v. Carey*,[335] a New York appellate court permitted inspection of stockholder list where avowed purpose was to solicit purchases and where there was no evidence of wrongful intent or that anything other than market would dictate price.

4. Other Defenses

a. Prior Misuse of Corporate Records

The inspection statute provides that a shareholder's right to inspection is subject to the defense that (1) the shareholder has, within the past two years, sold or offered for sale a list of shareholders or of holders of voting trust certificates in consideration for shares of the corporation or any other corporation, (2) has aided or abetted a person in procuring a list of shareholders or of holders of voting trust certificates for selling it, or (3) has improperly used information obtained through a prior examination of the books and account records, minutes, or share transfer records of the corporation or any other corporation.[336] It is important to note that the shareholder's current purposes are immaterial to this defense, and further that the plaintiff's prior misuse of records could be based on his conduct with regard to a different corporation.

[328] Citizens Ass'n for Sound Energy v. Boltz, 886 S.W.2d 283, 290 (Tex. App.—Amarillo 1994, writ denied).
[329] Smith v. Trumbull Farmers Gin Co., 89 S.W.2d 829, 830–31 (Tex. Civ. App.—Waco 1936, no writ).
[330] *Moore*, 59 S.W.2d at 818–19.
[331] 191 N.W.2d 406 (Minn. 1971).
[332] 471 S.E.2d 181, 183 (Va. 1996).
[333] 588 N.E.2d 630, 632–33 (Mass. 1992).
[334] 123 A. 557, 558–59 (Me. 1942).
[335] 739 N.Y.S.2d 18 (N.Y. App. 2002).
[336] TEX. BUS. ORGS. CODE ANN. § 21.222(b)(1)–(3) (2012).

b. Unclean hands

Independent of the inquiry into improper purpose, a corporation may assert that the plaintiff is not entitled to equitable relief because he has unclean hands. "A court acting in equity will refuse to grant relief to a plaintiff who has been guilty of unlawful or inequitable conduct with regard to the issue in dispute."[337]

i. Application

The clean hands doctrine requires that one who seeks equity, does equity.[338] Equitable relief is not warranted when the plaintiff has engaged in unconscionable, unjust, or inequitable conduct with regard to the issue in dispute.[339] The determination of whether a party has come to court with unclean hands is left to the discretion of the trial court.[340]

> In the exercise of this right, the stockholders must come into court with clean hands, and, if a state of facts exist sufficient to convince the court or jury that the stockholder is not seeking the information which might be revealed by the desired inspection, for the protection of his interest as a stockholder or that of the corporation, but that he is actuated by corrupt or unlawful motives, the court will not aid him by writ of mandamus in such purpose. A mandamus is always a remedy to right a wrong, not to promote one. The right of inspection granted to a stockholder of a corporation, by statute, is clearly for the benefit of a corporation and the stockholders, and, when the exercise of that right is for the purpose of injuring the corporation or stockholders generally, the right will be denied.[341]

ii. Must Be Related

However, the defense is not absolute.[342] The conduct on which unclean hands defense is based must involve the same transaction out of which the litigation arose, and the party asserting the doctrine must himself have been injured by the conduct.[343] The clean hands doctrine should not be applied unless the party asserting the doctrine has been seriously harmed and the wrong complained of cannot be corrected without the application of the doctrine.[344] Thus, prior misconduct by the shareholder when an employee or officer of the corporation cannot be the basis for denying his right to inspect corporate documents as a shareholder. In *Dunnagan v. Watson*,[345] the Court held that the unclean hands doctrine did not bar a partner who had been found liable for breach of his fiduciary duties from seeking judicial dissolution of the partnership. The Court held that the unconscionable, unjust, or inequitable conduct forming the basis of the defense must relate specifically to the cause of action asserted and that equitable relief is not limited by conduct that is derived from a cause of action independent from the plaintiff's specific claim and is merely collateral thereto.[346]

c. Balance of the Equities

In granting equitable relief, a court is required to balance the equities.[347] Some courts have held that, even if the shareholder is seeking inspection for a proper purpose, the court must still balance the inspection rights of the shareholders against the contrary interests of the corporation in nondisclosure, which interests might include a legitimate need to keep certain information confidential, concern that disclosure might lead to legal difficulties with federal agencies, the probability that disclosure would reveal trade or business secrets of the corporation or give the shareholder an unfair advantage in litigation or otherwise.[348]

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[337] Wynne v. Fischer, 809 S.W.2d 264, 267 (Tex. App.—Dallas 1991, writ denied).

[338] *In re* Francis, 186 S.W.3d 534, 551 (Tex. 2006).

[339] *Id.* Crown Const. Co., Inc. v. Huddleston, 961 S.W.2d 552, 559 (Tex. App.—San Antonio 1997, no pet.).

[340] *Francis*, 186 S.W.3d at 551.

[341] Guar. Old Line Life Co. v. McCallum, 97 S.W.2d 966, 967 (Tex. Civ. App.—Dallas 1936, no writ).

[342] Omohundro v. Matthews, 341 S.W.2d 401, 410 (Tex. 1960).

[343] *Id. See also* Sharma v. Vinmar Int'l, Ltd., 231 S.W.3d 405, 423 (Tex. App.—Houston [14th Dist.] 2007, no pet.).

[344] City of Fredericksburg v. Bopp, 126 S.W.3d 218, 221 (Tex. App.—San Antonio 2003, no pet.).

[345] 204 S.W.3d 30, 41 (Tex. App.—Fort Worth 2006, pet. denied).

[346] Id.

[347] *Cf.* Storey v. Cent. Hide & Rendering Co., 226 S.W.2d 615, 618–19 (Tex. 1950) (injunctive relief); Hot Rod Hill Motor Park v. Triolo, 276 S.W.3d 565 (Tex. App.—Waco Dec. 3, 2008, no pet.).

[348] *In re* LTV Sec. Litig., 89 F.R.D. 595, 610 (N.D. Tex. 1981) (citing Riser v. Genuine Parts Co., 258 S.E.2d 184 (Ga. App. 1979)); State v. Gulf Sulphur Corp., 231 A.2d 470, 473 (Del. 1967); Henshaw v. Am. Cement Corp., 252 A.2d 125 (Del. Ch. 1969); Weck v. District Court of the Second Judicial District, 408 P.2d 987 (Colo. 1966).

5. Waiver by Corporation

In the event that the corporation allows inspection or otherwise provides documents to the shareholder, then the corporation waives any defense it may have had as to those documents, and the issue of whether plaintiff had a proper purpose becomes moot.[349]

## J. Foreign Corporations

1. Choice of Law

Can a Texas resident who is a shareholder of a foreign corporation doing business in Texas sue that foreign corporation in Texas courts to enforce inspection rights? The Code provides that foreign corporations authorized to do business in Texas "enjoy[] the same, but no greater rights and privileges as [a] domestic [corporation]"; and, as to all matters affecting the transaction of intrastate business in this State, "a foreign [corporation] and each member, owner, or managerial official of the [corporation] is subject to the same duties, restrictions, penalties, and liabilities imposed on a domestic [corporation] . . . or on a member, owner, or managerial official of that domestic [corporation]"; provided, however, that only the laws of the jurisdiction of incorporation of a foreign corporation shall govern (1) the internal affairs of the foreign corporation, including but not limited to the rights, powers, and duties of its board of directors and shareholders and matters relating to its shares, and (2) the liability, if any, of shareholders of the foreign corporation for the debts, liabilities, and obligations of the foreign corporation for which they are not otherwise liable by statute or agreement.[350] It would seem that any Texas court having jurisdiction over a foreign corporation would have the authority to order a shareholder or director inspection under the laws of the state of incorporation.[351] However, a foreign corporation with its principal place of business and its corporate records in Texas, being sued in Texas for refusal to allow inspection, might very well be subject to the Texas inspection laws.

In *Williams v. Freeport Sulphur Co.*,[352] the court enforced the rights of shareholders of a Delaware corporation, headquartered in New York, to inspect the corporate records of the Delaware corporation's Texas subsidiary. The court held that the denial by the Delaware parent corporation of the right of "right of its stockholders to an inspection of its books and records is a violation of its duty to plaintiffs enjoined both by the common law and the statutes of this state."[353] The court further held that the plaintiffs were entitled to bring the suit in Texas, as opposed to New York or Delaware.[354] Significantly, the court imposed the inspection rights under the Texas statute. This statute clearly provided inspection rights to the Delaware parent corporation with respect to its Texas subsidiary; however, the application to Delaware shareholders of the Delaware parent is not so clear. The case was not brought as a derivative suit to enforce the rights of parent over the subsidiary; rather it was brought to prevent the Delaware parent corporation from withholding documents in its wholly owned subsidiary from its Delaware shareholders; yet the court applied the Texas statute.

While the Texas decision did not expressly consider the point, numerous courts have held that domestic inspection rights apply to foreign corporations, at least where the documents are located in the state. In *Valtz v. Penta Investment Corporation*[355] the court held that a Delaware corporation, with its principal place of business in California, was subject to the shareholder-inspection rights under California, rather than Delaware law. The court held that shareholder-inspection rights does not "address an internal affair; the inspection of shareholder lists is a right incidental to the ownership of stock, affects the relationship between the corporation and shareholder, and is thus subject to regulation by statute where the corporation does business."[356] *McCormick v. Statler Hotels Delaware Corp.*,[357] upholds that the enforcement of inspection rights of a shareholder in a Delaware corporation pursuant to the terms of the Illinois corporations statute, holds that where the foreign corporation's records are in the state, enforcement of inspection rights does not interfere with the internal affairs of the corporation.

In *Hollander v. Rosen*,[358] the Florida Court of Appeals held that a Georgia corporation was subject to an order under the Florida statute to permit inspection of its books and records by a shareholder, including the statutory penalty for failure to comply. The court based its analysis on the fact that corporations authorized to

[349] *See In re* Dyer Custom Installation, Inc., 133 S.W.3d 878, 882 (Tex. App.—Dallas 2004, orig. proceeding).

[350] *See* TEX. BUS. ORGS. CODE ANN. §§1.102–05, 9.202–03 (West 2012).

[351] *See* Fleisher Dev. Corp. v. Home Owners Warranty Corp., 670 F. Supp. 27, 33 (D.D.C. 1987) (ordering a Delaware corporation to permit inspection pursuant to section 220 of the Delaware General Corporations Law, notwithstanding the fact that the Delaware law provides exclusive jurisdiction to the Delaware chancery court to enforce the statute).

[352] 50 S.W.2d 817 (Tex. Civ. App.—Galveston 1930, no writ).

[353] *Id.* at 825.

[354] Id.

[355] 188 Cal. Rptr. 922, 925 (Cal. App. 1983).

[356] *Id.* at 924.

[357] 203 N.E.2d 697,703 (Ill. App. 1964).

[358] 555 So.2d 384, 385 (Fla. App. 1989).

do business in Florida were subject to the same "rights and privileges . . . duties, restrictions, penalties and liabilities" as domestic corporations.[359] The court went on to hold that the defendant corporation was subject to the same shareholder rights, notwithstanding the fact that it had not applied to do business in Florida, because it was doing business in Florida and was thus required to apply for authority.[360] In *Havlicek v. Coast-to-Coast Analytical Services*, Inc.,[361] the court held that directors of a Delaware corporation headquartered in California were subject to the California law requiring that directors be permitted inspection of corporate records. Interestingly, the court of appeals held that the relocation of the corporation and its documents to outside the state during the pendency of the appeal did not render the order to permit inspection moot.[362] In *Jefferson Industrial Bank v. First Golden Bancorporation*,[363] the court held that Colorado shareholder-inspection rights applied equally to domestic and foreign corporations.[364] However, in *Beckworth v. Bizier*, a federal district court in North Carolina applied the Connecticut inspection statute to a minority-shareholder plaintiff's suit for inspection.[365] The court found that shareholder-inspection rights was a matter "peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders . . . ."[366] The court dismissed the plaintiff's claim for inspection because the plaintiffs failed to comply with the pleading requirements contained in the Connecticut inspection statute.[367]

2. Jurisdiction

A related issue is whether the Texas court has jurisdiction to order a foreign corporation to permit inspection. This is particularly an issue with Delaware corporations because title 8, section 220 of the Delaware Code: "Delaware vests jurisdiction to determine a dispute over a Delaware demand for inspection in its Court of Chancery."[368] One unreported Texas opinion has held that the jurisdictional language of the Delaware statute does not divest Texas courts of jurisdiction because Texas, as the forum state, applies its own procedural rules and asserts jurisdiction over all matters necessary for disposition of this suit.[369]

Other jurisdictions remain split on this murky issue, with courts applying several different tools to reach varying conclusions. The Southern District of New York simply took the Delaware inspection statute[370] at face value and clearly held that section 220 denies it subject-matter jurisdiction over a shareholder's suit to inspect the books and records of a Delaware Corporation.[371] The Northern District of Oklahoma reached the same decision, citing the Restatement (Second) of Conflicts of Laws to rule that the "law of the state of incorporation shall be applied to determine issues involving the rights and liabilities of a corporation."[372] Likewise, a Virginia court applied the doctrine of comity and reasoned that:

> [C]omity suggests that limitations one state's legislature places on its own laws be universally acknowledged. This court has no jurisdiction to hear a claim under a Delaware statute when the Delaware legislature has

[359] *Id.* (citing Fla. St § 607.307).
[360] *Id.* at 386.
[361] 46 Cal.Rptr.2d 696, 701 (Cal. App. 1995).
[362] *Id.* at 700.
[363] 762 P. 2d 768, 769 (Colo. App. 1988).
[364] *See also* Genetti v. Victory Markets, Inc. 462 F. Supp. 124, 126 (M.D. Pa. 1973) (holding that it is well settled that an action to compel the inspection of a foreign corporations books and records does not offend the internal affairs doctrine, at least where such books are within the jurisdiction of the court.); Stoopack v. George A. Fuller Co., 190 N.Y.S.2d 596, 598 (N.Y. Sup. 1959) (New Jersey corporation licensed to do business in New York and maintaining documents in New York was subject to New York law entitling shareholder to inspect records); Toklan Royalty Corp. v. Tiffany, 141 P.2d 571, 574 (Okla. 1943) (holding that a foreign corporation, having its principal place of business in state under its charter, is subject to provisions of state statutes requiring corporations to keep records open to inspection of their stockholders).
[365] Beckworth v. Bizier, No. 3:12–CV–512–MOC–DSC, slip op. at *4–6 (W.D.N.C. Dec. 19, 2012).
[366] *Id.* at *4 (citing Bluebird Corp. v. Aubin, 657 S.E.2d 55, 63 (N.C. 2008)).
[367] *Id.* at *6.
[368] DEL. CODE ANN. tit. 8 § 220 (2010).
[369] *In re* Halter, No. 05-98-01164-CV, 1999 WL 667288 (Tex. App.—Dallas 1999, orig. proceeding); *see also* Randall Arabian Am. Oil Co., 778 F.2d 1146, 1152–53 (5th Cir. 1985); Gannon v. Payne, 706 S.W.2d 304, 306 (Tex. 1986).
[370] tit. 8, § 220.
[371] Reserve Solutions, Inc. v. Vernaglia, 438 F. Supp.2d 280, 288–89 (S.D.N.Y. 2006) (cited with approval by Transeo S.A.R.L. v. Bessemer Venture Partners VI L.P., No. 11–CV–5331, 2013 WL 1285453, at *17 (S.D.N.Y. Mar. 29, 2013)).
[372] Yale S. Corp. v. Eclipse Servs., Inc., No. 10–CV–0337–CVE–FHM, 2010 WL 2854687, at *2–4 (N.D. Okla. July 19, 2010) The court provided one caveat to its decision, applying Delaware law "unless it is shown that some other state has a more significant relationship to the occurrence and the parties." *Id.* at *2.

> conferred jurisdiction exclusively on its own courts and neither the Constitution of Virginia nor the General Assembly grants authority to supercede [sic] such restriction.[373]

Conversely, in *Sachs v. Adeli* a New York state court insisted that simply because Delaware law "vests exclusive jurisdiction over this dispute in the Delaware Court of Chancery. That . . . does not mandate that [a] case be tried in Delaware."[374] The *Sachs* rejected the notion that comity was a rule of law, and found that it did not prevent New York courts from exercising jurisdiction over the matter because comity is a rule used primarily for "convenience and expediency."[375] Perhaps the most instructive case on the issue is *Anderson v. Children's Corner, Inc.*[376] In *Anderson*, a Connecticut Superior Court examined the statutory history of section 220 and determined that prior to the statute's enactment the power to order an inspection was split between two courts.[377] The court opined that the Chancery Court was granted exclusive jurisdiction "so matters could be resolved expeditiously by one trial-level court."[378] The court then concluded that section 220 was not meant to divest Connecticut of jurisdiction over an inspection suit involving a Delaware corporation, "Rather the [Delaware] legislature was seeking to address the relationship between the state's two trial-level courts."[379]

## V. SHAREHOLDER OPPRESSION CAUSE OF ACTION IN TEXAS

### A. The Phenomenon of Shareholder Oppression

#### 1. Vulnerability of Minority Shareholders in Closely Held Corporations

In publicly held corporations shareholders may buy and sell stock with essentially no involvement in the business and management of the corporation. Shareholders participate in the financial success of the business both by receipt of dividends and any increased market value of their shares, while taking absolutely no risk from their ownership of the business other than the loss of the price initially paid for their shares. In public corporations, with a broad and diverse shareholder base, the principles of centralized control and majority rule rarely present a significant opportunity for abuse of individual minority shareholders. Furthermore, shareholders of public companies are also protected by a web of regulations imposed by state and federal law and by the stock exchanges on which the shares are traded. However, the vast majority of corporations in this country are not publicly held, most are so-called "close" or closely held corporations. Close corporations are largely unregulated, and the dynamics of management–owner interaction is much different.

Closely held corporations are typically characterized by a small number of shareholders, the absence of a market for the corporation's stock, and substantial shareholder participation in the running and management of the corporation.[380] Sections 21.701–.732 of the Texas Business Organizations Code provides special provisions and duties for "close corporations";[381] however, these statutory provisions apply only to corporations that elect to be statutory close corporations,[382] and very few do so. Therefore, the law applicable to almost all Texas corporations makes no distinction between publicly held and closely held corporations, even though the risks and benefits of stock ownership are vastly different as between those two types of organizations.

Because the corporation is ultimately subject to the control of the owner(s) of a majority of its shares, any person or family or group of individuals who owns or controls the majority of the shares, as a practical matter, exercise total power over the corporation because these majority shareholders almost always vote themselves and persons strongly aligned with them to all or most of the positions on the board of directors.[383] In closely held corporations, where number of shares and shareholders is small, the existence of a single person or a small, strongly aligned group of persons, owning or controlling a majority of the shares is the norm. Minority shareholders in these

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[373] Foti v. W. Sizzlin Corp., No. CH03-862, 2004 WL 2848398, at *1 (Va. Cir. Feb. 6, 2004).

[374] Sachs v. Adeli, 804 N.Y.S.2d 731, 733 (N.Y. App. Div. 2005) (interpreting the Delaware LLC statute that vested jurisdiction to the Chancery Court in cases involving requests for information); *see also* Todtman, Young, Tunick, Nachamie, Hendler, Spizz & Drogin, P.C. v. Richardson, 660 N.Y.S.2d 410, 412 (1997) ("A statute or rule of another state granting the courts of that state exclusive jurisdiction over certain controversies does not divest the New York courts of jurisdiction over such controversies.").

[375] *Sachs*, 804 N.Y.S.2d at 733.

[376] Anderson v. Children's Corner, Inc., No. CV106011812S, 2011 WL 925442 (Conn. Super. Ct. Feb. 15, 2011).

[377] *Id.* at *2.

[378] *Id.* at *3.

[379] Id.

[380] Douglas Moll, *Majority Rule Isn't What It Used to Be: Shareholder Oppression in Texas Close Corporations*, 63 TEX. B. J. 434, 436 (2000); *see also* Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 511 (Mass. 1975).

[381] TEX. BUS. ORGS. CODE ANN. §§ 21.701–.732 (West 2011).

[382] BUS. ORGS. §§ 21.702(a), .705.

[383] *See* Moll, *supra* note 380, at 436.

corporations are not able to elect officers or directors to protect their interests and are not able to prevail on any matter submitted to a vote of the shareholders, and thus as a practical matter have no power at all over the corporation.

At the most fundamental level, the presence or absence of a ready market for the stock of a corporation makes a huge difference in the vulnerability of the minority shareholders to predatory behavior by the majority. Shareholders of public corporations look primarily to their ability to buy, sell and trade shares to gain a return on their investment. Shareholders of public corporations who are unhappy with the management of the business or who become at odds with the officers or directors or other shareholders in any way are always free to sell their shares and cut their losses. None of this is true for shareholders in closely held corporations. The shareholders of these corporations are typically linked by personal or family relationships. [384] These shareholders usually expect employment and a role in managing the business, and look primarily to salaries and other distributions of corporate income for a return on their investment. Because of the close involvement and personal relationships among the small groups of shareholders of closely held corporations, the opportunities and likelihood are greatly increased for interpersonal conflict to arise among the shareholders or between management and particular shareholders. Likewise, because of the absence of a ready market in which to sell the shares, these shareholders are "locked-in" and are vulnerable to a variety of types of misconduct designed to "squeeze" them out (that is, to force them to sell at an unfairly low price) or to "freeze" them out (that is, to render their share ownership meaningless).[385] Texas courts have come to recognize that they must "take an especially broad view of the application of oppressive conduct to a closely held corporation, where oppression may more easily be found," and the minority shareholders who find themselves on the receiving end of a "squeeze out" do not have a ready market for the corporation's shares, but are at the mercy of the majority."[386]

2. Oppressive Conduct by Controlling Shareholders

"Oppressive conduct" is conduct that destroys or substantially impairs or diminishes the value of a minority shareholder's ownership interest in the corporation by reducing or eliminating any economic benefit of ownership, systematically violating the rights and duties associated with share ownership, and otherwise defeating the reasonable expectations of the shareholders as to ownership of the shares. This type of conduct can take many forms and appear in many different factual situations. When times are good and the corporation is growing, the majority may act to appropriate a greater portion of the economic benefits to themselves at the expense of the minority. When times are bad, the majority may act to preserve for themselves a greater piece of the shrinking pie at the expense of the minority. At any time, the majority may wish to get rid of minority ownership positions. The actions of the majority may be motivated by greed or by a perception (valid or not) that the minority owner is not contributing. More often, the motivation for oppressive conduct is personal conflict among the majority and minority shareholders.

Oppressive conduct is typically committed with the purpose of "squeezing out" a minority shareholder, forcing that shareholder to leave the corporation and sell his shares usually at an unfairly low price, or "freezing out" the minority shareholder by structuring corporate governance and distribution of economic benefits so as to render the minority shareholder's ownership essentially irrelevant. In a freeze-out situation or a squeeze-out attempt, the majority typically cuts off the minority shareholders from information about the corporation and from any participation in management. The majority will always manipulate the finances of the corporation so that profits are not distributed as dividends but are diverted to the majority through excessive salaries, bonuses, or other personal benefits. When all of the shareholders work in the corporation and all corporate profits are paid out as salary, generally, the majority will suddenly terminate the minority shareholder's employment (and thus all economic participation in the corporation). The majority may also take steps to further dilute the minority's stock position, and may attempt to extinguish the minority's position through a reverse stock split or cash out merger.

## B. Shareholder Oppression Cause of Action

1. Dissolution

The concept in Texas law of oppressive conduct of majority shareholders comes from the statutes providing for the appointment of a receiver for rehabilitation or dissolution of corporations. Section 11.404(a)(1)(C) of the Texas Business Organizations Code permits a district court to appoint a receiver in an action brought by a receiver upon a showing that "the actions of the governing persons of the entity are illegal, oppressive or fraudulent." [387] Very little case law exists interpreting this statute. However, courts have held that it is an extreme remedy, only to be utilized when there is no other way to protect the rights of the minority shareholders

[384] *Id.* at 436.
[385] *See id.* at 436.
[386] Davis v. Sheerin, 754 S.W.2d 375, 381 (Tex. App.—Houston [1st Dist.] 1988, writ denied).
[387] BUS. ORGS. § 11.404(a)(1)(C).

> "Our conclusion, after considering many of the authorities referred to, is that a court of equity may properly take jurisdiction to wind up the affairs of a corporation and sell and distribute its assets at the suit of a minority stockholder on the ground of dissensions among the stockholders, but that it is only an extremely aggravated condition of affairs that will warrant such drastic action, and that the court will follow such a procedure only when it reasonably appears that the dissensions are of such nature as to imperil the business of the corporation to a serious extent and that there is no reasonable likelihood of protecting the rights of the minority stockholder by some method short of winding up the affairs of the corporation."[388]

2. Advent of a New Legal Theory

In the 1980s, Texas courts began drawing on this prior line of authority, together with case law and statutory developments in other states, to fashion a new cause of action for "shareholder oppression." The shareholder oppression cause of action is unusual among traditional causes of action in the corporate context in a number of ways: First, the claim is based upon legal duties of loyalty that are found to exist among shareholders of a corporation. Much of the prior case law cast doubt on the existence of such duties. Second, unlike the traditional view of misconduct among corporate insiders, this cause of action belongs to the individual shareholder and does not need to be asserted through a derivative action. Individual shareholders may now seek a remedy for types of wrongdoing that were once shielded from a shareholder suit by problems of standing and other procedural hurdles. Third, the standard of conduct is not well-defined, is largely subjective, and may even involve a pattern of oppressive conduct made up of individual acts that are otherwise either not actionable or cause no real harm in and of themselves. Fourth, the usual remedy for oppression, a forced buy-out, allows the minority shareholder to receive a monetary award, not based on the amount of the plaintiff's loss, but based on the "fair value" of the plaintiff's stock. Thus, a plaintiff who has suffered no actual monetary damages may still be entitled to a substantial monetary award. Moreover, the judicially determined "fair value" may have little relationship to an actual cash market value of the minority interest. Absent this judicial remedy, the minority shareholder typically could not sell the stock perhaps at any price, but certainly not for a price approaching the "fair value" available from the court. Finally, the shareholder oppression cause of action introduces apparent exceptions to or at least modifications of other well-established legal principles, including the doctrine of centralized control of corporations, majority rule, the business judgment rule, and at-will employment.[389]

The Texas Supreme Court has never issued an opinion recognizing the cause of action, but ten of the fourteen Texas courts of appeals recognize shareholder oppression as an independent cause of action, and none have held to the contrary.[390] In *Willis v. Donnelly*,[391]

[388] Hammond v. Hammond, 216 S.W.2d 630, 633 (Tex. Civ. App.—Fort Worth 1949, no writ).

[389] *See generally* Moll, *supra* note 380, at 438.

[390] First Court of Appeals, Houston: Boehringer v. Konkel, 404 S.W.3d 18 (Tex. App.—Houston [1st Dist.] 2013, no pet.); Allen v. Devon Energy Holdings, L.L.C., 367 S.W.3d 355, (Tex. App.—Houston [1st Dist.] 2012, pet. granted, judgm't vacated w.r.m.); Joseph v. Koshy, No. 01-98-01432-CV, 2000 WL 124685, at *4 (Tex. App.—Houston [1st Dist.] Feb. 3, 2000, no pet.); Willis v. Bydalek, 997 S.W.2d 798, 801 (Tex. App.—Houston [1st Dist.] 1999, pet. denied); Advance Marine, Inc. v. Kelley, No. 01-90-00645-CV, 1991 WL 114463, at *2 (Tex. App.—Houston [1st Dist.] June 27, 1991, no pet.); Davis v. Sheerin, 754 S.W.2d 375, 383 (Tex. App.—Houston 1988, writ denied). Second Court of Appeals, Fort Worth: Duncan v. Lichtenberger, 671 S.W.2d 948 (Tex. App.—Fort Worth 1984, writ ref'd n.r.e.); Cotten v. Weatherford Bancshares, Inc., 187 S.W.3d 687, 697 (Tex. App.—Fort Worth 2006, pet. denied). Fourth Court of Appeals, San Antonio*:* Chapa v. Chapa, No. 04-12-00519-CV, 2012 WL 6728242, at *5 (Tex. App.—San Antonio Dec. 28, 2012, no pet.)(holding that appointment of a receiver was proper in a shareholder oppression case); Guerra v. Guerra, No. 04-10-00271-CV, 2011 WL 3715051, at *6 (Tex. App.—San Antonio Aug. 24, 2011, no pet.). Fifth Court of Appeals, Dallas: Argo v. Data Res. Corp. v. Shagrithaya, 380 S.W.3d 249 (Tex. App.—Dallas 2012, pet filed); Cardiac Perfusion Srvcs., Inc. v. Hughes, 380 S.W.3d 198 (Tex. App.—Dallas 2012, pet. filed); Ritchie v. Rupe 339 S.W.3d 275, 285 (Tex. App.—Dallas 2011, pet. granted). Sixth Court of Appeals, Texarkana: Pinnacle Data Srvcs., Inc. v. Gillen, 104 S.W.3d 188, 192 (Tex. App.—Texarkana 2003, no pet.). Seventh Court of Appeals, Amarillo: *In re* Trockman, No. 07-11-0364-CV, 2011 WL 554999 (Tex. App.—Amarillo Feb. 21, 2012, orig. proceeding). Eighth Court of Appeals, El Paso: Gonzalez v. Greyhound Lines, Inc., 181 S.W.3d 386, 392 n.5 (Tex. App.—El Paso 2005, no pet.). Twelfth Court of Appeals, Tyler: Redmon v. Griffith, 202 S.W.3d 225 (Tex. App.—Tyler 2006, pet. denied). Thirteenth Court of Appeals, Corpus Christi-Edinburg: Gibney v. Culver, No. 13-06-112-CV, 2008 WL 1822767 (Tex. App.—Corpus

the Texas Supreme Court assumed "without deciding" that such a cause of action exists.

The first three oppression cases deserve special scrutiny:

a. *Duncan v. Lichtenberger*

The first case among the recent series of shareholder oppression cases was *Duncan v. Lichtenberger*.[392] This case is something of a mystery in its reasoning. It can only be understood as shareholder oppression case, but the court uses different (and probably incorrect) terminology. The court affirms a trial court judgment in favor of the two minority shareholders of a corporation (20% each) against the majority shareholder (60%) for breach fiduciary duties owed directly to them.[393] In affirming the holding that the majority shareholder owed a fiduciary duty to the minority shareholders, the court cited *Canion v. Texas Cycle Supply, Inc.* for the proposition that corporate directors owe fiduciary duties to the corporation and its shareholders.[394] The court clearly misapplied that authority to hold that there is a fiduciary running from a majority shareholder to the minority shareholders individually.[395] However, the court also relied on *Patton v. Nicholas*,[396] which clearly recognizes individual duties from majority shareholders to minority shareholders.[397]

The facts cited by the court as sufficient evidence to support the judgment demonstrate a classic pattern of shareholder oppression: The majority shareholder had offered to buy the minority shares for $2500 just before instituting a campaign of oppression, even though the minority shareholders had each contributed $10,000 for their shares. The majority shareholder summarily fired both the minority shareholders and locked them out of the premises; after the lock-out, the majority shareholder never notified the minority shareholders of any further shareholders' or directors' meetings and excluded them from any participation in management. The majority shareholder received significant "management fees" while the minority shareholders received no compensation and no dividends. The majority shareholder also elected to not to distribute $62,000 in taxable profits, for which the minority shareholders had a tax liability due to the corporation's subchapter S status, and finally, the majority shareholder had spoken with admiration of another Fort Worth businessman who had successfully squeezed out a minority shareholder.[398] The relief granted was a money judgment for the amount of consideration the two shareholders originally paid for their shares. The court affirmed this remedy, but stated clearly that it was an equitable remedy and not a measure of damages.[399]

b. *Davis v. Sheerin*

The Houston case of *Davis v. Sheerin*[400] was the first Texas case truly to define the shareholder oppression cause of action in Texas and remains the leading case in Texas jurisprudence. In that case, the Texas corporation, W.H. Davis Co., was formed in 1955 and was owned by two shareholders, William Davis, 55%, and James Sheerin, 45%. Both Davis and Sheerin were directors and officers; however, Davis was the president and managed the day-to-day running of the company, while Sheerin was involved as an investor only and did not work in the company. Davis' wife, Catherine, also employed by the corporation, was apparently also a director. In 1985, Sheerin sued both William and Catherine Davis claiming shareholder oppression. Sheerin sued only in his individual capacity, and the corporation does not appear to have been made a party. The suit was filed initially because Davis refused to allow Sheerin to inspect the books and records of the corporation, claiming that Sheerin was not a shareholder.[401] The lawsuit also involved claims arising from a separate real estate partnership, but those claims are not relevant to this discussion.

Davis claimed that Sheerin had relinquished his stockholdings in the 1960s as a gift. The jury found that Sheerin did not make a gift of his stock to the

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Christi-Edinburg 2008, no pet.); DeBord v. Circle Y of Yoakum, Inc., 951 S.W.2d 127, 133 (Tex. App.—Corpus Christi 1997), *rev'd on other grounds*, Stary v. DeBord, 967 S.W.2d 352 (Tex. 1998). Fourteenth Court of Appeals, Houston: Willis v. Donnelly, 118 S.W.3d 10, 34 (Tex. App.—Houston [14th Dist.] 2003), *rev'd on other grounds*, 199 S.W.3d 262 (Tex. 2006); Allchin v. Chemic, Inc., No. 14-01-00433-CV, 2002 WL 1608616, at *7 (Tex. App.—Houston [14th Dist.] July 18, 2002, no pet.); Christians v. Stafford, No. 14-99-00038-CV, 2000 WL 1591000, at *2 (Tex. App.—Houston [14th Dist.] Oct. 26, 2000, no pet.); Hoggett v. Brown, 971 S.W.2d 472, 488, n.13 (Tex. App.—Houston [14th Dist.] 1997, pet. denied); Alexander v. Sturkie, 909 S.W.2d 166, 170 n.2 (Tex. App.—Houston [14th Dist.] 1995, writ denied).

[391] 199 S.W.3d 262, 277 (Tex. 2006).

[392] 671 S.W.2d 948 (Tex. App.—Fort Worth 1984, writ ref'd n.r.e.).

[393] *Id.* at 954.

[394] 537 S.W.2d 510, 513 (Tex. Civ. App.—Austin 1976, writ ref'd n.r.e.).

[395] *See* 671 S.W.2d at 952.

[396] 279 S.W.2d 848 (Tex. 1955).

[397] *See* 671 S.W.2d at 953.

[398] *Id.* at 950–51.

[399] *See id*. at 953.

[400] 754 S.W.2d 375, 377–78 (Tex. App.—Houston [1st Dist.] 1988, writ denied).

[401] *Id.* at 377.

Davis and his wife, did not represent that he would do so, and did not agree to do so in the future.[402] Additionally, the appellate court noted other undisputed evidence that the records of the corporation and tax returns continued to list Sheerin as a 45% shareholder and that Davis and his son had made several attempts to purchase Sheerin's shares during the 1970s and '80s.[403] The jury also found (1) that Davis and his wife had conspired to deprive Sheerin of his stock ownership in the corporation; (2) that Davis and his wife willfully breached fiduciary duties by receiving "informal dividends" through contributions to a profit sharing plan for their benefit and to the exclusion of Sheerin; and (3) that Davis and his wife willfully breached fiduciary duties by wasting corporate funds for payment of their legal fees in the dispute; however the jury also found (4) that Davis and his wife did not convert Sheerin's stock; (5) that Davis and his wife were not paid excessive compensation; (6) that Davis and his wife did not maliciously suppress dividends; (7) that Davis and his wife did not breach fiduciary duties by having the corporation make a variety of purchases and investments that Sheerin argued were improper; and (8) that Davis and his wife did not conspire to breach fiduciary duties.[404] The jury also found that the conspiracy to deprive Sheerin of his share ownership was not a proximate cause of any damages.[405] Furthermore, the appellate court noted as significant the undisputed facts that the corporation's attorney had written in 1979 that Davis' wish to avoid payment of dividends might be characterized as a fraudulent effort to deny a shareholder his dividends and that, shortly after the filing of the lawsuit, Davis and his wife held a meeting of the board of directors at which they noted in the minutes that "Mr. Sheerin's opinions or actions would have no effect on the Board's deliberations."[406] On the basis of these findings and the undisputed portion of the evidence, the Houston trial court entered a judgment that included the following relief:

(1) a declaratory judgment that Sheerin owned 45% of the stock in the corporation;
(2) an order that Davis and his wife "buy out" Sheerin's stock for the "fair value" of $550,000 determined by the jury;
(3) the appointment of a receiver for the corporation;
(4) an injunction against contributions to the profit sharing plan unless a proportionate sum was paid to Sheerin;
(5) a mandatory injunction for payment of dividends in the future;
(6) award of damages to Sheerin individually for the informal dividends paid in the past by profit sharing contributions;
(7) an award of damages to Sheerin for 45% of the amount the corporation paid for Davis' attorneys fees,[407] and
(8) an award of costs incurred by Sheerin in enforcing his inspection rights.[408]

The principal issue on appeal was whether the buy-out remedy was available under Texas law. The plaintiff contended that the defendants should be ordered to purchase the plaintiff's shares because the defendants had committed "oppression" of the plaintiff. At the time, Article 7.05(a)(1)(c) of the Texas Business Corporation Act (now Tex. Bus. Org. Code § 11.404(a)(1)(C)) provided that a court may appoint a receiver for the assets and business of a corporation to conserve the assets and avoid damage to the parties (also to conduct an orderly liquidation under article 7.06), "but only if all other requirements of law are complied with and if all other remedies available either at law or in equity . . . are determined by the court to be inadequate and only in [certain specific] instances," one of which is an action by a shareholder establishing "that the acts of the directors or those in control of the corporation are illegal, oppressive, or fraudulent."

The First Court of Appeals noted that "oppressive" conduct is prohibited by article 7.05(a)(1)(c) of the Texas Business Corporations Act, but that the only statutory remedy was the appointment of a receiver.[409] The court also noted that no Texas case had ever ordered the remedy of a "buy-out," but

[402] *Id.* at 382.
[403] Id.
[404] Id.
[405] *Id.* at 381.
[406] *Id.* at 382.

[407] The award of attorneys' fees is somewhat unclear. The court of appeals opinion states that Sheerin received "an award of $192,600 to appellee, on behalf of the corporation, for recovery of corporate funds used for appellants' attorney's fees." *Id.* at 378. The court does not explain what is meant by an award to Sheerin on behalf of the corporation, particularly since the court makes clear that the lawsuit was brought by Sheerin individually, and not as a derivative action, and since the corporation does not appear to have been a party. *See id.* at 377. The characterization of the judgment clearly reflects the awareness of the trial court (although not an issue on appeal) that the claim for using corporate funds to pay Davis' attorneys fees can only belong to the corporation. Therefore, given the procedural posture of the case, the court seems to have awarded Sheerin directly his share of the misappropriated corporate funds.
[408] *Id.* at 378.
[409] *Id.* at 378.

the court reasoned, based on decisions in other jurisdictions and on the holding of the Texas Supreme Court in *Patton v. Nicholas*[410] that the court had the inherent equitable power to fashion a remedy for oppressive conduct, other than receivership or liquidation.[411] Therefore, court held that "Texas courts, under their general equity power, may decree a 'buy-out' in an appropriate case where less harsh remedies are inadequate to protect the rights of the parties."[412]

Next the court discussed what conduct constituted oppressive conduct. The court noted that neither Texas statutory nor common law provided a definition of "oppression." [413] Therefore, the court examined authority from other jurisdictions and highlighted two different, but complimentary definitions: First, "oppression should be deemed to arise only when the majority's conduct substantially defeats the expectations that objectively viewed were both reasonable under the circumstances and were central to the minority shareholder's decision to join the venture," [414] and second, "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."[415]

The court held that the record clearly substantiated a finding of oppression, notwithstanding "the absence of some of the typical 'squeeze out' techniques used in closely held corporations, *e.g.*, no malicious suppression of dividends or excessive salaries."[416] The Davis court stated that "conspiring to deprive one of his ownership of stock in a corporation, especially when the corporate records clearly indicate such ownership . . . not only would substantially defeat any reasonable expectations appellee may have had, . . . but would totally extinguish any such expectations."[417] The court held this finding of great significance, notwithstanding the fact that the object of the conspiracy was unsuccessful and that the jury found no damages.

c. *Willis v. Bydalek*

The next significant oppression case decided in Texas also came out of the First Court of Appeals, *Willis v. Bydalek*.[418] In this case, Joseph Bydalek and Robert Fox formed RMF&JB Corporation to buy and run a bar in Huntsville, Texas.[419] Bydalek owned 49%, and Fox owned 51% of the stock. Bydalek invested $31,000.[420] Fox must also have invested initially, but this is not discussed in the appellate opinion. However, Fox's estate later infused at least an additional $59,000 in the company. [421] Bydalek and his wife ran the day-to-day operations of the corporation, kept the books, and were the only shareholders to draw a salary.[422] About the same time the club opened, Fox was killed in a car accident, and his sister Jeannine Willis took over his stock ownership as Administratrix of his estate.[423] Over the next five months, relations soured. The club had difficulties with the renewal of its alcohol license and the club lost money. [424] Willis called a special shareholders' meeting, which Bydalek did not attend. It was disputed whether he was given notice. Willis elected two attorneys and herself to the board of directors. Sometime later, she took over management of the bar, changed the locks, and effectively barred Bydalek from the premises. [425] Bydalek sued, and the jury found (1) that Bydalek was "wrongfully locked out," (2) that Willis acted "willfully and maliciously," (3) that the fair value of Bydalek's shares was $612.50, and (4) that Bydalek was entitled to $180,000 in punitive damages.[426] The jury found that Willis had not committed conversion. The trial court entered a judgment for shareholder oppression, ordered a buy-out for $612.50, and awarded punitive damages in the amount of $30,000.[427]

The court of appeals reversed the judgment, holding that the sole act of oppressive conduct found, "wrongful lock out," was no more than the firing of an at-will employee.[428] The court of appeals did not hold that firing an at-will employee who is a minority shareholder could never, under any circumstances, constitute oppression, but only that under the circumstances of this case the sole act of firing an at-will employee could not constitute shareholder oppression.[429] The court emphasized that only one act

[410] 279 S.W.2d 848, 857 (Tex. 1955).
[411] 754 S.W.2d at 379.
[412] *Id.* at 380.
[413] *Id.* at 381.
[414] *Id.* at 381 (citing *In re* Wiedy's Furniture Clearance Center Co., 487 N.Y.S.2d 901, 903 (N.Y. App. 1985)).
[415] *Id.* at 382 (citing Baker v. Commercial Body Builders, Inc., 507 P.2d 387 (Ore. 1973)).
[416] *Id.* at 382–83.
[417] *Id.* at 382.
[418] 997 S.W.2d 798 (Tex. App.—Houston [1st Dist.] 1999, pet. denied).
[419] *Id.* at 799.
[420] Id.
[421] *Id.* at 800.
[422] Id.
[423] Id.
[424] Id.
[425] *Id.* at 799.
[426] Id.
[427] *Id.* at 800–01.
[428] *Id.* at 802.
[429] *Id.* 802–03.

of oppressive conduct was proven. Unlike the court in *Davis v. Sheerin*, the *Willis* court did not supplement the jury's finding with other oppressive acts revealed by the record, and the court is careful to point out that most of these were disputed.[430] The significant factors influencing the court were that the corporation always lost money (so that the minority shareholders were not denied an economic return on their investment), and that the at-will employment doctrine and the business judgment rule both militated against a holding that the firing was oppressive.[431]

d. *Willis v. Donnelly*

One additional early case that bears special scrutiny is *Willis v. Donnelly*.[432] This case arose out of the founding of the Urban Retreat day spa. Michael Willis, a Houston entrepreneur, decided to create a high end salon. He formed two corporations for the purpose of pursuing the concept. He recruited Dan Donnelly, who owned a successful hair salon, and they entered into a letter agreement in which Donnelly would transfer staff and customers from his existing business to the Urban Retreat, would work in and manage the business as a salaried employee, and receive from the two corporations stock equal to a 25% ownership when the Urban Retreat's gross revenues reached the level of Donnelly's former company.[433] The letter agreement also contained a "Termination" provision that required Donnelly to sell back his shares in the event that his employment was terminated. Willis provided all the startup capital, which turned out to be significantly more than anticipated, and when the Urban Retreat's gross revenues reached the level that triggered Donnelly's right to be issued shares, the company was still not profitable.[434] Willis delayed issuing Donnelly his shares, and Donnelly eventually consented to the delay so that Willis could receive the tax benefits of the current losses under the corporation's subchapter S status.[435]

During the period of time after Donnelly became entitled to the shares, Willis acted contrary to Donnelly's interests in a number of ways: He characterized his capital infusions as loans; he transferred all the stock to his wife; he purchased the property on which the spa was located (although the corporation had an option to purchase the same property); and he increased the rent. Finally, Willis fired Donnelly without ever having issued Donnelly his shares.[436]

Donnelly sued both for breach of the letter agreement in not issuing his shares and for breach of fiduciary duties based on his status as a minority shareholder. The jury found in favor of Donnelly on all issues and found his damages under both theories to be $1.7 million.[437] Willis appealed the judgment on the jury verdict with regard to the breach of contract claim on the grounds that Willis was not a signatory to the contract, that Donnelly had waived performance, and limitations. On these issues, the court of appeals held that Willis was individually liable for the corporation's breach of contract because the jury had found that he had ratified the contract.[438] The court of appeals also held that there was evidence to support the jury's negative finding on waiver and that limitations did not begin to run until the firing, because the contract had not been clearly repudiated until that time.[439]

With regard to the breach of fiduciary duties claim, the court of appeals held that Willis owed Donnelly fiduciary duties as a minority shareholder and that Willis had engaged in oppressive conduct.[440] The court held that the evidence was sufficient to find that Donnelly was a minority shareholder, based on the letter agreement and on statements made by Willis recognizing that Donnelly was an owner.[441] This is the most puzzling part of the opinion. The existence of the breach of contract logically precludes Donnelly from being a shareholder.[442] The court's analysis of the existence of fiduciary duties seems to indicate that the court considered the creation of the ownership interest to be self-executing or that equity[443] required the court to treat the stock as if it had been issued; however, either of these possibilities would have precluded a money judgment for breach of contract. The court held that the record was more than sufficient to prove a breach.[444] The remedy analysis is also puzzling. While the court clearly held that the majority shareholder had

[430] *Id.* at 801–02.
[431] *Id.* at 802.
[432] 118 S.W.3d 10 (Tex. App.—Houston [14th Dist.] 2003), *rev'd*, 199 S.W.3d 262 (Tex. 2006).
[433] Willis v. Donnelly, 199 S.W.3d 262, 265–66 (Tex. 2006).
[434] *Id.* at 267.
[435] *Id.* at 268.
[436] Id.
[437] *Willis*, 118 S.W.3d at 25.
[438] *Id.* at 26–27. The appellate court reversed and remanded the contract claim, however, because the wrong measure of damages was submitted. *See id.* at 41.
[439] *Id.* at 27–28.
[440] *Id.* at 32.
[441] *Id.* at 30.
[442] This logical contradiction is ultimately the reason for the Texas Supreme Court's reversal. *See* Willis v. Donnelly, 199 S.W.3d 262, 277 (Tex. 2006).
[443] *See, e.g.*, First Heights Bank v. Gutierrez, 852 S.W.2d 596, 605 (Tex. App.—Corpus Christi 1993, writ denied) ("equity regards that as done that ought to be done").
[444] *Willis*, 118 S.W.3d at 33.

committed oppression,[445] the remedy imposed was an award of damages proximately caused by the breach and not a buy-out at fair value.[446] The evidence supporting the award of damages was the value of the real estate that was the subject of the majority shareholder's usurpation of corporate opportunities and the value of the capital invested that was mischaracterized as a loan[447]—both claims that belong solely to the corporation and damage solely the corporation.

The Texas Supreme Court reversed. The Court held that the Donnelly's breach of contract claim could be asserted only against the corporation, not the majority shareholder.[448] The Court reversed the judgment for breach of fiduciary duties on the grounds that such duties would arise solely as a result of Donnelly being a minority shareholder that Donnelly was never a shareholder when any of the conduct complained occurred: "[T]he breach of fiduciary duty claim in the pending case fails because all the alleged breaches of fiduciary duty occurred before Donnelly became a shareholder and before he was entitled to shareholder status. There can be no liability for alleged breaches of a duty that occurred before the duty arose."[449]

3. Shareholder Oppression Since 2006

a. *Ritchie v. Rupe*: Will the shareholder oppression cause of action change?

A fourth case, *Ritchie v. Rupe*, also merits special attention. Since the First Court of Appeals recognized the buy-out as a remedy for oppressive conduct in *Davis v. Sheerin* in 1988, the Texas Supreme Court has declined to express an opinion regarding the shareholder oppression cause of action.[450] Meanwhile, Texas courts of appeal have continued ruling on these types of cases and have, over the last twenty-five years, created a significant body of jurisprudence on this subject. During that time, numerous petitions for review have been filed to the Texas Supreme Court, and each time the Court denied those requests. On no occasion, however, has the Court refused review, which would constitute an implicit recognition that the court of appeals' opinion is "correct and the legal principles announced in the opinion are likewise correct."[451] Petitions for review have all been denied until March 2, 2012, when the Court granted Ritchie's Motion for Rehearing. Oral arguments were heard on February 26, 2013, and at this time more than nine amicus curiae briefs have been filed on the matter.

What is so special about *Ritchie* that warranted the Court's attention after Ritchie's second petition for review? In that case, Ann Caldwell Rupe became trustee of the Dallas Gordon Rupe III Family Trust after her husband's death. The trust held an 18% interest in Rupe Investment Corporation (RIC).[452] Mrs. Rupe sought to market her interest to third parties, and hired a retired capital fund manager, George Stasen, to assist her. Stasen met with the RIC's other shareholders regarding the sale who informed him that no one from RIC management would meet with any potential buyers. This rendered Mrs. Rupe's interest essentially worthless, because, as Stasen testified, no buyer would purchase an interest in a closely held corporation before speaking with corporate management.[453]

Mrs. Rupe's shareholder oppression claim centers on this one act: Managements' refusal to meet with potential buyers of her shares. At trial, the jury found for Mrs. Rupe, and the trial court concluded that the refusal constituted oppressive conduct and ordered that her shares be purchased for $7.3 million.

Before *Ritchie*, and even now, oppressive conduct is generally determined based on a series of bad acts that support the "the likelihood that [this oppressive conduct] would continue in the future," not one bad act.[454] The Houston court of appeals had refused to uphold a finding of oppressive conduct in *Willis v. Bydalek* "based solely on the jury's finding of a wrongful lockout."[455] The *Ritchie* opinion does not address the lack of a pattern, but instead focuses on the fact that because Mrs. Rupe's shares were unrestricted, as a shareholder she had the general reasonable expectation to "sell her stock to a party of her choosing at a mutually acceptable price."[456] Any corporate policy prohibiting a shareholder from marketing shares to third parties defeats that general reasonable expectation. The court did say that shareholders do not have the expectation that controlling shareholders or directors would either market the shares on the

[445] *Id.* at 32.
[446] *See id.* at 42.
[447] *Id.* at 43.
[448] 199 S.W.3d at 272–73. The court affirmed the court of appeals holding that there was a contract claim against the corporation and that the claim must be retried because the incorrect measure of damages was submitted. *Id.* at 275.
[449] *Id*. at 276–77.
[450] In *Willis v. Donnelly*, the Texas Supreme Court found that because Donnelly never became a shareholder, the Willises could not have owed fiduciary duties to Donnelly. 199 S.W.3d 262, 278 (Tex. 2006).
[451] Tex. R. App. P. 56.1(c).
[452] Ritchie v. Rupe, 339 S.W.3d 275, 280 (Tex. App.—Dallas 2011, pet. granted).
[453] *Id.* at 282.
[454] Davis v. Sheerin, 754 S.W.2d 375, 383 (Tex. App.—Houston [1st Dist.] 1988, pet. denied).
[455] 997 S.W.2d 798, 803 (Tex. App.—Houston 1999, pet. denied).
[456] *Ritchie*, 339 S.W.3d at 291.

minority's behalf or make any statements that would mislead potential investors.[457] No other oppressive act is mentioned in the opinion. Notably, the court of appeals remanded to determine the "fair market value" of Mrs. Rupe's shares.[458]

In their brief to the Texas Supreme Court, Petitioners Ritchie *et al.* argue that the "Texas shareholder oppression statute," which allows the appointment of a receiver based on "illegal, oppressive, or fraudulent"[459] conduct, should be the only remedy available.[460] Petitioners also assert that the "reasonable expectations test" is a flawed test that is not appropriate under the current statute and is not appropriate when a shareholder "acquire[s] her shares in a preexisting corporation by way of inheritance."[461]

Respondents point out that the receivership statutes are measures of last resort, to be used only "if all other remedies available either at law or in equity . . . are determined by the court to be inadequate."[462] Respondents also point out that the "reasonable expectations test" is used in courts throughout the country to determine whether oppressive conduct has occurred. In addition, Respondents note that the jury found that a relationship of trust and confidence existed and that Petitioners did not comply with their fiduciary duties arising from this relationship. A buy-out would be an appropriate remedy for the breach of fiduciary claim as well as shareholder oppression.[463]

Further, Respondents' argument that a shareholder who inherits their interest has no ownership expectations directly contradicts rights afforded under the Business Organization Code. A shareholder of record has the right to vote, to receive distributions, and to sell her shares, regardless of how those shares were acquired.[464]

If the Court agrees with Petitioners and limits the remedy for oppressive conduct to a receivership and/or dissolution, the result could force both controlling and noncontrolling business owners to wait while a receiver attempts to "rehabilitate the relationship." Liquidating an operating business because the owners cannot negotiate a fair separation amounts to nothing less than waste. Tying the court's hands and limiting the ability to fashion an equitable remedy in oppression cases is contrary to a basic principle to "protect relationships of trust from an agent's disloyalty."[465] Petitioners' argument to restrict remedies available to minority shareholders ignores the plain language of the statute, which requires that the court determine that all "other remedies available at law or in equity are inadequate" before resorting to receivership.[466] The buy-out alternative, however, gives the controlling shareholder what he wants—to continue the business without the presence of a minority shareholder, but requires payment of a fair price for the privilege.

b. *Cardiac Perfusion Services v. Hughes*

*Cardiac Perfusion Services, Inc. v. Hughes* is a Dallas court of appeals case currently awaiting a decision on a petition for review.[467] Michael Joubran founded Cardiac Perfusion Services 1991.[468] Randall Hughes was the company's first employee. A year later, Hughes purchased a 10% share of the company for $25,000.[469] A Buy–Sell Agreement governed the sale of shares and required that CPS purchase the shares of a terminated employee. CPS and Jourban filed suit against Hughes for breach of fiduciary duty and tortious interference with contract the day after terminating Hughes.[470] Jourban asked that the court reduce the purchase amount for Hughes shares by the amount that Hughes had harmed CPS. Hughes counterclaimed for shareholder oppression.

The jury found that Hughes had not tortiously interfered with CPS contracts and that Hughes had not breached any fiduciary duties to CPS. As to Hughes claims, the jury found that Joubran suppressed dividends, paid himself excessive compensation, improperly paid family members with CPS funds, used CPS funds to pay personal expenses, lowered CPS' value, and refused to let Hughes have access to CPS' books and records.[471] The trial court found that these acts constituted shareholder oppression and ordered that Jourban and CPS purchase Hughes' shares for the jury's fair value of $300,000, notwithstanding the Buy–Sell Agreement's book value purchase price.[472]

On appeal, the court upheld the trial court's determination to instruct the jury on the valuation method "sanctioned in *Ritchie*."[473] The court noted that enterprise value was proper to determine fair value "when a minority shareholder, with no desire to leave

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[457] *Id.* at 297.
[458] *Id.* at 302.
[459] TEX. BUS. ORGS. CODE § 11.404(a)(1)(C)(2012).
[460] Pet'rs Br. on the Merits 16.
[461] Pet'rs Br. on the Merits 15.
[462] Resp.'s Br. 17 (quoting TEX. BUS. CORP. ACT art. 7.05(A), 7.06(A)).
[463] Resp.'s Br. 35.
[464] *See* TEX. BUS. ORGS. CODE § 21.201(a) (2012).
[465] ERI Consulting Eng'rs, Inc. v. Swinnea, 318 S.W.3d 867, 874 (Tex. 2010).
[466] TEX. BUS. ORGS. CODE § 11.403(b)(4) (2012).
[467] 380 S.W.3d 198 (Tex. App.—Dallas 2012, pet. filed).
[468] *Id.* at 203.
[469] Id.
[470] Id.
[471] Id.
[472] Id.
[473] Id.

the corporation, has been forced to relinquish his ownership position by the oppressive conduct of the majority." [474] Because Joubran's conduct was oppressive, the court could, through use of its equitable power, order a buy-out at fair value.[475]

c. *Argo Data Resource Corp. v. Shagrithaya*

*Argo Data Resource Corp. v. Shagrithaya* is another recent Dallas shareholder oppression case currently awaiting decision on a petition for review. In this case, Max Martin and Balkrishna Shagrithaya formed Argo Data Resource Corporation, a business that provides software and other similar services to retail financial services companies.[476] Shagrithaya and Martin were the only shareholders, with Shagrithaya owning 47% of the business and Martin owning the other 53%. Shagrithaya asserted that the two men had agreed that they would receive equal salaries and for the first 25 years, they did receive "virtually equal compensation." [477] Martin and Shagrithaya's relationship began to deteriorate when customers began expressing concern about corporate succession due to the founders advancing age. Martin moved to address this issue, making himself chief executive officer then president of Argo and promoted another employee at chief technology officer. Shagrithaya never objected to Martin's plans until Martin cut Shagrithaya's salary from $1 million to $300,000 for that year. When efforts for Argo to buy Shagrithaya's shares broke down, Shagrithaya sued Martin for oppressive conduct, breach of fiduciary duty, and other related claims.[478] The jury found for Shagrithaya on all claims.[479]

That judgment did not withstand the Dallas court of appeals, however, which reversed the judgment "in its entirety" and rendered a take-nothing judgment.[480] Unlike *Ritchie*, but like *Cardiac*, *Argo* involved multiple allegations of oppressive conduct. The jury found that the Shagrithaya's salary reduction amounted to oppressive conduct. The court of appeals, citing *Willis v. Bydalek*, opined that because the parties had no formal agreement regarding compensation or employment, Shagrithaya had no objectively reasonable expectation regarding either.[481]

The court also overturned the jury's finding that Martin suppressed dividends, concluding that shareholders have "no general expectation of receiving a dividend" and that "Texas law does not require a corporation to issue dividends." [482] Shagrithaya received his share of the dividends that were issued, which amounted to more than $11 million. The court held that "his general reasonable expectations were not substantially defeated."[483]

In Shagrithaya's petition for review, he argues that the appellate court erred in not finding that Martin's conduct was oppressive. Shagrithaya brings up several oppressive acts not evident in the appellate court's opinion: The court "left undisturbed the jury's findings that [Martin] acted maliciously and in violation of [Shagrithaya's] reasonable expectations when [Martin refused to pay dividends dispute ARGO's record earnings; fraudulently represented his reasons for not paying dividends" and avoided the suppression of dividends claim by "paying a dividend on the eve of trial."[484]

The Court has not rendered its decision on Shagrithaya's petition for review.

d. *Boehringer v. Konkel*

A recent shareholder oppression case from Houston is *Boehringer v. Konkel*. [485] Mark Konkel bought 49.9% of Chris Boehringer's close corporation, Enginuity Engineering, in 2001.[486] Both shareholders were chemical engineers and the business designed "industrial processes," machinery, and other equipment used in refineries and chemical plants.[487] The company was very successful, increasing in sales from $550,000 per year in 2004 to more than $1 million per year from 2005 to 2008. During this successful period, Konkel and Boehringer's relationship deteriorated. Boehringer was verbally abusive to Konkel and other employees and threatened to make Konkel's life "miserable" just before a shareholder meeting. [488] At that meeting, Boehringer used his majority status to defeat all of Konkel's proposals. Boehringer also made his wife vice president, replacing Konkel in that role and created restrictions on stock transfers. After that, Boehringer forced Konkel to work from home, because "his presence in the office made Boehringer uncomfortable."[489] He then locked Konkel out of the office. Finally, Boehringer told Konkel that he would

[474] *Id.* at 205 (citing Ritchie v. Rupe, 339 S.W.3d 275, 300–01 (Tex. App.—Dallas 2011, pet. granted)).
[475] *Id.* at 204.
[476] Argo Data Res. Corp. v. Shagrithaya, 380 S.W.3d 249, 258 (Tex. App.—Dallas 2012, pet. filed).
[477] Id.
[478] *See id.* at 260.
[479] *Id.* at 263.
[480] *Id.* at 267.
[481] *Id.* at 268.
[482] *Id.* at 270.
[483] Id.
[484] Pet'rs Br. 10.
[485] 404 S.W.3d 18 (Tex. App.—Houston [1st Dist.] 2013, no pet.).
[486] *Id.* at 22.
[487] Id.
[488] *Id.* at 23.
[489] Id.

be required to be the office from 7:00 am to 5:00 pm from Monday through Thursday, as well as every other Friday. Boehringer resigned the next day.

Konkel filed suit against Boehringer for shareholder oppression in 2009. At trial, the jury found that Boehringer denied Konkel access to books and records, awarded himself an excessive salary, and withheld dividends from Konkel. Based on these jury findings, the trial court determined that shareholder oppression had occurred. The court of appeals upheld the jury findings and the trial court's oppression finding.

In its analysis, the court of appeals determined that Konkel had a "general and reasonable expectation" to access company records.[490] Konkel had testified that he had made between 10 and 20 requests for records over approximately a ten-year period. Boehringer never provided requested bank records or tax returns. In 2009, Boehringer provided 3 tax returns. On one other occasion, Boehringer provided a one-page spreadsheet he had drafted. No other documents were provided until ordered produced in during the lawsuit. Even though Konkel had provided some information, the court of appeals Boehringer had not responded to Konkel's other repeated requests for records. Boehringer's behavior amounted to "ill-will, bad, or evil motive, or gross indifference to Konkel's rights as a shareholder."[491]

The court of appeals also upheld the jury's finding that Boehringer awarded himself excessive salaries and compensation. A 2001 board resolution showed that only shareholders could change salaries. That resolution also showed that Boehringer and Konkel agreed that each would receive $60,000 annually. The court noted that while shareholders do not have a general expectation of compensation through their employment, the resolution supported "an inference that they viewed their contributions to the corporation as equal."[492] Boehringer, however, had secretly raised his salary to $240,000 per year, in comparison with Konkel's $70,000. This was enough to support the jury's finding of excessive compensation. The court also noted that Konkel did not raise the issue of his own compensation, but instead complained that Boehringer's salary increases were detrimental to Konkel.[493]

In reference to Konkel's claim that Boehringer withheld dividend payments, the court cited *Argo*, noting that "[t]he right to proportionate participation in the earnings of a company is a general reasonable expectation of any shareholder."[494] Boehringer did not pay dividends in 2008, stating that the company could not afford to do so that year; however, Boehringer increased his salary despite these allegations. The court found that Boehringer's drastic increase in salary showed that "Boehringer received compensation in excess to what was reasonable for his position and level of responsibility such that he received a de facto dividend to the exclusion of Konkel."

The court of appeals pointed out that "[d]enying access to company books or records, paying excessive compensation, and wrongfully withholding dividends are typical wrongdoings found in shareholder oppression cases."[495] These three bad acts all related to Konkel's reasonable expectations based on his mere status as a shareholder. The court ultimately found that these acted substantially defeated Konkel's general reasonable expectations, and went on to point out that "any one of the acts alone would support the trial court's finding of shareholder oppression."[496]

4. Legal Basis of the Oppression Cause of Action

Clearly a duty exists in Texas not to oppress minority shareholders. In cases like *Hoggett* and *Duncan*, the courts clearly say that *some* duty is owed to minority shareholders, but then neglect to name what that duty is.

Commentators and courts in other states have struggled for some time to agree on the logical and legal basis of the shareholder oppression cause of action. Two different approaches predominate regarding the legal basis for analyzing duties to individual minority shareholders. The conclusion of the Massachusetts courts is that a unique duty exists to protect minority shareholders in a closely held corporation, based on the similarities between general partnerships and closely held corporations, and that these duties are different from and higher than those duties that directors owe to corporations and are distinct from those duties imposed in large or public corporations. The analysis of the Delaware courts is that the fiduciary duties owed to shareholders are the same in large or public corporations as they are in closely held corporations and that these duties are the same duties that directors owe to corporations. Neither of these approaches works in Texas corporate law.

[490] *Id.* at 28.
[491] Id.
[492] Id.
[493] *Id.* at 29.
[494] *Id.* (citing Argo Data Res. Corp. v. Shagrithaya, 380 S.W.3d 249, 265 (Tex. App.—Dallas 2012, pet. filed)).
[495] *Id.* (citing Willis v. Bydalek, 997 S.W.2d 798, 801–02 (Tex. App.—Houston [1st Dist.] 1999, pet. denied).
[496] *Id.* at 32.

a. Texas Shareholder Oppression Cause of Action Is Not Based on an Analogy to Partnership Law.

The Massachusetts Supreme Judicial Court essentially created the modern shareholder oppression cause of action in *Donahue v. Rodd Electrotype Co.*,[497] and reasoned that closely held corporations act and operate more like partnerships,[498] and stated that minority shareholders in a closely held corporation, like members of a partnership, are at risk because of the illiquidity of their ownership interests.[499] Therefore, the Massachusetts Court held: "Because of the fundamental resemblance of the close corporation to the partnership, the trust and confidence which are essential to this scale and manner of enterprise, and the inherent danger to minority interests in the close corporation, we hold that stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe each other."[500] Under Massachusetts law, partners owe each other a duty of "utmost good faith," which is a higher duty than the duty of good faith and loyalty owed by directors to their corporations. The Massachusetts Court imposed this higher duty on majority shareholders in closely held corporations as to their minority shareholders. The court clearly limited the imposition of these special duties to closely held corporations, without providing any kind of bright-line definition as to what constituted a closely held corporation.[501] This approach has found a great deal of acceptance among academic commentators.[502]

However, this approach is problematic in that it assumes that there are partnership-like duties in some corporations and not in others, a concept that is foreign to Texas jurisprudence. Creating corporate law by analogy to partnership law is also not very satisfying because, even in closely held corporations that are operated very much like partnerships, there are very real legal differences between the business forms, and a court must assume the parties chose these differences deliberately. As the Austin court of appeals noted in *van Bavel v. Oasis Design, Inc.*,[503] "The choice of business form is an important decision. There are advantages and disadvantages that come with the choice between partnership and corporation." The corporation, unlike the partnership, is recognized as a juridical "person" separate and distinct from its owners and operators. The owners of a corporation are insulated from the debts and obligations of that corporation, unlike the owners of a partnership. The owners of a partnership, unlike the owners of a corporation, have a right to participate in the management of the enterprise. The owners of a partnership, unlike the owners of a corporation, are deemed to be agents for each other and for the partnership and have the legal power to bind the partnership. The owners of a partnership may voluntarily dissolve the partnership and wind up its affairs at the will or even the whim of any one of the partners; whereas a corporation is essentially perpetual in existence absent an agreement of the owners or exceedingly rare judicial intervention.

Furthermore, basing remedies on the unique characteristics of the closely held corporation and its similarities to a partnership necessitates difficult and arbitrary line drawing. To which corporations will those duties apply and how will the parties know in advance so as to properly order their affairs and conduct? Texas corporate law does provide a statutory scheme for delineating rights and duties of close corporations similar to those of a partnership and are unlike those in larger corporations, but this statutory scheme applies only to those small corporations that affirmatively elect the status of a statutory Close Corporation.[504] There is no statutory or common-law basis for imposing that election by judicial fiat. Section 21.563 of the Texas Business Organizations Code defines "closely held corporations" as those corporations with fewer than 35 shareholders and no public market for their shares. However, this arbitrary dividing line is solely for the purpose of providing special procedures for smaller corporations in a shareholder derivative action. One Texas court has held that the legislature did not intend that definition to apply for any other purpose.[505]

Language in two Texas opinions, both reversed by the Supreme Court on other grounds, seem to acknowledge the possibility of duties in a shareholder oppression cause of action as being tied in with the analogy of a closely held corporation to a

[497] 328 N.E.2d 505 (Mass. 1975).

[498] *Id.* at 511–12 (referring to closely held corporations as "incorporated partnerships").

[499] *Id.* at 513–15.

[500] *Id.* at 515. *See also* Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 661–62 (Mass. 1976).

[501] *Donahue*, 328 N.E.2d at 511.

[502] *See* Moll, *supra* note 306, at 436.

[503] No. 03-97-00434-CV, 1998 WL 546342, at *6 (Tex. App.—Austin Aug. 31, 1998, no pet.).

[504] TEX. BUS. ORGS. CODE § 21.701, *et seq.* (West 2011).

[505] Redmon v. Griffith, 202 S.W.3d 225, 238 n.8 (Tex. App.—Tyler 2006, pet. denied) (holding that the definition contained in Article 5.14 is only applicable to a derivative proceeding brought by a shareholder of "a closely held corporation," is limited to that article, and is inapplicable to circumstances involving the creation of fiduciary duties between majority and minority shareholders in close corporations).

partnership.[506] Texas courts certainly acknowledge that oppression is far more likely in a closely held corporation.[507] But none of the cases recognizing and applying the cause of action draw any support from partnership law or distinguish among corporations by size; and at least one Texas appellate opinion has expressly rejected the approach of carving out special duties for closely held corporations.[508] It is notable that *Davis v. Sheerin*, the leading shareholder oppression case in Texas, did not even cite *Donahue v. Rodd Electrotype Co.*, even though that Massachusetts case was clearly the most prominent shareholder oppression case in the country at the time the Davis opinion was written.

b. Shareholder Oppression Is Not an Extension of Corporate Directors' Fiduciary Duties.

Delaware, undoubtedly the most influential jurisdiction on questions of corporate law, has rejected the Massachusetts approach of creating unique duties for closely held corporations based on a partnership analogy.[509] Rather, the Delaware courts have held that minority shareholders' claims for mistreatment or oppressive conduct fall under the general law of corporate fiduciary duties of loyalty, care and good faith.[510] While the Delaware Supreme Court has not yet ruled on an oppression-type claim by a minority shareholder in a closely held corporation, other courts have predicted that the Delaware law would recognize such a claim.[511]

However, there is a critical difference between Delaware and Texas law in the area of corporate fiduciary duties. Under Delaware law, directors owe fiduciary duties not only to the corporation but also directly to the shareholders.[512] This is not the case in Texas. "Traditionally, a corporate officer owes a fiduciary duty to the shareholders collectively, *i.e.*, the corporation, but he 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." [513]

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[506] *See* Willis v. Donnelly, 118 S.W.3d 10, 32 (Tex. App.—Houston (14th Dist.) 2003), *rev'd in part on other grounds*, 199 S.W.3d 262 (Tex. 2006) (noting that existence of fiduciary duties depend on certain circumstances such as in closely held corporations in which the shareholders "operate more as partners than in strict compliance with the corporate form"); DeBord v. Circle Y of Yoakum, Inc., 951 S.W.2d 127, 133 (Tex. App.—Corpus Christi 1997), *rev'd on other grounds*, Stary v. DeBord, 967 S.W.2d 352 (Tex. 1998).

[507] *See* Davis v. Sheerin, 754 S.W.2d 375, 381 (Tex. App.—Houston [1st Dist.] 1988, pet. denied).

[508] *See Redmon*, 202 S.W.3d at 234 ("While oppressive conduct is more easily found in the context of a close corporation, we are aware of no case law expressly limiting it to such a context.").

[509] *See* Riblet Products Corp. v. Nagy, 683 A.2d 37, 40 (Del. 1996); Nixon v. Blackwell, 626 A.2d 1366, 1380–81 (Del. 1993).

[510] *See* Nixon v. Blackwell, 626 A.2d at 1380–81 (holding that claims of minority shareholder oppression in a closely held corporation may be pursued through the "entire fairness test, correctly applied and articulated").

[511] *See* Clemmer v. Cullinane, 815 N.E.2d 651, 652–53 (Mass. App. 2004) (holding that *Nixon* did not foreclose a shareholder oppression cause of action, but merely required that the claim be pursued through Delaware's "entire fairness" test, and on that basis held that the plaintiff had stated a claim for shareholder oppression under Delaware law); *see, e.g.*, Hollis v. Hill, 232 F.3d 460, 465, 469 n.28, 470–71 (5th Cir. 2000); Mroz v. Hoaloho Na Eha, Inc., 410 F. Supp.2d 919, 934–35 (D. Hi. 2005); Minor v. Albright, No. 01 C 4493, 2001 WL 1516729 (N.D. Ill. 2001); Reserve Solutions, Inc. v. Vernaglia, 438 F. Supp.2d 280, 290 (S.D.N.Y. 2006); Sokol v. Educ. Sys. Corp., 809 N.Y.S.2d 484 (N.Y. App. Div. 2005). *See also* Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1051 (Del. Ch. 1996) ("I need not address the general question whether Delaware fiduciary duty law recognizes a cause of action for oppression of minority shareholders; I assume for purposes of this motion, without deciding, that under some circumstances it may."); Litle v. Waters, Civ. A No. 12155, 1992 WL 25758 (Del. Ch. Feb. 11, 1992) (applying "reasonable expectations test" and holding that plaintiff had stated a claim for minority shareholder oppression). *But* see Nightingale & Assocs., L.L.C. v. Hopkins, Civ. Docket No. 07-4239(FSH), 2008 WL 4848765 (D. N.J. November 05, 2008) (dismissing oppression claim under Delaware law on grounds that the Delaware Supreme Court in *Nixon v. Blackwell* "has refrained from applying remedies for alleged oppression, finding that a person buying into a minority position can bargain for certain protections"—clearly an erroneous holding).

[512] Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984); Barron v. Allied Artists Pictures Corp., 337 A.2d 653, 658 (Del. Ch. 1975); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993); Boyer v. Wilmington Materials, Inc., 754 A.2d 881, 906–07 (Del. Ch. 1999).

[513] Redmon v. Griffith, 202 S.W.3d at 233. *See* Gearhart Indus., Inc. v. Smith Int'l Inc., 741 F.2d 707, 721 (5th Cir. 1984); Schautteet v. Chester State Bank, 707 F. Supp. 885, 888 (E.D. Tex. 1988); Kaspar v. Thorne, 755 S.W.2d 151, 155

Furthermore, coshareholders do not owe fiduciary duties to each other in Texas.[514] Therefore, the approach under Delaware law is not available in Texas. The cause of action in Texas law must be based upon analysis of the legal interests possessed by individual shareholders and legal duties existing to protect those interests.

While the idea has not been developed in any Texas opinion, it seems clear that most Texas cases consider the shareholder oppression cause of action to be something of different character from the breach of fiduciary duty cause of action. In *Cotten v. Weatherford Bancshares, Inc.*, the Fort Worth Court of Appeals held that corporate officers do not owe fiduciary duties to individual shareholders unless a contract or confidential relationship exists between them.[515] In that case, a preferred shareholder in a subsidiary had sued the directors of the subsidiary who were also the controlling shareholders in the parent corporation, which held all the common shares in the subsidiary. The court held that there was no confidential relationship and no contract creating fiduciary duties between the plaintiff and the defendants, and therefore, no fiduciary duties owed to the plaintiff.[516] Nevertheless, the court held that the plaintiff, as a shareholder, had a claim for oppression against the directors of the corporation.[517] While the court's reasoning is not altogether clear, the court correctly perceived that a claim for breach of fiduciary duties and a claim for shareholder oppression are not the same thing. Similarly in *Faour v. Faour*,[518] the court of appeals reversed a judgment awarding damages to a minority shareholder for breach of fiduciary duties by the majority shareholder. The court held that the duties owed and breached by the defendant were solely to the corporation, and that the individual shareholder did not have a cause of action.[519] The court did acknowledge *Patton v. Nicholas*,[520] *Davis v. Sheerin*,[521] and *Duncan v. Lichtenberger*.[522] The court distinguished these authorities by holding that they were not actions seeking damages for breach of fiduciary duties, but were equitable proceedings.[523] The court did not analyze the nature of the minority shareholders' legal interests that were being protected in these equitable proceedings, but the court was clear that the cause of action asserted in these oppression cases was very different from the type of claim that a corporation might bring against an officer or director for breach of fiduciary duties.[524]

c. What Is Going On in Texas Fiduciary Duty Law?

d. Statement of the General Rule

Texas law seems considerably unclear, even perhaps schizophrenic, on the issue of fiduciary duties owed to minority shareholders. On the one hand, the case law seems to be clear and consistent that *generally* officers, directors, and controlling shareholders do not owe fiduciary duties directly to individual shareholders by virtue of their status as shareholders.[525] "A corporate officer owes a fiduciary duty to the shareholders collectively, *i.e.* the corporation, but he 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."[526] Furthermore, a coshareholder in a closely held corporation does not as a matter of law owe a fiduciary duty to his coshareholder.[527]

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(Tex. App.—Dallas 1988, no writ); Schoellkopf v. Pledger, 739 S.W.2d 914, 918 (Tex. App.—Dallas 1987), *rev'd on other grounds*, 762 S.W.2d 145 (Tex. 1988); Hoggett v. Brown, 971 S.W.2d 472, 488 (Tex. App.—Houston [14th Dist.] 1997, writ denied); Faour v. Faour, 789 S.W.2d 620, 621–22 (Tex. App.—Texarkana 1990, writ denied);.

[514] Pabich v. Kellar, 71 S.W.3d 500, 504 (Tex. App.—Fort Worth 2002, pet. denied); *Hoggett*, 971 S.W.2d at 488.

[515] 187 S.W.2d at 698.

[516] *Id.* at 698–99.

[517] *Id.* at 700.

[518] 789 S.W.2d 620, 623 (Tex. App.—Texarkana 1990, writ denied).

[519] *Id.* at 622.

[520] 279 S.W.2d 848 (Tex. 1955).

[521] 754 S.W.2d 375 (Tex. App.—Houston [1st Dist.] 1988, writ denied).

[522] 671 S.W.2d 948 (Tex. App.—Fort Worth 1984, writ ref'd n.r.e.).

[523] *Faour*, 789 S.W.2d at 622–23.

[524] *See also* Redmon v. Griffith, 202 S.W.3d 225, 234 (Tex. App.—Tyler 2006, pet. denied) (distinguishing the fiduciary duty an officer or director owes to the corporation from a fiduciary relationship that may exist between majority and minority shareholders).

[525] *See, e.g.*, Massachusetts v. Davis, 168 S.W.2d 216, 221 (Tex. 1942), *cert. denied*, 320 U.S. 210 (1943); Cotten v. Weatherford Bancshares, Inc., 187 S.W.3d 687, 698 (Tex. App.—Fort Worth 2006, pet. denied); Grinnell v. Munson, 137 S.W.3d 706, 718 (Tex. App.—San Antonio 2004, no pet.); Hoggett v. Brown, 971 S.W.2d 472, 488 (Tex. App.—Houston [14th Dist.] 1997, writ denied); Bush v. Brunswick Corp., 783 S.W.2d 724, 727 (Tex. App.—Fort Worth 1990, writ denied).

[526] Faour v. Faour, 789 S.W.2d 620, 621–22 (Tex. App.—Texarkana 1990, writ denied) (emphasis in original).

[527] Redmon v. Griffith, 202 S.W.3d 225, 237 (Tex. App.—Tyler 2006, pet. denied); Pabich v. Kellar, 71 S.W.3d 500, 504 (Tex. App.—Fort

e. The Exception

However, the cases are equally emphatic that *sometimes*, "in certain limited circumstances, a majority shareholder who dominates control over the business may owe such a duty to the minority shareholder."[528] All the cases agree that the duty owed to minority shareholders, and thus the instances when such shareholders may sue individually, are limited. Neither the older duty cases nor the new shareholder oppression cases explain exactly when the duty arises and why.

f. The Confidential Relationship

Under Texas law, a fiduciary relationship can be either "formal" or "informal." A formal fiduciary relationship arises as a matter of law in certain relationships, such as attorney–client, partnership, and trustee–beneficiary relationships.[529] Informal fiduciary relationships arise from confidential relationships "where one person trusts in and relies upon another, whether the relation is moral social, domestic or merely personal." [530] In other words, a "formal" fiduciary relationship involves the imposition of fiduciary duties as a matter of law based on the legal status of the parties to the transaction; whereas an "informal" fiduciary relationship grows out of the particular facts of the case showing that the plaintiff's trust and confidence in the defendant has placed the defendant in a position of unfair advantage.[531] Informal relationships do not exist as a matter of law but are normally fact issues. [532] Not every relationship involving a high degree of trust and confidence rises to a fiduciary relationship.[533] Such a relationship is an extraordinary one and will not be lightly created; the mere fact that one subjectively trusts another does not alone indicate that confidence is placed in another in the sense demanded by fiduciary relationships because something apart from the transaction between the parties is required.[534] To impose an informal fiduciary duty in a business transaction, the special relationship of trust and confidence must exist prior to and apart from the agreement or transaction made the basis of the suit.[535]

Many courts have sought to explain the authorities finding that majority shareholders owe a duty directly to minority shareholders by shoehorning these cases into the confidential relationship category. In *van Bavel v. Oasis Design, Inc.*,[536] the court held that a fiduciary duty could exist between co-shareholders, but that the facts would have to evidence a confidential relationship. The court cites two cases in which the issue really was a confidential relationship, *Dodson v. Kung*, [537] and *Kaspar v. Thorne*. [538] However, the court's analysis breaks down on *Duncan v. Lichtenberger*, [539] and so the court simply mischaracterizes the holding. The court states:

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Worth 2002, pet. denied); *Hoggett*, 971 S.W.2d at 488. *See also* Art v. Schmart Eng'g, Inc., No. 13-07-00621-CV, 2008 WL 4515521, at *4 (Tex. App.—Corpus Christi-Edinburg Oct. 9, 2008, no pet.) (reversing judgment on counterclaim for negligence and breach of fiduciary duties asserted by majority shareholder against minority shareholder in an unsuccessful oppression case on the grounds of no duty between co-shareholders).

[528] *Hoggett*, 971 S.W.2d at 488 n.13 (citing Patton v. Nicholas, 279 S.W.2d 848 (Tex. 1955) (injunction issued against majority shareholder maliciously suppressed dividends)); Davis v. Sheerin, 754 S.W.2d 375, 382 (Tex. App.—Houston [1st Dist.] 1988, writ denied) (court-ordered buy-out of minority shareholder where majority shareholder engaged in oppressive conduct); Duncan v. Lichtenberger, 671 S.W.2d 948, 953 (Tex. App.—Fort Worth 1984, writ ref'd n.r.e.) (minority shareholders entitled to reimbursement of monetary contribution to corporation where majority shareholder completely excluded minority shareholders from management of business); Thompson v. Hambrick, 508 S.W.2d 949, 954 (Tex. Civ. App.—Dallas 1974, writ ref'd n.r.e.) (fact issue existed as to whether majority shareholders wrongfully obtained premium for selling control of the corporation); Morrison v. St. Anthony Hotel, 295 S.W.2d 246, 250 (Tex. Civ. App.—San Antonio 1956, writ ref'd n.r.e.) (former minority shareholder entitled to sue majority shareholder for malicious suppression of dividends).

[529] Meyer v. Cathey, 167 S.W.3d 327, 330 (Tex. 2005); Ins. Co. of N. Am. v. Morris, 981 S.W.2d 667, 674 (Tex. 1998).

[530] Crim Truck & Tractor Co. v. Navistar Int'l Transp. Corp., 823 S.W.2d 591, 593–94 (Tex. 1992).

[531] *See* Pabich v. Kellar, 71 S.W.3d 500, 504–05 (Tex. App.—Fort Worth 2002, pet. denied).

[532] Kaspar v. Thorne, 755 S.W.2d 151, 155 (Tex. App.—Dallas 1988, no writ)

[533] *Meyer*, 167 S.W.3d at 330.

[534] Kline v. O'Quinn, 874 S.W.2d 776, 786 (Tex. App.—Houston [14th Dist.] 1994, writ denied), *cert. denied*, 515 U.S. 1142 (1995).

[535] *Meyer*, 167 S.W.3d at 331.

[536] No. 03-97-00434-CV, 1998 WL 546342, at *4 (Tex. App.—Austin Aug. 31, 1998).

[537] 717 S.W.2d 385, 387–88 (Tex. App.—Houston [14th Dist.] 1986, writ ref'd n.r.e.).

[538] 755 S.W.2d 151, 155 (Tex. App.—Dallas 1988, no writ).

[539] 671 S.W.2d 948, 951 (Tex. App.—Fort Worth 1984, writ ref'd n.r.e.).

> Here, van Bavel and Knapp were co-shareholders, co-officers and co-directors, not an uncommon situation in closely held corporations. Finding a fiduciary duty, however, requires considerably more than the normal circumstances of a closely held corporation. . . . There must be some evidence on which the jury could rationally conclude that it was reasonable for van Bavel to expect Knapp to put van Bavel's interests ahead of his own. The only other evidence of something beyond the typical facts of a closely held corporation was that they owned a boat together. This is, as a matter of law, not enough.[540]

However, in those Texas cases involving oppressive conduct directed at minority shareholders, the opinions seem to hold that there is a fiduciary duty precisely because the controlling position of the majority shareholder over the minority shareholder.[541] All of these cases involve issues of standing, breach, and appropriate remedy. None state or analyze the degree of trust and confidence involved in the relationship between the parties. All recognize a duty owing to the minority shareholder simply because he is a shareholder. In *Redmon v. Griffith*, the court pays lip service to the requirement of special circumstances to recognize a fiduciary duty between minority and majority shareholder, but then goes on to hold that such a duty exists on the facts of that case merely because the majority shareholder exercises "a great deal of control over the business."[542] The fact of a "great deal of control" by a majority shareholder in a closely held corporation is not a limited special circumstance, but a factual situation that would always exist by virtue of the parties' ownership status. Plainly, something else has to be going on in these cases.

i. Proposed Synthesis—Minority Shareholders Are Analogous to Trust Beneficiaries

The way to bring clarity to this line of authority is to focus on the interests of the minority shareholder that the case law seeks to protect. I would propose that these interests grow out of the relationship of the minority shareholder to the corporation, not the relationship of the minority shareholder to the majority shareholder or corporate officers and directors. Historically in Texas law, the relationship between a corporation and its shareholders has been seen as a particular species of trust.[543] The corporation holds legal title to its assets and business.[544] But that legal title is held for the benefit of the shareholders, who are the equitable and beneficial owners of the corporation's assets.[545] The Texas Supreme Court has held that a corporation "is a trustee for the interests of it shareholders in its property, and is under the obligation to observe its trust for their benefit. Its possession is friendly, and not adverse, and the shareholder is entitled to rely upon its not attempting to impair his interest."[546] The court further characterized the "trusteeship of a corporation for its shareholders" as "an acknowledged and continuing trust."[547] "It cannot be regarded of a different character. It arises out of the contractual relation whereby the corporation acquires and holds the stockholder's investment under express recognition of his right and for a specific purpose. It has all the nature of a direct trust . . . ."[548] In *Patton v. Nicholas*,[549] the Texas Supreme Court termed the malicious suppression of dividends in a closely held corporation to be a wrong "akin to breach of trust"

[540] *van Bavel*, 1998 WL 546342, at *6.

[541] *See, e.g.*, Patton v. Nicholas, 279 S.W.2d 848 (Tex. 1955); Boehringer v. Konkel, 404 S.W.3d 18 (Tex. App.—Houston [1st Dist.] 2013, no pet.); Cardiac Perfusion Srvcs., 380 S.W.3d 198, 204 (Tex. App.—Dallas 2012, pet. filed) (upholding courts equitable power to order buy-out of minority shares); Davis v. Sheerin, 754 S.W.2d 375 (Tex. App.—Houston [1st Dist.] 1988, writ denied); *Duncan*, 671 S.W.2d at 950 (Tex. App.—Fort Worth 1984, writ ref'd n.r.e.); Morrison v. St. Anthony Hotel, 295 S.W.2d 246 (Tex. Civ. App.—San Antonio 1956, writ ref'd n.r.e.).

[542] Redmon v. Griffith, 202 S.W.3d 225, 237–38 (Tex. App.—Tyler 2006, pet. denied).

[543] *See* Yeaman v. Galveston City Co., 167 S.W. 710, 723 (Tex. 1914); Disco Machine of Liberal Co. v. Payton, 900 S.W.2d 124, 126 n.2 (Tex. App.—Amarillo 1995, writ denied); Hinds v. Sw. Sav. Ass'n, 562 S.W.2d 4, 5 (Tex. Civ. App.—Beaumont 1977, writ ref'd n.r.e.); Graham v. Turner, 472 S.W.2d 831, 836 (Tex. Civ. App.—Waco 1971, no writ); Rex Refining Co. v. Morris, 72 S.W.2d 687, 691 (Tex. Civ. App.—Dallas 1934, no writ).

[544] Rapp v. Felsenthal, 628 S.W.2d 258, 260 (Tex. App.—Fort Worth 1982, writ ref'd n.r.e.).

[545] McAlister v. Eclipse Oil Co., 98 S.W.2d 171, 176 (Tex. 1936); *In re* Estate of Trevino, 195 S.W.3d 223, 230 (Tex. App.—San Antonio 2006, no pet.); Cotten v. Weatherford Bancshares, Inc., 187 S.W.3d 687, 697 (Tex. App.—Fort Worth 2006, pet. denied); Martin v. Martin, Martin & Richards, Inc., 12 S.W.3d 120, 124 (Tex. App.—Fort Worth 1999, no pet.); Rapp, 628 S.W.2d at 260; Gossett v. State, 417 S.W.2d 730 (Tex. Civ. App.—Eastland 1967, writ ref'd n.r.e.).

[546] *Yeaman*, 167 S.W. at 723.

[547] Id.

[548] *Id.* at 723–24.

[549] 279 S.W.2d 848, 854 (Tex. 1955).

and cited with approval authorities from other jurisdictions as describing directors and dominant shareholders occupying a "semi-trustee status."

g. Implications of the Trust Analogy

i. Distinguishing Director Fiduciary Duties from Duties Owed to Shareholders

The principal economic feature of the corporation is the separation of ownership from control. This notion speaks primarily to the ownership of the business as an entity or going concern. There is a second notion in which the corporation separates the legal ownership of its assets from the beneficial ownership. A corporation is like a trust in that the corporation owns legal title to its assets and business operations, while the shareholders hold equitable ownership. In that sense, the corporation is like a trustee and the shareholders are like the beneficiaries of the trust. However, there is an additional aspect to corporations that is unlike a trust. While the corporation holds legal title, it can do nothing apart from its agents. Control over the assets and operation of the corporation is vested in the directors and officers. A trustee holds both legal title and exercises control. A corporation only holds legal title. Therefore, the analysis under Texas law places fiduciary duties on the directors and officers, and these duties are owed to the corporation. These are the duties that come out of the exercise of control—duties that are based in the law of agency.[550] The duties owed to the shareholders, however, are the duties that come out of ownership—the same kinds of duties that the trustee owes to the beneficiary of the trust by virtue of the separation of legal and equitable title. Therefore, in distinguishing the duties owed to the shareholders as owners from the duties owed to the corporation by its managers, it is important to examine the interests that the law protects in equitable ownership. Admittedly, this is somewhat of an artificial distinction, growing out of the legal fiction of the corporation as a separate person. The Delaware scheme of looking to the directors as owing fiduciary duties directly to the shareholders probably makes more sense, but at present this analysis is necessitated by the choices made in Texas jurisprudence.

ii. The Duties Derive from Shareholder Status

Under this reasoning, the relationship between shareholder and corporation is most definitely a "formal" fiduciary relationship. The rights and duties protecting the shareholder arise as a matter of law from the legal status of the shareholder and are not issues for the finder of fact. There was some hint of this in *Willis v. Donnelly*, which treated the claim that a majority shareholder owes a minority shareholder fiduciary duties as distinct from a fiduciary duty arising from a confidential relationship and held that no fiduciary duty could have arisen in that case because the plaintiff was never a shareholder.[551]

iii. Liability of Officers, Directors, and Controlling Shareholders

In identifying the nature and source of the duties, it is useful to analyze the duties as being owed by the corporation. In practical terms of assigning liability for the breach of those duties, however, corporations "can act only through human agents."[552] Therefore, conduct that violates the duties that the corporation owes to shareholders will always be performed by corporate directors, officers or employees, and will be caused by those in control of the corporation whether directors or majority shareholders. Under Texas law, "where a third party knowingly participates in the breach of duty of a fiduciary, such third party becomes a joint tortfeasor with the fiduciary and is liable as such."[553] Furthermore, instigating, aiding, or abetting the wrongdoing constitutes participation.[554] "A corporate officer may be held individually liable for a corporation's tortious conduct if he knowingly participates in the conduct or has either actual or constructive knowledge of the tortious conduct."[555] In *Cotton v. Weatherford Bancshares, Inc.*, the court held

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[550] *See* RESTATEMENT (SECOND) OF TRUSTS § 16A, cmt. (a) (1959) ("The officers and directors of a corporation do not hold the title to the property of the corporation and therefore are not trustees.").

[551] 199 S.W.3d 262, 277 (Tex. 2006).

[552] *In re* Merrill Lynch Trust Co., 235 S.W.3d 185, 188 (Tex. 2007).

[553] Kinzbach Tool Co. v. Corbett-Wallace Corp., 160 S.W.2d 509, 514 (Tex. 1942). *See also* Baty v. ProTech Ins. Agency, 63 S.W.3d 841, 863 (Tex. App.—Houston [14th Dist.] 2001, pet. denied); Cotten v. Weatherford Bancshares, Inc., 187 S.W.3d 687, 701 (Tex. App.—Fort Worth 2006, pet. denied); Cox Tex. Newspapers, L.P. v. Wootten, 59 S.W.3d 717, 721 (Tex. App.—Austin 2001, pet. denied); Sw. Tex. Pathology Assoc., L.L.P. v. Roosth, 27 S.W.3d 204, 208 (Tex. App.—San Antonio 2000, pet. dism'd w.o.j.); Thompson v. Vinson & Elkins, 859 S.W.2d 617, 624 n.5 (Tex. App.—Houston [1st Dist.] 1993, writ denied); Kirby v. Cruce, 688 S.W.2d 161, 166 (Tex. App.—Dallas 1985, writ ref'd n.r.e.).

[554] *Cotten*, 187 S.W.3d at 701; Pabich v. Kellar, 71 S.W.3d 500, 508 (Tex. App.—Fort Worth 2002, pet. denied); Portlock v. Perry, 852 S.W.2d 578, 582 (Tex. App.—Dallas 1993, writ denied). *See In re* Skyport Global Commc'ns, Inc., No. 10-03150, 2011 WL 111427, at *49 (S.D. Tex. Jan. 13, 2011).

[555] *Cotton*, 187 S.W.3d at 701.

that corporate directors could be held individually liable for oppression against preferred shareholders if they favored the interests of the common shareholders over the interests of the preferred shareholders.[556]

iv. Liability Flows From Control, Not Majority Ownership

Most of the opinions describe the duties as being owed by the majority shareholders to the minority shareholders. However, in Texas Business Organizations Code § 11.404, the statutory basis for remedies to oppressive conduct does not apply to "majority shareholders" but to "directors and those in control of the corporation." Moreover, as noted above, it is more useful and accurate to recognize that the corporation owes the duties to its shareholders. This analysis preserves the general rule that co-shareholders, as such, do not owe duties to each other.[557] A majority shareholder may be held liable if he uses his position of control to cause the corporation to violate the rights of one of the other shareholders, but the liability flows from control, not from majority ownership.[558]

There are many ways that a shareholder with less than majority ownership might obtain control over the corporation, such as banding together with other shareholders to act jointly as a majority or obtaining control over the board of directors. In *Hoggett v. Brown*, the Fourteenth Court of Appeals held that a 50% shareholder did not owe fiduciary duties to a minority shareholder because he did not have control.[559] The court's recitation of the facts, however, clearly indicates that this conclusion is wrong, that the 50% shareholder was in a position to oppress the minority shareholder without a majority ownership of the shares. In *Hollis v. Hill*,[560] the corporation had two shareholders, both with 50% ownership, and were the only directors. This situation of deadlock left one shareholder, who was the president, in effective control over the other, who was the vice president. The Fifth Circuit noted that fiduciary duties applied as a result of one shareholder's control of the corporation, without regard to ownership.[561]

5. Interests Protected—"Reasonable Expectations"

According to *Davis v. Sheerin*, the purpose of oppression cause of action is to protect minority shareholder's "interest and his rights in the corporation."[562] The *Davis* and the *Ritchie* courts have referred to these rights and interests as the "reasonable expectations" of the shareholders.[563] Oppression of minority shareholders is conduct that "substantially defeats" these "reasonable expectations."[564]

What are the shareholder's reasonable expectations? Texas courts recognize that rights and interests of each shareholder arise "from the nature of the organization, and the relation of the stockholders to the corporation and its property."[565] The *Davis* court articulated a generalized duty of good faith and fair dealing—the shareholder's interest in "fair play on which every shareholder that entrusts his money to a company is entitled to rely."[566] The *Davis* opinion also contemplates other more fact-specific kinds of expectations that "that objectively viewed were both reasonable under the circumstances and were central to the minority shareholder's decision to join the venture."[567] Furthermore, the ownership of stock in a corporation involves an "array of rights" possessed the individual shareholders that "spring from many sources:

(a) the corporation's organic documents,
(b) agreements between shareholders or between the corporation and shareholders,
(c) statutory corporation law, and

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[556] *See id.* at 700–01. *See also* TEX. BUS. ORG. CODE § 11.404 (receivership remedy for "oppressive conduct" by "directors and those in control of the corporation").

[557] Allen v. Devon Energy Holdings, LLC, 367 S.W.3d 355, 390 (Tex. App.—Houston [1st Dist.] 2012, pet. granted, judgm't vacated w.r.m.); *Hoggett*, 971 S.W.2d at 488.

[558] *See, e.g.*, Tigrett v. Pointer, 580 S.W.2d 375, 379 (Tex. App.—Dallas 1978, writ ref'd n.r.e.) ("the peculiar duty of a controlling stockholder to deal fairly with the corporation, its stockholders, and creditors is broader than the trust-fund doctrine. It rests on his inside knowledge of the corporation's affairs and his opportunity to manipulate them for his personal advantage.").

[559] Hoggett, 971 S.W.2d at 488 n.13.

[560] 232 F.3d 460, 463 (5th Cir. 2000) (applying Nevada law).

[561] *Id.* at 467 n.21.

[562] 754 S.W.2d 375, 383 (Tex. App.—Houston [1st Dist.] 1988, writ denied).

[563] *See id.* at 381; Ritchie v. Rupe, 339 S.W.3d 275, 291 (Tex. App.—Dallas 2011, pet. filed). *See also* Boehringer v. Konkel, 404 S.W.3d 18, 23 (Tex. App.—Houston [1st Dist.] 2013, no pet.) (holding that general expectations are central to the decision to invest in the corporation); Argo Data Res. Corp. v. Shagrithaya, 380 S.W.3d 249, 265 (Tex. App.—Dallas 2012, pet. filed) (reasoning that general reasonable expectations arise from "the mere status of being a shareholder").

[564] *Davis*, 754 S.W.2d at 383.

[565] Moroney v. Moroney, 286 S.W. 167, 169 (Tex. Comm. App. 1926, judgm't adopted).

[566] *Davis*, 754 S.W.2d at 382.

[567] *Id.* at 381.

(d) decisional law governing the operation of corporations."[568]

Because corporations are set up differently, these rights and interests "may well vary from one corporation to the next."[569]

a. Statutory and Common Law Rights of Shareholders

In *Willis v. Bydalek*, the court held: "Texas law does not recognize a minority shareholder's right to continued employment without an employment contract. . . . All are presumed to know the law. Expectations of continued employment that are contrary to well-settled law cannot be considered objectively reasonable." [570] However, the court's reasoning must also be true in the converse: If all are presumed to know the law, then every shareholder must be deemed to have an objectively reasonable expectation in the corporation's respect of the shareholder's rights and fulfillment of the corporation's duties, where those rights and duties are recognized in statutory or common law.

i. Right to Security in Ownership

The most fundamental right of a shareholder as against the corporation is to be secure in his ownership. A trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary. [571] Similarly, the corporation and those who control it have a duty to recognize, to respect, and not to attempt to interfere with such ownership. "The shareholder is entitled to rely upon [the corporation's] not attempting to impair his interest. He is chargeable with no vigilance to preserve his stock or its fruits from appropriation by the corporation, but may confide in its protection for their security."[572] In *Davis v. Sheerin*, the court held that an attempt by the majority shareholder to deprive the minority shareholder of his ownership interest in the corporation by refusing to acknowledge that he was a shareholder, even though the attempt was ultimately unsuccessful and resulted in no damages, violated the shareholder's rights and interests in the extreme, because such conduct "not only would substantially defeat any reasonable expectations appellee may have had . . . but would totally extinguish any such expectations."[573]

ii. Right to Vote and Be Heard

Probably the next most fundamental right is the right to meet periodically, to have the opportunity to confront management, and vote on the directors and other matters in a proceeding where the vote of every share of the same class will be counted the same.[574] Efforts to disenfranchise a shareholder or otherwise eliminate his participation rights are oppressive. [575]

iii. Right to Information

A shareholder's right to information about the corporation is also vital and reflects the fundamental duties of disclosure owed by trustees.[576] Likewise, both under the common law and statutory law, corporations are required to keep records and accounts and to permit shareholders to inspect the records. [577] The shareholder's right to examine the books and records of the corporation "is a privilege . . . incident to his ownership of stock."[578] The right to inspect corporate books and records exists so that the shareholder may "ascertain whether the affairs of the corporation are properly conducted and that he may vote intelligently

[568] Schautteet v. Chester State Bank, 707 F. Supp.885, 888 (E.D. Tex. 1988).
[569] Id.
[570] Willis v. Bydalek, 997 S.W.2d 798, 803 (Tex. App.—Houston [1st Dist.] 1999, no writ).
[571] Restatement (Second) of Trusts §170(1).
[572] Yeaman v. Galveston City Co., 167 S.W. 710, 723 (Tex. 1914).
[573] Davis v. Sheerin, 754 S.W.2d 375, 382 (Tex. App.—Houston [1st Dist.] 1988, writ denied).
[574] *See* TEX. BUS. ORGS. CODE §§ 21.351–21.363.
[575] *See* Boehringer v. Konkel, 404 S.W.3d 18, 20 (Tex. App.—Houston [1st Dist.] 2013, no pet.) (controlling shareholder "voted his 501 shares against Konkel's 499, with Konkel losing every measure; Boehringer also made his wife vice president in place of Konkel); *Davis*, 754 S.W.2d at 383 (controlling shareholder's refusal to allow minority shareholder "any interest or voice in the corporation"); Willis v. Bydalek, 997 S.W.2d at 802 (failure to notify a shareholder of meetings is oppressive, citing Baker v. Commercial Body Builders, Inc., 507 P.2d 387, 390–91, 398 (Or. 1973)).
[576] *See* RESTATEMENT (SECOND) OF TRUSTS § 172 (1959) (duty to the beneficiary to keep and render clear and accurate accounts with respect to the administration of the trust); § 173 (duty to the beneficiary to give him upon his request at reasonable times complete and accurate information as to the nature and amount of the trust property, and to permit him or a person duly authorized by him to inspect the subject matter of the trust and the accounts and vouchers and other documents relating to the trust).
[577] *See* TEX. BUS. ORGS. CODE §§ 3.151–3.153, 21.173, 218–222 (2012).
[578] Johnson Ranch Royalty Co. v. Hickey, 31 S.W.2d 150, 153 (Tex. App.—Amarillo 1930, writ ref'd).

on questions of corporate policy and management."[579] Refusal to give minority shareholder access to corporate information is oppressive. [580]

iv. Right to Equality and Neutrality

When there are two or more beneficiaries of a trust, the trustee is under a duty to deal impartially with them. [581] Similarly, in a corporation, shares are theoretically fungible. Every share of the same class gets the same vote, the same dividend, and is entitled to the same treatment. In a dispute among shareholders over who will control the corporation, the corporation must remain strictly neutral. [582] The most common challenged conduct in oppression cases is manipulation of the control over the corporation to make the majority's investment more valuable than the minority's or otherwise to use the minority shareholder's own corporation against him to disadvantage the minority relative to the majority.[583]

v. Expectation of Economic Return

Inherent in the nature of the investment is a reasonable expectation of economic return, if the venture is successful. In *Moroney v. Moroney*,[584] the court held: "Indeed, in every profitable corporate venture, the rights of the stockholder are of great importance, and at all times will be properly protected, whether in a court of law or equity, according to the exigencies of the situation. The chief value of corporate stock is its right to receive dividends. So important is this right that courts of equity will, in a proper case, compel a payment of dividends."[585]

In many small corporations, dividends are not paid but all shareholders obtain an economic return through salary. This is the reason that loss of employment is so often at the center of shareholder oppression cases—not so much that the shareholder has an expectation of lifetime employment as that the termination of employment by those in control of the corporation eliminates the minority shareholder's ability to receive any economic return on his investment. In *Willis v. Bydalek*, the court held that a minority shareholder's loss of employment (without more) was not oppressive because the employee was at will and could not have an objectively reasonable expectation of continual employment.[586] However, the court repeatedly emphasizes that the corporation lost money and that the other shareholder did not take a salary or any other money out of the corporation. Therefore, there was no economic return to lose. The court distinguished the withholding of dividends in *Boehringer v. Konkel,*[587] *Davis v. Sheerin*, and in *McCauley v. Tom McCauley & Son, Inc.,*[588] and the firing of the minority shareholders in *Duncan v. Lichtenberger*, in *In re Topper*,[589] and in *Baker v. Commercial Body Builders, Inc.,*[590] by noting that in each of those cases the corporation was generating income, that money was available to give the minority shareholder a return, and that the majority shareholder in each case was benefiting economically at the expense of the minority.

vi. Equitable Interests in Corporation's Assets

The shareholders are the equitable and beneficial owners of the corporation's assets.[591] For this reason, many courts have recognized that conduct by those in control of the corporation that harms the corporation or diminishes its assets—claims which belong solely to the corporation—do, in some sense, violate the rights and interests of the minority shareholders and can

[579] Id.

[580] *See* Boehringer v. Konkel, 404 S.W.3d 18, 25 (Tex. App.—Houston [1st Dist.] 2013, no pet.) (denying access to books and records alone would "support the trial court's finding of shareholder oppression"); Redmon v. Griffith, 202 S.W.3d 225, 235–36 (Tex. App.—Tyler 2006, pet. denied).

[581] Restatement (Second) of Trusts at § 183 (1959).

[582] Alexander v. Sturkie, 909 S.W.2d 166, 170 (Tex. App.—Houston [14th Dist.] 1995, writ denied).

[583] *See* Boehringer v. Konkel, 404 S.W.3d 18, 28 (Tex. App.—Houston [1st Dist.] 2013, no pet.) (oppression by majority's $20,000 per month salary increase, which resulted in a "de facto dividend to the exclusion of . . . the minority shareholder"); Davis v. Sheerin, 754 S.W.2d 375, 382 (Tex. App.—Houston [1st Dist.] 1988, writ denied) (oppression by payment of "informal dividends" only to the majority and use of corporate funds to pay the majority shareholder's legal fees).

[584] 286 S.W. 167, 169 (Tex. Comm. App. 1926, judgm't adopted).

[585] *See also* Byerly v. Camey, 161 S.W.2d 1105, 1110 (Tex. Civ. App.—Fort Worth 1942, writ ref'd w.o.m.) ("The stockholder has a right to his share of the profits while the corporation is a going concern, and to a share of the proceeds of its assets, when sold for distribution in case of its dissolution and winding up.").

[586] *See* Willis v. Bydalek, 997 S.W.2d 798, 802 (Tex. App.—Housotn [1st Dist.] 1999, no writ).

[587] *Boehringer*, 404 S.W.3d at 25.

[588] 724 P.2d 235, 238–40 (N.M. 1986).

[589] 433 N.Y.S.2d 359, 361–62 (N.Y. Sup. Ct. 1980).

[590] 507 P.2d 387, 390–91 (Or. 1973).

[591] McAlister v. Eclipse Oil Co., 98 S.W.2d 171, 176 (Tex. 1936).

constitute oppression, particularly when the majority does not suffer equally with the minority.[592]

b. Organic Documents of the Corporation

Shareholders are permitted broad latitude in ordering the affairs of the corporation. Therefore, shareholders may create or modify rights and interests in the corporation's articles, by-laws and other organizational documents, by written shareholder agreements, or by resolutions passed unanimously at shareholder meetings. "The shareholders of a corporation are the equitable owners of its assets and may bind the corporation by a contract that all of the shareholders sign."[593]

c. Quasi-Contractual Expectations

As formulated in *Davis v. Sheerin* and followed by other courts of appeals, the shareholder oppression cause of action protects minority shareholders' reasonable expectations from being substantially defeated by the actions of controlling shareholders.[594] In order to be worthy of protection, a shareholder's expectation must be (1) objectively reasonable under the circumstances and (2) central to the minority shareholder's decision to join the venture.[595] This formulation permits minority shareholders to protect rights and interests that stem from even unspoken understandings and practices. For example, if all the shareholders understood from the outset of the enterprise that all the shareholders would participate and have a voice in management, that all would be employed by the corporation so long as they owned their stock, and that all profits would be fairly distributed by means of increases in salary and bonuses, then these mutual expectations would surely become rights and interests incident to stock ownership, just as if they were expressly provided in a written shareholder's agreement.

i. Reasonable Expectations and Implied Contracts

Under Texas law, contracts may be expressly stated orally or in writing or may be implied from the facts and circumstances indicating a mutual intent to form an agreement.[596] "Our courts have recognized that the real difference between express contracts and those implied in fact is in the character and manner of proof required to establish them."[597] The terms of an implied agreement are determined from all the surrounding circumstances, including the statements and conduct of the parties, industry customs and standards, course of dealing, etc.[598] A minority shareholder's reasonable expectations concerning the rights and interests that are incident to stock ownership are really nothing more than the agreements made by the shareholders that may be implied from the facts and circumstances. In assessing a shareholder's reasonable expectations, a court "must investigate what the majority shareholders knew, or should have known, to be the [shareholder]'s expectations in entering the particular enterprise."[599] Not every instance of an expectation frustrated will deemed oppressive, the expectations that will be protected by the shareholder oppression cause of action are only those that are both "objectively reasonable" under all the circumstances and "central" to the decision to become a shareholder.[600] Likewise, conduct "should not be deemed oppressive simply because the [minority shareholder]'s subjective hopes and desires in joining the venture are not fulfilled. Disappointment alone should not necessarily be equated with oppression."[601] Returning to *Willis v. Bydalek*, the court held that the plaintiff's "expectations of continued employment, without a contract, [were not] 'objectively

[592] *See Boehringer*, 404 S.W.3d at 25 (majority shareholder gave himself a sizeable salary increase, removed minority as vice president and replaced him with majority's wife); Redmon v. Griffith, 202 S.W.3d 225, 235 (Tex. App.—Tyler 2006, pet. denied) (defendants made improper loans to themselves, paid personal expenses from corporate funds, diverted corporate opportunities, and paid excessive dividends to themselves); Davis v. Sheerin, 754 S.W.2d 375, 382 (Tex. App.—Houston [1st Dist.] 1988, writ denied) (excessive salaries by controlling shareholders is a "typical 'squeeze out' technique").

[593] *In re* Estate of Trevino, 195 S.W.3d 223, 230 (Tex. App.—San Antonio 2006, no pet.); *see* Martin v. Martin, Martin & Richards, Inc., 12 S.W.3d 120, 124 (Tex. App.—Fort Worth 1999, no pet.).

[594] *Davis*, 754 S.W.2d at 381.

[595] Id.

[596] *See* Haws & Garrett Gen. Contractors, Inc. v. Gorbett Bros. Welding Co., 480 S.W.2d 607, 609 (Tex. 1972).

[597] Id.

[598] *See id. See also* Runnells v. Firestone, 746 S.W.2d 845, 850–51 (Tex. App.—Houston [1st Dist.] 1988), writ denied, 760 S.W.2d 240 (Tex. 1988); City of Houston v. First City, 827 S.W.2d 462, 473 (Tex. App.—Houston [1st Dist.] 1992, writ denied); Adams v. Petrade Int'l, 754 S.W.2d 696, 717 (Tex. App.—Houston [1st Dist.] 1988, writ denied).

[599] *In re* Kemp & Beatley, Inc., 473 N.E.2d 1173, 1179 (N.Y. 1984).

[600] Davis v. Sheerin, 754 S.W.2d 375, 381(Tex. App.—Houston [1st Dist.] 1988, writ denied).

[601] *In re* Kemp & Beatley, Inc., 473 N.E.2d at 1179.

reasonable.'" [602] This statement, however, begs the question. The opinion certainly reveals that the expectation that employment was a right and interest incident to stock ownership existed in that case. All parties understood that expectation. All parties acted in accordance with that expectation until the dispute arose. The plaintiff in that case certainly relied to his detriment on that expectation by relocating to Texas from Wisconsin and investing his life savings into the venture. Under these circumstances, the expectation that employment was a benefit of stock ownership was certainly objectively reasonable at least in the beginning and was undoubtedly central to the investment decision. Therefore, in *Willis v. Bydalek*, the same facts establishing the plaintiff's reasonable expectations also establish that the plaintiff did, in fact, have a contract. The court is simply wrong that the absence of a contract was determinative. However, the holding is no doubt correct that, under the circumstances, the minority shareholder's disappointment did not constitute oppression because there was no loss of economic return, the venture was not successful, and the majority shareholder did not act in bad faith or evidence a pattern of oppressive behavior beyond the firing.

ii. Balancing Other Factors

Courts have held that caution is necessary in determining what constitutes oppressive conduct.[603] In determining whether a shareholder's expectations are objectively reasonable under the circumstances, and whether the frustration of those expectation constitutes oppression, the court cannot ignore other relevant factors that may justify the conduct of the majority. There is a very real risk that the effort to protect the interests of minority shareholders could unduly restrict the ability of management to run corporations. Despite the existence of legal duties protecting minority shareholders, a corporation's officers and directors are still afforded rather broad latitude in conducting corporate affairs. [604] In determining whether the shareholder's expectations are objectively reasonable, and thus whether specific conduct is oppressive, courts are required to balance the minority shareholder's reasonable expectations against the corporation's need to exercise its business judgment and run its business efficiently.[605]

## VI. ESTABLISHING LIABILITY FOR SHAREHOLDER OPPRESSION

### A. Proving Oppressive Conduct

1. Shareholder Status

The first fact that must be established is that the plaintiff is in fact a shareholder. In many cases, this is the central issue.[606] Because the fiduciary duties arise from the formal relationship of minority shareholder to the corporation and because shareholder status is the prerequisite to asserting any claim on behalf of the corporation, proof of share ownership is critical. However, as will be shown below, contesting share ownership is a risky defense strategy. If the plaintiff convinces the court that he is a shareholder, then the defendant's refusal to recognize the share ownership will be strong evidence of oppression.

a. Unperformed Agreement to Issue Shares

Very frequently, the minority shareholder is an employee who has made an agreement to earn his ownership interest over time. After the employee has performed his part of the agreement, the majority shareholder may regret the deal and delay or refuse to issue the shares. This was the situation exactly in *Willis v. Donnelly*.[607] In that case, the defendant was the sole shareholder of a corporation that was established to operate a day spa. The defendant contracted with the plaintiff, who owned a successful hair salon, to give up his existing business and to transfer his staff and customers, for which the plaintiff would receive a 25% ownership in the corporation as soon as the new business reached a certain revenue goal.[608] However, defendant soon regretted this agreement, because the costs and capital requirements were much greater than anticipated, and when the revenue targets were reached the corporation was still losing money. [609] The defendant demanded that the plaintiff "act like an owner" by contributing capital or assuming some of the debt and was frustrated when the plaintiff refused to do so.[610] Therefore, the defendant delayed issuing the stock and later persuaded the plaintiff to consent to the delay so that the defendant could get all the tax benefits of the losses from the S corporation. [611] Ultimately, the plaintiff was fired without ever having

[602] Willis v. Bydalek, 997 S.W.2d 798, 803 (Tex. App.—Houston [1st Dist.] 1999, pet. denied).
[603] *Id.* at 801; McCauley v. Tom McCauley & Son, Inc., 724 P.2d 232, 237 (N.M. 1986).
[604] *Willis*, 997 S.W.2d at 801; Masinter v. WEBCO Co., 262 S.E.2d 433, 438 (W. Va. 1980).
[605] *See* Ritchie v. Rupe, 339 S.W.3d 275, 289 (Tex. App.—Dallas 2011, pet. granted); *Willis*, 997 S.W.2d at 801; Landstrom v. Shaver, 561 N.W.2d 1, 8 (S.D. 1997).
[606] *See, e.g.*, Willis v. Donnelly, 199 S.W.3d 262 (Tex. 2006); Davis v. Sheerin, 754 S.W.2d 375 (Tex. App.—Houston [1st Dist.] 1988, writ denied).
[607] 199 S.W.3d 262.
[608] *Id.* at 266.
[609] *Id.* at 267.
[610] *See* Willis v. Donnelly, 118 S.W.3d 10, 24 (Tex. App.—Houston [14th Dist.] 2003), *aff'd in part, rev'd in part*, 199 S.W.3d 262 (Tex. 2006).
[611] *Willis*, 199 S.W.3d at 268.

received his shares.[612] The Supreme Court reversed a judgment for the plaintiff for breach of fiduciary duty, holding that no duties arose because the plaintiff was never a shareholder.[613] Based on this holding, the plaintiff's only claim was for breach of the contract to issue the shares, which greatly restricted the remedies available to the plaintiff and probably diminished the potential recovery.[614]

When does one become a shareholder? The transfer of share ownership is a matter of contract. When there is a "manifest intention of the parties to this enterprise" that a person is a shareholder, and then he is a shareholder.[615] The Texas Supreme Court has held: "He becomes a full stockholder, certainly where he has performed his obligation, and possession all of a stockholder's right, even if no certificate is issued to him at all."[616] In *Greenspun v. Greenspun*,[617] an employee of a corporation claimed that that the sole shareholder of the corporation had conveyed 500 shares to him; the sole shareholder denied that such a conveyance had taken place and relied on the fact that he had possession of all the stock certificates while the employee had none. The jury found that there was an agreement to transfer 500 shares, and the Court of Appeals held that, as a legal matter, "transfer of title may take place though there is no delivery of the certificates themselves, nor endorsement of them, nor transfer of them on the books of the corporation, and even though the sale be by parol."[618] In affirming the lower court's opinion, the Texas Supreme Court specifically adopted this portion of the opinion.[619]

The plaintiff in *Willis v. Donnelly* should probably have argued that he became a shareholder by virtue of the letter agreement the moment that the revenue target was reached, that the agreement to transfer ownership was essentially self-executing. However, that argument was precluded by the theory that the defendant had breached the letter agreement by not issuing the shares, which the jury found was the fact.[620] Furthermore, the undisputed evidence was that the transfer of ownership was delayed (not merely the issuance of share certificates) so that the defendant could continue to enjoy the tax benefits of the corporation' losses, which would have to be shared with the plaintiff once the plaintiff became a shareholder.[621] Therefore, in *Willis v. Donnelly*, it was clear on that record that ownership had not been transferred to the plaintiff.

b. Stock Ownership Not Recorded

Another very common factual situation in closely held corporations is that stock certificates are never formally issued. Often the blank stock certificates simply stay in the corporate book. Sometimes the owners even neglect to create a stock ledger showing the names and number of shares held by each shareholder, or the owners fail to keep the ledger up to date with subsequent transfers or issuances. When disputes arise later, the majority shareholder is sometimes tempted to claim that the minority shareholder is not a shareholder because the minority shareholder does not have a share certificate or because the minority shareholder's interest is not recorded in the corporate books. As a legal matter, the issuance of the stock certificate is not necessary for a person to be a shareholder. In *Yeaman v. Galveston City Co.*,[622] the Texas Supreme Court held: "In a corporation the certificate of stock is not the stock itself; it is but a muniment of title, an evidence of ownership of the stock. It is not necessary to a subscriber's complete ownership of the stock."[623] The same is true with regard to the stock ledger.[624]

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[612] *Id.* at 268–69.

[613] *Id.* at 277.

[614] *See Willis*, 118 S.W.3d at 40 (holding that the proper measure of damages is "fair market value" of the shares, as opposed to "fair value" in a compulsory buy-out), *aff'd in relevant part*, 199 S.W.3d at 275–76.

[615] Yeaman v. Galveston City Co., 167 S.W. 710, 719 (Tex. 1914).

[616] *Id.* at 720.

[617] 194 S.W.2d 134 (Tex. Civ. App.—Fort Worth), *aff'd*, 198 S.W.2d 82 (Tex. 1946).

[618] *Id.* at 137.

[619] *See Greenspun*, 198 S.W.2d at 83.

[620] *Willis*, 199 S.W.3d at 269.

[621] *Id.* at 277–78. The plaintiff might have created a fact issue, however, by maintaining that he was a shareholder and that the tax reporting was a ruse.

[622] 167 S.W. 710, 720 (Tex. 1914),

[623] *See also* Estate of Crawford, 795 S.W.2d 835, 838 (Tex. App.—Amarillo 1990, no writ) ("Complete ownership of certificated stock may exist without the issuance of a certificate or its delivery."); *Rogers v. Butler*, 563 S.W.2d 840, 843 (Tex. Civ. App.—Texarkana 1978, writ ref'd n.r.e.) ("Rogers and Butler were stockholders in Fiesta International, Inc., even though certificates of stock were never issued."); Estate of Bridges v. Mosebrook, 662 S.W.2d 116, 120 (Tex. App.—Fort Worth 1983, writ ref'd n.r.e.).

[624] Humble Oil & Refining Co. v. Blankenburg, 235 S.W.2d 891, 894 (Tex. 1951)("Entry on the books of the corporation is not necessary to pass title to stock."); De Anda v. De Anda, 662 S.W.2d 107, 109 (Tex. App.—San Antonio 1983, no writ) ("The requirement that stock transfer be recorded on the corporate books is to protect the corporation, however, failure of the corporation to record a transfer does not invalidate the transfer."); Alba Nat'l Bank v. Shaw, 18 S.W.2d 728, 729 (Tex. Civ. App.—Texarkana 1929, writ ref'd) ("It has been definitely decided in this state that the entry of the transfer on the books of the

2. Oppressive Conduct Defined

The standard definition of the elements of shareholder oppression is as follows:

> 1. [M]ajority shareholders' conduct that substantially defeats the minority's expectations that, objectively viewed, were both reasonable under the circumstances and central to the minority shareholder's decision to join the venture; or
> 2. [B]urdensome, 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.[625]

However, as the court noted in *Davis v. Sheerin*, "Oppressive conduct has been described as an expansive term that is used to cover a multitude of situations dealing with improper conduct, and a narrow definition would be inappropriate."[626] "Courts may determine, according to the facts of the particular case, whether the acts complained of serve to frustrate the legitimate expectations of minority shareholders, or whether the acts are of such severity as to warrant the requested relief."[627] "Oppressive conduct is an independent ground for relief not requiring a showing of fraud, illegality, mismanagement, wasting of assets, nor deadlock, the other grounds available for shareholders, though these factors are frequently present."[628] "Moreover, a claim of oppressive conduct can be independently supported by evidence of a variety of conduct."[629]

3. Pattern of Conduct and Continuance into Future

A claim of oppressive conduct can be independently supported by evidence of a variety of conduct.[630] A finding of oppression is never based on a single act. Rather the courts focus on a pattern of conduct. It is this pattern of conduct that proves that "the likelihood that [the oppressive conduct] would continue in the future,"[631] "Likelihood that it would continue in the future,"[632] "consequent possibility of repetition"[633]

In *Davis v. Sheerin*, the court of appeals based its holdings that there was sufficient evidence of oppression and that it would continue in the future on "the jury's finding of conspiracy to deprive appellee of his interest in the corporation, together with the acts of willful breach of fiduciary duty as found by the jury, and the undisputed evidence indicating that appellee would be denied any future voice in the corporation."[634] The pattern of oppressive conduct found by the court in *Davis* consisted of the following acts:

> (a) denial of the minority shareholder's right to inspect the books and records of the corporation;
> (b) the denial of the minority shareholder's ownership interest, coupled with clear documentary evidence of ownership;
> (c) the intent to deprive the minority shareholder of his ownership interest, coupled with past attempts to purchase the shares;
> (d) misappropriation of corporate funds through contributions to a profit sharing plan solely for the majority shareholder, which the court characterized as "informal dividends;"
> (e) misappropriation of corporate funds to pay the majority shareholder's attorney during the lawsuit, which the court characterized as "waste;" and
> (f) the majority shareholder's statement at a board meeting that the minority shareholder's "opinions or actions would have no effect on the Board's deliberations."[635]

This list is very interesting because items 1, 4 and 5 clearly have legal remedies, and the trial court did in

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corporation, where such formality is required, is not necessary to vest the title to the stock in a transferee, if the contract of assignment is otherwise sufficient.").

[625] Redmon v. Griffith, 202 S.W.3d 225, 234 (Tex. App.—Tyler 2006, pet. denied). *See* Cotton v. Weatherford Bancshares, Inc., 187 S.W.3d 687, 699–700 (Tex. App.—Fort Worth 2006, pet. filed); Gonzalez v. Greyhound Lines, Inc., 181 S.W.3d 386, 392 n.5 (Tex. App.—El Paso 2005, pet. denied); Willis v. Donnelly, 118 S.W.3d 10, 32 n.12 (Tex. App.—Houston [14th Dist.] 2003), *aff'd in part, rev'd in part*, 199 S.W.3d 262 (Tex. 2006); Pinnacle Data Servs., Inc. v. Gillen, 104 S.W.3d 188, 196 (Tex. App.—Texarkana 2003, no pet.); Willis v. Bydalek, 997 S.W.2d 798, 801 (Tex. App.—Houston [1st Dist.] 1999, pet. denied); Davis v. Sheerin, 754 S.W.2d 375, 381–82 (Tex. App.—Houston [1st Dist.] 1988, writ denied).

[626] *Davis*, 754 S.W.2d at 381 (citing *McCauley*, 724 P.2d at 236).

[627] Id.

[628] *Id.* at 381–82.

[629] *Redmon*, 202 S.W.3d at 234.

[630] *See id.*; *Davis*, 754 S.W.2d at 381.

[631] *Davis*, 754 S.W.2d at 383.

[632] Id.

[633] *Id.* at 384.

[634] *Id.* at 383.

[635] *Id.* at 378, 382.

fact award damages on all three claims. Item 2 refers to the position that the defendant took in the lawsuit. Items 2 and 3 did not result in any actual harm. Finally, and most significantly, items 5 and 6, and to a large extent item 2, all occurred after the lawsuit was filed. Half the oppressive behavior found significant by the court of appeals occurred in the defendant's conduct of the lawsuit. Clearly, the majority shareholder made things worse for himself by the way he reacted to and defended the lawsuit.

In *Willis v. Bydalek*, although not stated by the Court as such, the absence of a pattern of conduct was probably decisive in the court's reversal of the judgment of shareholder oppression. In that case, the court emphasized that the judgment had been based solely on one oppressive act, that of firing the minority shareholder, and distinguished *Davis v. Sheerin* and *Duncan v. Lichtenberger*, on the grounds that each of those cases involved multiple acts of oppression.[636]

4. Loss or Damage Is Not Required

The recovery in a shareholder oppression claim is not dependent upon any actual, measurable loss or damage. In *Davis v. Sheerin*,[637] upheld a judgment based on shareholder oppression, even though the jury found the majority shareholder's conspiracy to deprive the minority shareholder of his ownership interest was not a proximate cause of any damages. Moreover, although the appellate court held that the evidence supported the trial court's determination that the majority shareholder's actions were oppressive, based in large part on the jury's finding of a conspiracy to deprive the minority shareholder of his share interest in the corporation,[638] the appellate court was not troubled by the jury's ultimate negative finding on the cause of action for civil conspiracy due to their failure to find that the conspiracy was a proximate cause of any damages. "The court's judgment did not award damages based on a conspiracy cause of action. Instead, the court considered the various acts found by the jury and made a determination that such acts constituted oppressive conduct."[639]

i. Burden of Proof

In *Willis v. Donnelly*, the court of appeals held that it was proper for the burden of proof to be placed on the majority shareholder on the breach of fiduciary duty questions because "the profiting fiduciary has the burden to prove questioned transactions were 'fair, honest, and equitable.'"[640]

5. Specific Oppressive Conduct

a. Interference with Ownership

i. Attempt to Deprive of Stock Ownership

As the court noted in *Davis v. Sheerin*, "[C]onspiring to deprive one of his ownership of stock in a corporation, especially when the corporate records clearly indicate such ownership, is more oppressive" than traditional squeeze-out techniques because such conduct, if successful, "not only would substantially defeat any reasonable expectations appellee may have had . . . but would totally extinguish any such expectations"[641] *Willis v. Bydalek*, citing *Davis*, also notes that attempting "to deprive the minority shareholder of his stock" is evidence of oppressive conduct.[642] In *Willis v. Donnelly*, the court held that it was oppressive conduct for the majority shareholder to treat the minority shareholder as a nonowner because he had decided that the minority shareholder was "not acting like an owner" when the minority shareholder refused to contribute additional capital or to personally assume some of the corporation's debt.[643]

ii. Attempts to Purchase at an Unfair Price

*Davis v. Sheerin* noted that prior attempts to purchase minority shareholder's stock was evidence of majority shareholder's "desire to gain total control of the corporation."[644] Note: controlling shareholders must be extremely cautious in engaging in presuit settlement discussions with an aggrieved minority shareholder. An offer to purchase shares at an unfairly low price may become evidence of oppression.

iii. Cash-out Merger

"A merger or sale of assets that results in a "freeze out" of a shareholder is permitted by law, provided the transaction is properly approved by the requisite

[636] 997 S.W.2d 798, 802.
[637] 754 S.W.2d 375, 381 (Tex. App.—Houston 1988, writ denied),
[638] *Id.* at 383.
[639] *Id.* at 381; *see also* Allchin v. Chemic, Inc., No. 14-01-00433-CV, 2002 WL 1608616, at *8 (Tex. App.—Houston [14th Dist.] 2002, no pet.) ("jury's failure to award damages is not a factor" in the determination of whether there was shareholder oppression).
[640] 118 S.W.3d at 34. *See also* Int'l Banks Life Ins. Co. v. Holloway, 368 S.W.2d 567, 577 (Tex. 1963) (directors have "the burden of proving fairness of the personal profits realized by them in each transaction); Tex. Bank & Trust Co. v. Moore, 595 S.W.2d 502, 508–09 (Tex. 1980); Estate of Townes v. Townes, 867 S.W.2d 414, 417 (Tex. App.—Houston [14th Dist.] 1993, writ denied); Miller v. Miller, 700 S.W.2d 941, 947 (Tex. App.—Dallas 1985, writ ref'd n.r.e.).
[641] *Davis*, 754 S.W.2d at 382.
[642] 997 S.W.2d at 802.
[643] 118 S.W.3d at 33.
[644] 754 S.W.2d at 383

number of shareholders."[645]

b. Depriving Shareholder of Economic Return

i. Loss of Employment

*Willis v. Bydalek* casts strong doubt on whether the firing of an at-will employee, and thus the denial of salary and denial of the right to participate, can be an act of oppression.[646] The court holds that the strong at-will employment doctrine and the deference shown to management under the business judgment rule, prevent "firing alone" from constituting shareholder oppression in the sense of "burdensome, harsh, or wrongful conduct" or "visible departure from the standards of fair dealing."[647] The court leaves open the possibility that firing an at-will minority shareholder might be evidence of oppressive conduct as part of a pattern of other oppressive acts, particularly if the other shareholders are receiving money from the corporation and the firing prevents the minority shareholder from receiving any economic return.[648] Furthermore, the court holds that the expectation of continued employment, without a contract, as a matter of law cannot constitute an "objectively reasonable" expectation.[649] "Texas law does not recognize a minority shareholder's right to continued employment without an employment contract. All are presumed to know the law. Expectations of continued employment that are contrary to well settled law cannot be considered objectively reasonable."[650] To some extent, the court's analysis begs the question. A shareholder would have an objectively reasonable expectation of continued employment if there was an explicit or implicit agreement that continued employment is one of the benefits of stock ownership in this corporation. In that case, there would be an employment agreement—"So long as you are a shareholder, you will have a job." This agreement, whether explicit or implied, would not run afoul of the Statute of Frauds because its term is indefinite. In *Willis v. Bydalek*, the court noted that the minority shareholder moved to Huntsville, Texas from Wisconsin and invested a substantial sum from his savings.[651] From these facts, a strong argument could be made for an implied contract, but the record before the court of appeals did not present such a finding.

ii. Defining Limits of Implied Contract—For Cause?

In *Redmon v. Griffith*, the court held: "The possibility exists that the firing of an at-will employee who is a minority shareholder can constitute shareholder oppression."[652] The court overturned a summary judgment on shareholder oppression, holding that the plaintiff could pursue a remedy for his termination of at-will employment within the context of his shareholder oppression claim.[653] The oppression claim in that case alleged oppressive acts in addition to the termination of employment.

In *Allchin*, the plaintiff claimed that he was constructively discharged, "forced to resign," as a result of the defendant's misconduct. The court's opinion assumes that such a claim could be part of a pattern of oppression, but holds that the evidence conclusively demonstrated that the plaintiff resigned voluntarily. "An employee who voluntarily leaves the employment of the corporation presents a less persuasive case for concluding the majority shareholders oppressed him."[654]

iii. Change Shareholder Status

A relatively common occurrence is that co-shareholders in a closely held corporation all work in the company and all participate in the company solely through salary, and then the situation changes so that the scheme of economic participation that all accepted in the past no longer works in an equitable manner. Most commonly, this is because one of the shareholders no longer works in the company, whether by termination, resignation, retirement, disability, or death. At this point, there should be a fiduciary duty to reconsider the past scheme of economic participation and come up with an alternative policy that fairly allows all to participate—usually, this would involve beginning to distribute profits by dividends, but could also involve payments on a consulting contract or some other mechanism to the nonemployee shareholder. In *Braswell v. Braswell*, the wife of the majority shareholder in a closely held corporation was awarded shares in the company as a result of a divorce.[655] The wife argued that the division of the stock was not equitable because she was now a shareholder in a corporation that was subject to the control of her ex-husband. The court noted that the corporation had never before paid dividends, but reasoned that both

[645] Hoggett v. Brown, 971 S.W.2d 472, 486 (Tex. App.—Houston [14th Dist.] 1997, writ denied). *See* Farnsworth v. Massey, 365 S.W.2d 1, 5 (Tex. 1963).

[646] Willis v. Bydalek, 997 S.W.2d 798, 801 (Tex. App.—Houston [1st Dist.] 1999, pet. denied).

[647] *Id.* at 802–03.

[648] *See id.* at 802.

[649] *Id.* at 803.

[650] *Id.* (citing Sabine Pilot Serv., Inc. v. Hauck, 687 S.W.2d 733, 734 (Tex. 1985)).

[651] *Id.* at 801.

[652] Redmon v. Griffith, 202 S.W.3d 225, 238 (Tex. App.—Tyler 2006, pet. denied).

[653] *Id.* at 239.

[654] Allchin v. Chemic, Inc., No. 14-01-00433-CV, 2002 WL 1608616, at *9 (Tex. App.—Houston [14th Dist.] July 18, 2002, no pet.).

[655] 476 S.W.2d 444, 447 (Tex. App.—Waco 1972, writ dism'd).

husband and wife had lived on the husband's salary taken out of the corporation and that it would have been costly in taxes and unwise for the corporation to pay dividends prior to the divorce. "We do not believe these facts raise a presumption that the corporation acting through its dominant officer and stockholders will not now regularly declare and pay reasonable dividends. If they should improperly refuse to do so, then any minority stockholder has his or her legal remedy.[656]

iv. Loss of Economic Return

The fundamental assumption of Texas law is that the shareholder has an economic purpose in acquiring his shares and that his reasonable expectations of an economic return should be protected. "The stockholder has a right to his share of the profits while the corporation is a going concern, and to a share of the proceeds of its assets, when sold for distribution in case of its dissolution and winding up."[657] In *Willis v. Bydalek*, one of the key factors in the court's holding that a minority shareholder's loss of employment was not oppressive was that the firing did not represent any loss of an economic return on investment (although it did certainly represent a loss of salary to the minority shareholder).[658] The court repeated emphasizes that the corporation lost money and that the other shareholder did not take a salary or any other money out of the corporation. Therefore, there was no economic return to lose. The court distinguished the withholding of dividends in *Davis v. Sheerin*, and in *McCauley*[659] and the withholding of dividends and firing of the minority shareholder in *Duncan v. Lichtenberger*, in *In re Topper*,[660] and in *Baker v. Commercial Body Builders, Inc.*,[661] by noting that in each of those cases the corporation was generating income, that money was available to give the minority shareholder a return, and that the majority shareholder in each case was benefiting economically.

c. Inequality Among Shares

Theoretically, shares in a corporation are fungible and all should have the same rights and benefits. As a practical matter, however, controlling shareholders are in a position to direct more than their fair share of benefits to themselves at the expense of the minority. This is an area where there can be much confusion because of the overlapping duties of those in control. A majority shareholder who deprives the minority shareholders of dividends by paying all the corporation's profit to himself as a bonus may be paying a preferential dividend on his shares and oppressing the minority shareholder, but the same conduct may also breach a duty of loyalty to the corporation through excessive compensation. The shareholders may sue in their own right for the oppression, but may only pursue the excessive compensation claim as a derivative claim on behalf of the corporation. Ultimately, there is no real conflict in the legal theories. The oppression claim is not really based on the preferential dividend; rather that conduct is part of the proof of a pattern of oppressive conduct. The court would not grant any specific remedy to compensate for the amounts wrongfully taken in the past. The breach of fiduciary duty claim by the corporation, however, would be a claim specifically for the damages caused by the wrongful conduct. Very frequently, an aggrieved minority shareholder will bring both claims, seeking to participate in the damages awarded to the corporation either through a court-ordered distribution or through an adjustment made to the value of the shares.

i. Inequitable Distributions through Constructive Dividends

Ordinarily, a claim that the officers or directors of a corporation took excessive compensation would be a claim belonging to the corporation. However, a minority shareholder can also characterize the same conduct as the payment of "informal" or "constructive" dividends to the controlling shareholders. The minority shareholders would be oppressed by the failure to pay them their share of the dividends. In *Davis v. Sheerin*, court held that jury's finding that "appellants received informal dividends by making profit sharing contributions for their benefit and to the exclusion of

[656] Patton v. Nicholas, 279 S.W.2d 848, 853 (Tex. 1955); *Morrison v. St. Anthony Hotel*, 295 S.W.2d 246, 250 (Tex. Civ. App.—San Antonio 1956, writ ref'd n.r.e.).

[657] Byerly v. Camey, 161 S.W.2d 1105, 1110 (Tex. Civ. App.—Fort Worth 1942, writ ref'd w.o.m.). *See also In re* Topper, 433 N.Y.S.2d 359, 361–62 (N.Y. Sup. Ct. 1980) (holding conduct oppressive when corporation flourished, but majority shareholders never paid dividends, and majority removed minority shareholder as officer and fired him); Baker v. Commercial Body Builders, Inc., 507 P.2d 387, 390–91, 398 (Or. 1973) (holding conduct oppressive when majority shareholder prevented minority shareholder from reviewing corporate books, took salary increase while denying one to minority shareholder, removed minority shareholder as officer and director, and ceased notifying him of meetings).

[658] *See* 997 S.W.2d 798, 802 (Tex. App.—Houston [1st Dist.] 1999, pet. denied).

[659] 724 P.2d 235, 238–40.

[660] 433 N.Y.S.2d 359, 361–62 (N.Y. App. Div. 1980).

[661] 507 P.2d 387, 390–91.

appellee" was evidence supporting a pattern of oppression.[662]

"A distribution by a corporation to its shareholders may constitute a dividend in law even though not formally designated as a dividend by the board of directors."[663] "[W]hether or not a corporate distribution is a dividend or something else, such as a loan, gift, compensation for services, repayment of a loan, interest on a loan, or payment for property purchased, presents a question of fact to be determined in each case."[664]

In *Ramo, Inc. v. English*, the corporation distributed substantial sums of money to the controlling shareholder, which were recorded on the books as advances. Only the first advance was documented with a board resolution; none of the advances were evidenced by a promissory note; and apparently the advances were without interest. The jury found that the controlling shareholder had no intention to repay the money.[665] A lender contended that these distributions were not loans, but were actually dividends in violation of a covenant in the security agreement. The Texas Supreme Court held that whether the distributions were loans or dividends was a question for the jury, but that the evidence would have supported a finding that the distributions were really dividends if a jury question had been submitted.[666]

In *Rivas v Cantu*, [667] the plaintiff sued the controlling shareholder for breach of contract and fraud for having failed to transfer 50% of the shares in a corporation as promised prior to incorporation. The plaintiff claimed as damages 50% of the amount of "constructive dividends" that the controlling shareholder had received. The court of appeals approved this measure of damages.[668] The court noted that "a constructive dividend occurs when an expenditure is made by a corporation for the personal benefit of a stockholder, or corporate-owned facilities are used by a stockholder for his personal benefit" and that" the crucial concept is that the corporation conferred an economic benefit on the stockholder without expectation of repayment."[669] The court held that constructive dividends could be established by evidence of excessive compensation paid by the corporation to family members of the controlling stockholders; however, a constructive dividend does not occur automatically when a stockholder's family member works for the corporation, but only when that relative is overcompensated.[670] There must be evidence that compensation was paid for work that was not done, or work that was not needed by the corporation, or that the compensation for the services performed was unreasonably high.[671]

In *Boehringer v. Konkel*, the majority shareholder withheld dividends for two years, claiming that the corporation did not have the funds to pay dividends in those years.[672] However, the plaintiff also increased his salary to $20,000 per month during this time. The court concluded that the majority "withheld payment of a dividend and used his two-fold pay increase as a means of denying [the minority shareholder] his proportionate participation in the company's earnings . . . ."[673]

ii. Inequitable Distributions Resulting from Harm to Corporation

In *Willis v. Donnelly*, the court of appeals held that a series of acts by the majority shareholder that harmed the corporation were oppressive because they were "purposeful actions to dilute the value of shares while employment the business and its assets solely for [the majority shareholder's] own benefit.[674]

iii. Inequitable Distributions through Looting

In *Redmon v. Griffith*, the plaintiff's pleading that defendants made improper loans to themselves, paid personal expenses from corporate funds, and paid excessive dividends to themselves was held to properly state a pattern of oppressive conduct.[675]

iv. Inequitable Distributions through Diverting Corporate Opportunities

In *Redmon v. Griffith*, the plaintiff's pleading that the defendants diverted corporate opportunities was held to adequately state a pattern of oppressive conduct.[676] In *Willis v. Donnelly*, one of the oppressive acts was the majority shareholder's purchase of the real estate on which the corporation had its facility. The

[662] 754 S.W.2d 375, 382 (Tex. App.—Houston [1st Dist.] 1988, pet. denied).
[663] Legrand-Brock v. Brock, 246 S.W.3d 318, 322 (Tex. App.—Beaumont 2008, pet. denied); Ramo, Inc. v. English, 500 S.W.2d 461, 465 (Tex. 1973)
[664] *Id*.
[665] *Id.* at 464.
[666] *Id.* at 467.
[667] 37 S.W.3d 101 (Tex. App.—Corpus Christi 2000, pet. denied).
[668] *Id.* at 118.
[669] *Id.* (citing Hillsboro Nat'l Bank v. Comm'r of Internal Revenue, 460 U.S. 370, 392, (1983). *See* Ireland v. United States, 621 F.2d 731, 735 (5th Cir.1980)).
[670] *Rivas*, 37 S.W.3d at 119.
[671] Id.
[672] Boehringer v. Konkel, 404 S.W.3d 18, 28 (Tex. App.—Houston [1st Dist.] 2013, no pet.).
[673] Id.
[674] 118 S.W.3d at 32 (citing Duncan v. Lichtenberger, 671 S.W.2d 948, 953 (Tex. App.—Fort Worth 1984, writ ref'd n.r.e.) and Patton v. Nicholas, 279 S.W.2d 848 (Tex. 1955), as authorities for this proposition).
[675] *Redmon*, 202 S.W.3d at 235.
[676] Id.

corporation had an option on the land, but the majority shareholder caused the corporation to waive the option at closing. The majority shareholder then raised the corporation's rent to pass on the full debt to the corporation.[677]

v. Inequitable Distributions through Excessive Compensation

The court in *Davis v. Sheerin*, deemed excessive salaries by controlling shareholders a "typical 'squeeze out' technique."[678] In addition, the *Boehringer* court determined that a sizeable salary increase for the majority shareholder resulted in a "de facto dividend" to the exclusion of the minority shareholder.[679]

vi. Inequitable Distributions through Payment of Defendant's Attorneys Fees

Frequently, in litigation over issues of corporate control or oppression of minority shareholders, the officers and directors in control of the company will view their indemnification rights as a means to use the resources of the corporation against its minority shareholders. Certainly, there is authority permitting the indemnification of officers and directors and providing that the corporation's expense of legal fees in defending a derivative suit is considered conduct within the ordinary business of a corporation.[680] Thus, corporate officers may expend such sums in the defense of a derivative suit brought by minority shareholders.[681] However, when the dust settles, the use of corporate fund to pay lawyers to protect or defend an effort by a majority shareholder to squeeze out a minority shareholder can become an independent basis for recovery. The corporation has no legal interest in the ownership of its shares, and in a dispute between shareholders as to ownership and control of the company, the corporation must occupy a neutral position.[682] Therefore, corporate officers and directors who use company friends to pay for the defense in disputes over the control and ownership of the company's shares are appropriating to themselves a personal benefit and are likely in violation of their duty of loyalty.

The *Davis v. Sheerin* court held that the finding that "appellants wasted corporate funds by using them for their legal fees" was evidence supporting a pattern of oppression.[683] The court in *Willis v. Bydalek* also observed that "wasting corporate funds on personal attorney's fees" is evidence of oppressive conduct.[684] In *Advance Marine, Inc. v. Kelley*, the court held that the controlling shareholders' use of "corporate funds to hire an attorney to represent them individually under the guise of representing the interests of the corporation" constituted "wasting corporate assets."[685] However, the court reversed an order that the defendants repay the corporation two-thirds of the attorneys expended because the plaintiff had not brought the action in a derivative capacity and because the plaintiff had obtained full relief by the order to purchase her stock and the order was unnecessary.

d. Denying Shareholder Participation in Management

Given that the doctrine of shareholder oppression is based on the majority's legal right to control the management of the corporation, it is somewhat paradoxical that many cases suggest that excluding a minority shareholder from participation in the management of the corporation can be oppressive conduct.

i. No Notice of Meetings

All shareholders have the legal right to be notified of shareholder meetings.[686] Holding shareholder meetings without notice to a minority shareholder (or directors meetings without notice to a minority shareholder who is a director) certainly defeats a reasonable expectation of the minority shareholder.

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[677] *Willis*, 118 S.W.3d at 32.

[678] Davis v. Sheerin, 754 S.W.2d 375, 382 (Tex. App.—Houston [1st Dist.] 1988, writ denied).

[679] *Boehringer*, 404 S.W.3d at 28.

[680] *See* Ex Parte Edman, 609 S.W.2d 532, 533 (Tex. 1980).

[681] *Id.* at 534 (nonprofit corporation).

[682] Alexander v. Sturkie, 909 S.W.2d 166, 170 (Tex. App.—Houston [14th Dist.] 1995, writ denied). "We start with the general proposition that, ordinarily, a corporation has no special interest in the opportunity to purchase its own shares, and a director violates no duty to the corporation by dealing in its stock for his own account. 3 FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 862, p. 303 (perm. ed. 1986). This is because 'a corporation, as such, has no interest in its outstanding stock or in dealings therein by its officers, directors or shareholders. If there is a struggle for control the corporation would normally occupy a neutral position.' Faraclas v. City Vending Co., 194 A.2d 298, 301 (Md. 1963)." *Id.* "We agree that in matters of control the corporation should occupy a neutral position. Therefore we do not concern ourselves with the parties' vigorous contentions and diagrams demonstrating who might or might not ultimately be 'in control' as a result of the trial court's, or this court's, decision." *Id.* at n.2.

[683] 754 S.W.2d at 382.

[684] 997 S.W.2d at 802.

[685] No. 01-90-00645-CV, 1991 WL 114463, at *2 (Tex. App.—Houston [1st Dist.] June 27, 1991, no pet.).

[686] Tex. Bus. Orgs. Code Ann. § 21.353 (West 2012).

*Willis v. Bydalek* notes that the failure to notify a shareholder of meetings is evidence of oppression.[687]

ii. Removal from Office

*Willis v. Bydalek* notes that the removal of a minority shareholder from a corporate office or directorship can be evidence of oppressive conduct, and distinguishes such removal of an officer from the firing of an at-will employee.[688]

iii. Dominating Control of the Business

Similarly, the court in *Hoggett v. Brown* stated that a majority shareholder might owe fiduciary duties directly to minority shareholders when the majority shareholder "dominates control over the business."[689] In *Willis v. Donnelly*, the court of appeals held part of the majority shareholder's oppressive conduct was that he "dominated control over the business," that the majority shareholder, and not the board of directors, hired the new CEO and promised him ownership.[690]

iv. Denial of Participation

*Davis v. Sheerin* held that the controlling shareholder's denial of "any interest or voice in the corporation" was evidence of oppressive conduct.[691]

e. Denying Right to Information

Oppression cases frequently involve denial of the right of inspection; however, most opinions take a broader view of the minority's right to and reasonable expectation of information. Not only are specific violations common law and statutory rights to corporate information oppressive, but so is the practice of keeping a minority shareholder in the dark about the status of the company.[692] In *Redmon v. Griffith*, the refusal to give a minority shareholder access to financial statements prepared by the corporation's CPA was evidence of oppression, which, in addition to evidence of using corporate funds to pay personal expenses was sufficient to overcome motion for summary judgment.[693]

f. Violation of Express Contracts

i. Breach

In *Willis v. Donnelly*, the court of appeals held that the majority shareholder's transfer of all his shares to his wife in breach of the minority shareholder's right of first refusal under a written agreement was oppressive.[694] The Willis court cited *Thompson v. Hambrick*,[695] for the proposition that the majority shareholder's sale of shares without offering the right of first refusal to minority shareholders was a breach of fiduciary duty. In *Thompson*, there was a written shareholder's agreement that provided the majority shareholders with a right of first refusal on the minority shareholders' shares. The majority shareholders sold their shares without offering them to the minority. The court held that the contract was ambiguous and that there was a fact issue as to whether the intention of the parties was that the right of first refusal was to apply to the majority shares as well. The *Thompson* court's holding that there was also a fact issue as to breach of fiduciary duties by the majority shareholder in selling their shares at a premium seems to be independent of the contract; however, the *Willis* court's reading of the opinion as holding that breach of the contract was also a breach of fiduciary duties is plausible. The *Willis* court also held that the majority shareholder's unilateral reduction of the minority shareholder's salary to a level below that provided in the written contract and the majority shareholder's delay in issuing the minority shareholder's shares after he became entitle to them under the terms of the written contract were oppressive acts.[696]

ii. Attempt to change terms

In *Willis v. Donnelly*, the court of appeals held that the attempt by the majority shareholder to induce

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[687] 997 S.W.2d at 802. *See also* Baker v. Commercial Body Builders, Inc., 507 P.2d 387, 390–91, 398 (Or. 1973) (cited by *Willis* and holding conduct oppressive when majority shareholder prevented minority shareholder from reviewing corporate books, took salary increase while denying one to minority shareholder, removed minority shareholder as officer and director, and ceased notifying him of meetings).

[688] 997 S.W.2d at 802. *See also* In re Topper, 433 N.Y.S.2d 359, 361–62 (N.Y. App. Div. 1980) (holding conduct oppressive when corporation flourished, but majority shareholders never paid dividends, and majority removed minority shareholder as officer and fired him).

[689] 971 S.W.2d at 488 n.13.

[690] 118 S.W.3d at 32.

[691] 754 S.W.2d at 383.

[692] *See* Boehringer v. Konkel, 404 S.W.3d 18, 30 (Tex. App.—Houston [1st Dist.] 2013, no pet.) (Denying access to company books or records can constitute oppressive conduct); Willis v. Bydalek, 997 S.W.2d at 802 (noting that the withholding of information is evidence of oppressive conduct); Baker v. Commercial Body Builders, Inc., 507 P.2d 387, 390–91, 398 (Or. 1973) (holding conduct oppressive when majority shareholder prevented minority shareholder from reviewing corporate books, took salary increase while denying one to minority shareholder, removed minority shareholder as officer and director, and ceased notifying him of meetings).

[693] 202 S.W.3d at 235–36.

[694] 118 S.W.3d at 33.

[695] 508 S.W.2d 949, 951–54 (Tex. Civ. App.—Dallas 1974, writ ref'd n.r.e.).

[696] 118 S.W.3d at 33.

the minority shareholder to cap the amount of equity he was entitled to receive under a written contract at a lower amount was oppressive.[697]

iii. Bad Faith Manipulation

In *Willis v. Donnelly*, another aspect of the pattern of oppression noted by the court of appeals was the majority shareholder's keeping the corporation thinly capitalized, which limited its ongoing ability to operate, and purchasing the real estate on which the corporation had its office for himself, rather than through the corporation. The court of appeals reasoned that these acts were oppressive because both had the effect of reducing the price that the plaintiff would receive for his shares under the buy–sell provisions of a written agreement.[698]

g. Quasi Contract

Many cases relating to reasonable expectations of minority shareholders do not involve express agreements or statutory rights of share ownership, but implied agreements that arise as a necessary result of the circumstances under which the minority acquired his shares or as a result of the course of dealing of the parties.[699] In *Willis v. Donnelly*, the court of appeals held that one of the minority shareholder's expectations that was "reasonable and central to the decision to join the venture" was that the majority shareholder would provide adequate capital to the business and that this reasonable expectation was defeated by the majority shareholder's treatment of his capital contributions as loans and his keeping the corporation thinly capitalized.[700] There was no express agreement as to the majority's duty to contribute capital, but the court held that this duty was necessarily implied from promises made by the majority at the outset of the venture and by the operation of the buy–sell agreement, which had little value to the minority shareholder if the corporation was undercapitalized.[701]

h. Lack of Good Faith and Fair Dealing

Finally, courts frequently focus on the bad faith or evil intent of the controlling shareholder or the overall unfairness of the outcome. Part of the definition of oppression is "visible departure from the standards of fair dealing and a violation of fair play on which each shareholder is entitled to rely."[702] Therefore, conduct or transactions that might otherwise be permissible can be deemed oppression of done in bad faith or with the intent of achieving a patently unfair result.

i. Malicious suppression of dividends

The decision to declare dividends is one that is well within the protection of the business judgment rule. However, in a shareholder oppression context, the refusal to distribute corporate profits to the shareholders is oppressive if made with malicious intent. The Texas Supreme Court in *Patton v. Nicholas* recognized the Texas cause of action for malicious suppression of dividends.[703] The court held that "the malicious suppression of dividends is a wrong akin to breach of trust, for which the courts will afford a remedy."[704] Of particular importance to the court's holding was the controlling shareholder's state of mind. The court held that "the finding of his control of the board for the malicious purpose of, and with the actual result of, preventing dividends" was supported by "quite adequate" evidence of a "wrongful state of mind."[705] This evidence included the following: that the minority shareholders came under personal attack to such an extent that they both felt compelled to resign,[706] that the minority shareholders were not re-elected as directors following their resignation,[707] that no dividends were paid, while the controlling shareholder continued to receive a very high salary,[708] that the controlling shareholder made oral statements about the minority shareholder showing "strong personal ill will" and had stated that the corporation would not pay dividends so long as the plaintiffs were shareholders,[709] and that the controlling shareholder had manipulated the business by increasing inventories and purchasing property to use up the corporation's cash to the extent that the corporation's surplus increased to 50% over five years and yet the corporation never declared dividends.[710] There was also a jury finding that the controlling shareholder's salary was "unreasonable."[711]

In *Davis v. Sheerin*, termed malicious suppression of dividends a "typical 'squeeze out' technique."[712] *Redmon v. Griffith* held that an allegation that defendants "maliciously suppressed the payment of dividends owed to them" adequately stated an oppressive act that demonstrated shareholder

[697] Id.
[698] *Id.* at 32.
[699] See generally D. Moll, Reasonable Expectations v. Implied-in-fact Contract: Is the Shareholder Oppression Doctrine Needed?, 42 B.C. L. REV. 989 (2001).
[700] 118 S.W.3d at 32.
[701] Id.
[702] *Davis*, 754 S.W.2d at 382.
[703] 279 S.W.2d 848 (Tex. 1955).
[704] *Id.* at 854.
[705] *Id.* at 853.
[706] *Id.* at 851.
[707] Id.
[708] Id.
[709] *Id.* at 852.
[710] *Id.* at 853.
[711] Id.
[712] 754 S.W.2d at 382.

oppression.[713] In *Willis v. Bydalek*, the court cited other cases holding that the withholding of dividends, when the corporation had money to distribute to its shareholders, and the majority shareholders were getting a benefit, constituted evidence of oppression.[714] The court's analysis does not mention the requirement of maliciousness or bad faith, but rather focuses on the disparity in treatment between the majority and minority shareholders.

ii. Monkeying with the books

*Willis v. Bydalek* notes that keeping the corporate books and records "inaccurately and inequitably" is evidence of oppressive conduct.[715]

iii. False Accusations

*Willis v. Bydalek* also notes that the falsely accusing a minority shareholder of wrongdoing so as to fire him for cause is evidence of oppressive conduct.[716]

**B. Defenses**

1. Dealing with the Oppressive Conduct

Defending a claim of shareholder oppression can be challenging because there is no clear standard. Ultimately, the defendant must force the plaintiff, through special exceptions, discovery, and no-evidence motions for summary judgment, to break the pattern of oppression into discrete acts or omissions. Then each individual item may be attacked. The item may not have happened, may be fair and in good faith, may fall within the business judgment rule, etc. The ultimate goal is to knock out or minimize enough of the items that the court must conclude that the plaintiff has not proven a pattern of oppression or that the misconduct remaining is limited enough that a lesser remedy than forced buyout is most appropriate. Remember that the law requires much more than a de minimus frustration of the shareholder's rights and interest; the expectations of a shareholder must be (1) objectively reasonable, (2) central to the decision to join the venture, and (3) substantially defeated.[717] In *Willis v. Bydalek*, the court held that a minority shareholder's expectation of continued employment could not be objectively reasonable under those circumstances for an at-will employee, and that loss of employment standing alone was insufficient to constitute oppression.[718]

2. Denying that the Plaintiff is a Shareholder.

Obviously, if the plaintiff is not a shareholder, then the plaintiff has no shareholder rights and cannot be oppressed. Several shareholder oppression cases have turned upon whether or not the plaintiff was a shareholder. In *Willis v. Donnelly*, a Texas Supreme Court reversed a shareholder oppression judgment on the grounds that the plaintiff had not yet become a shareholder pursuant to his agreement with the Corporation.[719] A defendant might also challenge the minority shareholder's shareholder status on the basis that the plaintiff had not given consideration for his shares. This situation might arise when friends set up a new corporation and one of them may have been given shares but not asked to contribute any money or do anything. Stock issued without consideration is not validly issued. Indeed, we concur with the suggestion that an issuance of stock without valid consideration is void under Texas law.[720] A corporation cannot, through its conduct, ratify the issuance of stock where no consideration was given for the shares.[721] Article 2.16 of the Texas Business Corporation Act, which provides that "[i]n the absence of fraud in the transaction, the judgment of the board of directors or the shareholders . . . , as the case may be, as to the value and sufficiency of consideration received for shares shall be conclusive" does not bar a defendant from introducing evidence to dispute that the plaintiff furnished consideration for his stock.[722]

However, there is a very significant downside risk in disputing the plaintiff's share ownership. In *Davis v. Sheerin*, the majority shareholder contended that a

[713] 202 S.W.3d at 235.
[714] 997 S.W.2d at 802.
[715] Id.
[716] Id.
[717] Willis v. Bydalek, 997 S.W.2d 798, 801 (Tex. App.—Houston [1st Dist.] 1999, pet. denied).
[718] *Id.* at 802–03.
[719] 199 S.W.3d at 276–77.
[720] *See* Vermilion Parish Peat Co. v. Green Belt Peat Moss Co., 465 S.W.2d 950, 954 (Tex. Civ. App.—Dallas 1971, writ ref'd n.r.e.).
[721] *See* Gulf States Abrasive Mfg., Inc. v. Oertel, 489 S.W.2d 184, 188 (Tex. Civ. App.—Houston [1st Dist.] 1972, writ ref'd n.r.e.); Vermilion Parish Peat Co., 465 S.W.2d at 954; United States Steel Indus., Inc. v. Manhart, 405 S.W.2d 231, 233 (Tex. Civ. App.—Waco 1966, writ ref'd n.r.e.).
[722] Miller v. Kendall, 804 S.W.2d 933, 941 (Tex. App.—Houston [1st Dist.] 1995, no writ) ("We do not read Article 2.16, which refers to the directors' act in valuating consideration for stock, as a parol evidence rule that bars the admission of evidence that the corporation's record of that act is mistaken."). *See also* United Steel Ind. v. Manhart, 405 S.W.2d 231, 233 (Tex. Civ. App.—Waco 1966, writ ref'd n.r.e.) ("The judgment of the board of directors 'as to the value of consideration received for shares' is conclusive, but such does not authorize the board to issue shares contrary to the Constitution for services to be performed in the future . . . or property not received . . . .").

minority shareholder had abandoned or relinquished his share of ownership some years before as a gift to the majority shareholder. In that case, the jury rejected the majority shareholder's contention, and the majority shareholder's attempt to deny the minority shareholder's shareholder status became one of the key bases for affirming a shareholder oppression judgment against the majority shareholder.[723]

3. Business Judgment Rule

Actions against officers or directors of a corporation for breach of their duty of due care almost inevitably trigger the response that management is not liable for ordinary mistakes of business judgment. The "business judgment rule" shields a corporate director who acts in good faith and without corrupt motive from any liability for mistakes of business judgment that damage corporate interests. In Texas, it is generally held that the business judgment rule protects non-interested directors from liability unless the challenged action is ultra vires or tainted by fraud or self-dealing. [724] In the oppression context, business decisions protected by the business judgment rule or mere "dissatisfaction with corporate management" will not establish oppression.[725]

In *Allchin v. Chemic, Inc.*, the court of appeals affirmed a directed verdict on the oppression claim, and held that the allegations of the plaintiff, which were principally complaints about his treatment as an employee and about the competence and performance of the other shareholder in his job responsibilities, did not support a finding of a pattern of oppressive conduct. [726] The plaintiff's pattern of oppressive conduct consisted of "not providing as much training as Allchin expected (although Wadiak provided training material and opportunities to work in the field); failing to use his talent and best effort to maximize Chemic's success (*e.g.*, drinking and not working a sufficient number of hours); failing to participate materially and contribute to the operation of the business ("[l]ack of self-control/leadership in the corporation"); failing to allow Allchin to participate and contribute to the management of the company (*e.g.*, hiring an employee Allchin did not want to hire); and, using Chemic for personal gain (no examples provided)" The court held: "Allchin's complaints reflect disagreements about policy, and, as such, do not support a claim of shareholder oppression warranting a buy-out."[727]

4. Acquiescence

Frequently, a minority shareholder will point to conduct or transactions as part of the pattern of oppression that the shareholder may have expressly or impliedly agreed to or practices and policies in which shareholder previously participated. Generally, these instances may be excluded from the evidence of a pattern. Only a "nonconsenting" shareholder may challenge a breach of fiduciary duty. [728] In *Pacific American Gasoline Co. of Texas v. Miller*, the court of appeals rejected a claim by a group of shareholders that the corporation's issuance of certain securities was ultra vires and void because the securities were not supported by adequate consideration.[729] The Court held that these shareholders "cannot now be heard" on these claims because they had participated in the shareholders' meeting approving the issuance and had previously acquiesced to the issuance: "Plainly the stockholder who acquiesced therein, and actively participated in the issuance of these [securities], cannot now be heard to say that the consideration received was not equal to the face value of the note."[730] The United States Supreme Court has noted the equitable principle that a "stockholder has no standing if either he or his vendor participated or acquiesced in the wrong." [731] In *Hoggett v. Brown*, the plaintiff

[723] *Davis*, 754 S.W.2d at 382.

[724] See *Langston v. Eagle Pub. Co.*, 719 S.W.2d 612, 616–17 (Tex. App.—Waco 1986, writ ref'd n.r.e.); *Gearhart Indus.*, 741 F.2d at 721 (citing *Cates v. Sparkman*, 11 S. W. 846, 849 (Tex. 1889)). *See generally* Michele Healy Ubelaker, Comment, *Director Liability Under the Business Judgment Rule.—Fact or Fiction?*, 35 SW.L.J. 775 (1981–1982).

[725] *See Davis*, 754 S.W.2d at 382–83; Texarkana College Bowl, Inc. v. Phillips, 408 S.W.2d 537, 539 (Tex. Civ. App.—Texarkana 1966, no writ).

[726] Allchin v. Chemic, Inc., No. 14-01-00433-CV, 2002 WL 1608616, at *7 (Tex. App.—Houston [14th Dist.] July 18, 2002, no pet.).

[727] Id.

[728] Dyer v. Shafer, Gilliland, Davis, McCollum & Ashley, Inc., 779 S.W.2d 474, 477 (Tex. App.—El Paso 1989, writ denied.)

[729] 76 S.W.2d 833, 841 (Tex. App.—Amarillo 1934, writ ref'd).

[730] Id.

[731] Bangor Punta Operations, Inc. v. Bangor & Aroostook RR Co., 417 U.S. 703, 720 (1974) (quoting Hyams v. Old Dominion Co., 93 A. 747, 750 (Me. 1915)). *See also* Bernstein v. Workers' Compensation Med. Ctr., Inc., 755 So.2d 141, 141 (Fla. App. 2000) (Plaintiff's "participation in the wrongs complained of" precludes his "adequately and fairly represent[ing] the interests of the shareholder class and, therefore, lacks standing to bring this derivative action."); Liken v. Shaffer, 64 F. Supp. 432, 442 (N.D. Iowa 1946) (If a stockholder "participated in the wrong complained of, a court of equity will not recognize him as a proper suitor in a court of equity and will abate the action without reference to the merits of the claim sought to be asserted in behalf of the corporation."); Pinnacle Consultants,

acquiesced to defendant's acting as a director even though never formally elected and organizational documents never amended to increase size of board, by treating defendant as director and signing documents stating he was a director; therefore the plaintiff was barred from asserting as part of an oppression claim that the defendant had illegally assumed control.[732]

5. Safe Harbor

A director may also escape liability if he relies on advice of counsel or of a CPA,[733] but one court has held that the advice must be in writing.[734]

Ltd. v. Leucadia Nat'l Corp., 261 A.D.2d 164, 165 (N.Y. App. 1999) (holding that a shareholder who acquiesced in the challenged transaction "has so standing to maintain" an action challenging that transaction).

[732] 971 S.W.2d at 484–85. The court noted further: "Texas courts have applied equitable principles to notice requirements in situations where corporate control was at stake. *See* Camp v. Shannon, 348 S.W.2d 517, 520 (Tex. 1961) (holding that corporate president who called, and participated in, shareholders meeting to elect directors was estopped from questioning the legality of the meeting and election of directors who later removed him); R.H. Sanders Corp. v. Haves, 541 S.W.2d 262, 265 (Tex. Civ. App.—Dallas 1976, no writ) (holding that voting agreement that did not comply with certain notice requirements of the Act was enforceable because all of the shareholders knew of the agreement and participated in the transaction in question); Caldwell v. Kingsbery, 451 S.W.2d 247, 250–51 (Tex. Civ. App.—Austin 1970, writ ref'd n.r.e.) (holding that corporate director waived any defect in notice of directors/ shareholders meeting called to remove him as director where director attended and participated in the meeting without objection); Been v. Producers Ass'n of San Antonio, Inc., 352 S.W.2d 292, 293 (Tex. Civ. App.—San Antonio 1961, no writ) (holding that ousted directors of marketing association who continually protested the legality of special shareholders meeting called to elect new directors did not waive their complaint). In light of these cases, we see no reason why one director, under proper facts, cannot be barred by waiver, estoppel, or laches from challenging another's authority to act as director. With those principles in mind, we now review whether the jury's finding that Brown was not a director is against the great weight and preponderance of the evidence." *Id.* at 484.

[733] Tex. Bus. Orgs. Code § 3.102 (2012).

[734] *Dobson v. Poor*, No. 04-96-00920-CV, 1998 WL 300530, at *7 (Tex. App.—San Antonio June 10, 1998, no pet.).

## VII. SHAREHOLDER OPPRESSION REMEDIES

### A. Dissolution and Equitable Power

The concept of shareholder oppression in Texas law derives from art. 7.05 of the Texas Business Corporation Act which authorized the appointment of a receiver, either to rehabilitate or dissolve the business, if the shareholder could establish that "the acts of the directors or those in control of the corporation are illegal, oppressive or fraudulent."[735]

1. Appointment of a Receiver

The statutory provisions that control the appointment of a receiver for a corporation are enumerated in Texas Business Organizations Code §§ 11.401–11.411 and Texas Civil Practice & Remedies Code §§ 64.001–64.076. A court may not administer corporations in receivership for more than three years unless there is an application for extension, notice to parties, and a hearing; no receivership shall expand beyond eight years.[736] The Texas Business Organizations Code governs requirements regarding conflicting provisions of the general receivership statutes.[737]

a. Receiver for specific corporate assets

Texas Business Organizations Code § 11.401 allows the appointment of a receiver over specific corporate assets, where "all other requirements of law are complied with and if other remedies available either at law or in equity are determined by the court to be inadequate." Such assets must be located within the state. It does not matter if the assets are owned by a domestic or foreign corporation so long as the disputed assets are the subject of litigation.[738] The appointment of a receiver over an entire corporation instead of over specific assets is inappropriate where the more limited role of the receiver can remedy the wrong alleged.[739]

b. Appointment of a Rehabilitative Receiver

A shareholder may petition the court for appointment of a receiver to rehabilitate the corporation. It has been held that the appointment of a

[735] TEX. BUS. ORGS. CODE § 11.402 (West 2012).

[736] Bayoud v. Bayoud, 797 S.W.2d 304, 309 (Tex. App.—Dallas 1990, writ denied). *See also* TEX. CIV. PRAC. & REM. CODE § 64.072 (2012).

[737] King Commodity Co. v. State, 508 S.W.2d 439, 446–48 (Tex. Civ. App.—Dallas 1974, no writ) (TEX. BUS. ORGS. CODE'S provisions for suit in county of corporation's registered officers was controlling).

[738] TEX. BUS. ORGS. CODE §§11.402–11.403 (2012).

[739] Humble Exploration Co. v. Fairway Land Co., 641 S.W.2d 934, 939 (Tex. App.—Dallas 1982, writ ref'd n.r.e.).

rehabilitative receiver was not reversible error despite evidence that the corporation could not be rehabilitated that was presented to the trial court.[740] Because the appointment of a receiver is an equitable remedy within the discretion of the trial court, absent a clear abuse of discretion the reviewing court will not disturb the original finding.[741] Appointment of a receiver is a drastic remedy, and a court will not order it simply because a shareholder is dissatisfied with the management of a corporation.[742] Nevertheless, receivership is a proper remedy for serious abuses by the management of a corporation.[743]

c. Appointment of a Liquidating Receiver

The most drastic form of receivership liquidates the remaining assets of a corporation.[744]

d. Effect of Appointment

A receiver appointed by the court has certain statutory powers enumerated in the Texas Business Organization Code §§ 11.406–11.410. If no feasible plan for remedying the problems of the corporation is presented within twelve months of the appointment of a receiver, a shareholder may obtain an order that the corporation be liquidated.[745] Liquidation requires that all debts, obligations, and liabilities be discharged, including any claims asserted against the corporation in pending lawsuits.[746]

2. Equitable Powers

The appointment of a receiver is a harsh, even a radical remedy. Even in the corporate arena, economic waste incident to receiverships and forced sales are accentuated.[747] If the court can, by a combination of lesser remedies, cure the illness presented by the movant—such as malicious suppression of dividends—the less drastic measures should be implemented.[748] To this end, the Texas Business Organizations Code provides that the appointment of a liquidating receiver is appropriate "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 of specific assets of the corporation and appointment of a receiver to rehabilitate the corporation, are determined by the court to be inadequate."

In *Patton v. Nicholas*, the Texas Supreme Court in the context of a claim for corporate dissolution recognized that Texas courts, "under their general equity powers," may tailor "the remedy to fit the particular case."[749] In Patton, the court held that the more appropriate remedy to malicious suppression of dividends was a mandatory injunction for the immediate and future payment of dividends, rather than appointment of a receiver. "The essence of equity jurisdiction has been the power of the Chancellor to do equity and to mold each decree to the necessities of the particular case. Flexibility rather than rigidity has distinguished it."[750] On the basis of these authorities,

[740] *See* Aubin v. Territorial Mort. Co., 640 S.W.2d 737, 742 (Tex. App.—Houston [14th Dist.] 1982, no writ).

[741] *Id*. *See also* Strategic Minerals Corp. v. Dickson, 320 S.W.2d 882, 885 (Tex. Civ. App.—Austin 1959, writ ref'd n.r.e.); Aubin v. Territorial Mortgage Co. of America, 640 S.W.2d 737, 742 (Tex. App.—Houston [14th Dist.] 1982, no writ); Citizens Bldg. Inc. v. Azios, 590 S.W.2d 569, 573 (Tex. Civ. App.—Houston [1st Dist.] 1979, writ ref'd n.r.e.).

[742] Texarkana College Bowl, Inc. v. Phillips, 408 S.W.2d 537, 539 (Tex. Civ. App.—Texarkana 1966, no writ).

[743] Robinson v. Thompson, 466 S.W.2d 626 (Tex. Civ. App.—Eastland 1971, no writ).

[744] Patton v. Nicholas, 279 S.W.2d 848, 856–57 (Tex. 1955) (order appointing liquidating receiver over thriving business reversed where permanent injunction to compel distribution of dividends would correct act complained of).

[745] *See* Leck v. Pugh, 676 S.W.2d 180, 180 (Tex. App.—Waco 1984, no writ).

[746] *See generally* Burnett v. Chase Oil & Gas, Inc., 700 S.W.2d 737 (Tex. App.—Tyler 1985, no writ) (noting that liquidation envisions a final wind-up of corporate affairs).

[747] Patton v. Nicholas, 279 S.W.2d 848, 887 (1955); Texas Consol. Oils v. Hartwell, 240 S.W.2d 324, 327 (Tex. Civ. App.—Dallas 1951, mand. overr.) (stating "No more radical remedy could be devised" than conservation of assets through receivership, which discredits, cripples and most often ends a business or enterprise).

[748] *See* 279 S.W.2d at 887 (court-ordered mandatory injunction requiring corporation to declare and pay dividend entered in place of appointment of receiver for liquidation of profitable corporation); Davis v. Sheerin, 754 S.W.2d 375, 380 (Tex. App.—Houston [1st Dist.] 1988, writ denied) (although not explicitly provided by statute, Texas courts, under their general equity power, may decree a "buyout" of a minority shareholder's interest in a close corporation where less harsh remedies are inadequate to protect the rights of the parties).

[749] 279 S.W.2d 848, 857 (Tex. 1955).

[750] Greater Fort Worth v. Mims, 574 S.W.2d 870, 872 (Tex. Civ. App.—Fort Worth 1978, writ dism'd w.o.j.) (citing Meis v. Sanitas Srv. Corp., 511 F.2d 655, 658 (5th Cir.1975), in its determination of whether the appointment of a receiver was an abuse of discretion.).

the court in *Davis v. Sheerin*,[751] concluded "that Texas courts, under their general equity power, may decree a "buy-out" in an appropriate case where less harsh remedies are inadequate to protect the rights of the parties.

## B. The Buy-Out Remedy

### 1. Buy-Out at "Fair Value"

In *Davis v. Sheerin*, the court held that an appropriate remedy for oppression of a minority shareholder is an order forcing the controlling shareholder to purchase the minority shareholder's stock at "fair value" determined by the court.[752] "An ordered 'buy-out' of stock at its fair value is an especially appropriate remedy in a closely held corporation, where the oppressive acts of the majority are an attempt to 'squeeze out' the minority, who do not have a ready market for the corporation's shares, but are at the mercy of the majority."[753] In *Davis*, the jury determined the fair value, and the defendant did not contest the number on appeal, so there is no real discussion in any Texas opinion to date of what "fair value" means or how it is to be calculated.

### 2. What is Fair Value?

The typical measure of damages for loss of property, such as stock, would be fair market value. The problem with the notion of "fair market value" in the case of a minority interest in a closely held corporation is that there is no market for the shares—and thus no way to determine a "market value."[754] Courts have generally acknowledged that the "true value" of a closely held corporation is, at best, a subjective guess.[755] However, Texas shareholder oppression cases have used the term "fair value" as opposed to "fair market value."

In *Alaska Plastics, Inc. v. Coppock*,[756] one of the authorities cited in *Davis v. Sheerin* for the concept of "fair value,"[757] the Alaska Supreme Court similarly does not define the term and ultimately does not order a buy-out at that amount; however the court does note that the price in a court-ordered buy-out should be "a price to be determined according to a specified formula or at a price determined by the court to be a fair and reasonable price."[758] The court further noted a fair price should be one that the defendant would be able to show was fair if transaction was challenged as a breach of fiduciary duties.[759] *In McCauley v. Tom McCauley & Son, Inc.*,[760] the other case cited in Davis, the New Mexico Supreme Court states that the trial court should consider the net asset value, the market value, and the investment or earnings value, along with other factors including the nature and history of the corporation, the earnings capacity of the corporation, the corporation's dividend-paying capacity, and the size of the block of stock being valued; however, the court may decide to give no weight at all to a particular factor and has considerable discretion in the valuation of intangibles. In *Advance Marine, Inc. v. Kelley*,[761] an unpublished Houston court of appeals opinion, the court did review a valuation for oppression purposes. While the court mistakenly used the term "fair market value" in the opinion, it is clear that the corporation's stock was valued as a whole and the minority shareholder was awarded his percentage interest with no minority discount. The plaintiff introduced the testimony of a certified public accountant who had experience valuing small businesses, who relied on income tax returns, financial statements, and information provided by the corporation's accountant, and utilized the "prudent investor formula" to determine the per share value of the corporation's stock. The defendant challenged the failure to apply the discount on appeal, to which the court responded that this factor and other potential factors, such as the trends in the economy and in the pleasure boating business, "may affect the weight of the evidence, but they do not show that [plaintiff's valuation expert's] testimony was against the great weight and preponderance of the evidence."

### 3. Minority Discount

The most contentious issue in valuation of minority shares is the application of discounts for minority status and lack of marketability. In most contexts, appraisers believe that a minority interest in a closely held corporation is worth less than the minority percentage of the market value of the business as a whole. The reason for this disparity in value is that no market exists for the minority shares, so that any buyer would be entirely dependent upon the declaration of dividends for a return on investment; and the purchaser, as a minority shareholder, would have no

[751] 754 S.W.2d 375, 380 (Tex. App.—Houston [1st Dist.] 1988, writ denied).
[752] 754 S.W.2d at 383.
[753] *Id.* at 381.
[754] *See* Ward v. Succession of Freeman, 854 F.2d 780, 783 n.1 (5th Cir. 1988); Sommers Drug Stores Co. Emp. Profit Sharing Trust v. Corrigan Enters., Inc., 793 F.2d 1456, 1462 (5th Cir.1986).
[755] Kademian v. Ladish Co., 792 F.2d 614, 626 (7th Cir.1986).
[756] 621 P.2d 270 (Alaska 1980).
[757] *See* 754 S.W.2d at 381.
[758] 621 P.2d at 275 (quoting Baker v. Commercial Body Builders, Inc., 507 P.2d 387, 396 (Or. 1973)).
[759] 621 P.2d at 276.
[760] 724 P.2d 232, 241–42 (N.M. Ct. App. 1986).
[761] No. 01-90-00645-CV, 1991 WL 114463 (Tex. App.—Houston [1st Dist.] June 27, 1991, no pet.).

power to compel the distribution of dividends. Therefore, any purchaser of a minority interest would be given an incentive in the form of a discount to take these additional risks. Unquestionably such discounts must be applied if the measure for the buy-out remedy was "fair market value."

The term "fair value" is drawn from the dissenting shareholder's appraisal remedy, in which the shareholder is entitled to "fair value" for his shares.[762] "Fair value" in the appraisal remedy is based on "the value of the domestic entity as a going concern without including in the computation of value any control premium, any minority discount, or any discount for lack of marketability."[763] The only Texas court to have addressed the issue noted that "fair value" in the context of the appraisal remedy is based on the "enterprise value" of the corporation which accounts for the assets, liabilities, and income stream of the corporation as a whole—the highest level at which a company's worth may be assessed—and does not include a discount based on shares' minority status or lack of marketability.[764]

Typically, the appraisal remedy arises as a result of a merger approved by the majority of the shareholders that forces the dissenting minority to sell their shares along with everybody else at the same price. Dissenting shareholders do not believe the price is fair and would not agree to sell their shares at that price absent statutory compulsion, and therefore the purpose of the statutory remedy is to require the corporation to pay the minority shareholders the difference between the agreed value and the fair value found through an appraisal. In this context, the corporation is being sold (or merged) as a whole. All the shareholders are receiving their percentage interest in the sales proceeds, without any discount or premium applied to their individual interests. The chief danger is that the sale may not be at arm's length, and so the court pays the dissenting shareholders what they would have received in a hypothetical sale conducted at arm's length for a fair price. This hypothetical situation necessarily precludes any application of a minority discount because the dissenting shareholders are not selling their minority interests separately but as part of the sale of the entire company.[765]

### C. Damages Remedies

1. Breach of Fiduciary Duty

In *Redmon v. Griffith*, the court overturned a summary judgment on a breach of fiduciary duties claim based solely on the allegations and summary judgment evidence offered in support of the shareholder oppression claim. The court's reasoning was based on the assumption that a fiduciary relationship exists between a majority and minority shareholder of a closely held corporation, where the majority shareholder exercises sufficient control over the corporation.[766] The practical implication of the court's holding in *Redmon* is that a tort/damages remedy may available for oppressive conduct. Under Texas law breach of fiduciary duties is a tort.[767]

A plaintiff may be awarded actual damages for breach of fiduciary duty.[768] In addition to out-of-pocket damages, a plaintiff may recover lost profits for a breach of fiduciary duty if proven with reasonable certainty.[769] Further, the trial court has discretion to apply an appropriate equitable remedy that may result

[762] TEX. BUS. ORGS. CODE ANN. §§ 10.351–10.368 (West 2012). The term "fair value" is also used in the Delaware appraisal remedy. 8 DEL. CODE § 262. *See* Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1142, 1144 (Del. 1989).

[763] *Id.* § 10.362(b) (West 2012).

[764] *See* R.V.K. v. L.L.K., 103 S.W.3d 612, 618 (Tex. App.—San Antonio 2003, no pet.) (A divorce case in which "fair value" in an appraisal remedy is contrasted with the appropriate approach in valuing assets in a divorce.)

[765] "The application of a discount to a minority shareholder is contrary to the requirement that the company be viewed as a "going concern." Cavalier's argument, that the only way Harnett would have received value for his 1.5% stock interest was to sell his stock, subject to market treatment of its minority status, misperceives the nature of the appraisal remedy. Where there is no objective market data available, the appraisal process is not intended to reconstruct a pro-forma sale but to assume that the shareholder was willing to maintain his investment position, however slight, had the merger not occurred. Discounting individual share holdings injects into the appraisal process speculation on the various factors that may dictate the marketability of minority shareholdings. More important, to fail to accord to a minority shareholder the full proportionate value of his shares imposes a penalty for lack of control, and unfairly enriches the majority shareholders who may reap a windfall from the appraisal process by cashing out a dissenting shareholder, a clearly undesirable result." *Cavalier Oil Corp.*, 564 A.2d at 1145.

[766] 202 S.W.3d at 238.

[767] *Redmon*, 202 S.W.3d at 241; Douglas v. Aztec Pet. Corp., 695 S.W.2d 312, 318 (Tex. Civ. App.—Tyler 1985, no writ).

[768] Swinnea v. ERI Consulting Eng'rs, Inc., 236 S.W.3d 825, 841 (Tex. App.—Tyler 2007, pet. filed); Duncan v. Lichtenberger, 671 S.W.2d 948, 953 (Tex. Civ. App.—Fort Worth 1984, writ ref'd n.r.e.).

[769] Carr v. Weiss, 984 S.W.2d 753, 769 (Tex. App.—Amarillo 1999, pet. denied).

in a monetary award.[770] For instance, constructive trust and disgorgement are equitable remedies by which the wrongdoer is divested of ill-gotten gains.[771] Thus, a fiduciary must account for, and yield to the beneficiary, any profit he makes as a result of his breach of fiduciary duty.[772]

Based on the holding in *Redmon*, a plaintiff could conceivably argue that he is entitled to actual damages for certain misconduct, such as excessive compensation, that could otherwise be pursued only as a derivative claim on behalf of the corporation—although a court paying attention to the duties involved might very well hold that the violation of duties owed solely to the corporation cannot be a proximate cause of actual damages to an individual shareholder. The *Redmon* holding would also clearly entitle a shareholder to punitive damages. In *Davis v. Sheerin*, the court held that informal dividends to appellants by making contributions to profit sharing plan and waste of corporate funds for legal fees were breaches of fiduciary duties that could be remedied by damages and injunction.[773]

2. Wrongful Termination

In *Redmon v. Griffith*,[774] the court suggests that a plaintiff could pursue a breach of contract claim for wrongful termination of at-will employment arising out of oppressive conduct; however, such a claim could be made only against the corporation, not against the controlling shareholder. "Where a corporation enters into a contract, the officer's signature on the contract, with or without a designation as to his representative capacity, does not render him personally liable under the contract."[775]

3. Punitive Damages

In *Willis v. Bydalek*,[776] the trial court awarded the plaintiff substantial punitive damages ($180,000.00) solely based on a judgment of shareholder oppression with a forced buy-out (for $612.50). The court of appeals did not address the punitive damages issue because it reversed the holding of oppression. In *Davis v. Sheerin*, the trial court did not award punitive damages on the oppression claim. In *Patton v. Nicholas*, as a remedy for malicious suppression of dividends, the Texas Supreme Court ordered the trial court to issue a mandatory injunction requiring the controlling shareholder and the corporation to immediately declare and pay a reasonable dividend in the amount to be determined by the trial court, and further to continue paying reasonable dividends in the future, with the trial court retaining jurisdiction for a period not to exceed five years to enforce the good faith compliance with the order.[777]

The Court further provided that if the order was not complied with in good faith, then the trial court, in addition to its contempt powers, was instructed to liquidate the corporation.[778] The court reversed the awards of actual and punitive damages, holding that the award of actual damages would represent a double recovery, and holding that no punitive damages could be awarded in the absence of actual damages.[779] Implicitly, the court held that punitive damages could not be awarded on the basis of the considerable monetary recovery that would result from the equitable relief granted. However, in *International Bankers Life Ins. Co. v. Holloway*, the Texas Supreme Court indicated that a form of punitive damages could be included in a court's equitable remedy, noting: "[T]here should be a deterrent to conduct which equity condemns and for which it will grant relief. The limits beyond which equity should not go in its exactions are discoverable in the facts of each case which give rise to equitable relief."[780]

## VIII. DERIVATIVE CLAIMS

### A. Nature of the Derivative Action

A cause of action for injury to the property of a corporation is vested in the corporation as distinct from its individual shareholders.[781] Thus, any action to redress such injuries must be brought by the corporation or by a shareholder for the corporation.[782]"A corporate stockholder cannot recover damages personally for a wrong done solely to the corporation, even though he may be injured by that

[770] *See* Int'l Bankers Life Ins. Co. v. Holloway, 368 S.W.2d 567, 576–77 (Tex. 1963).
[771] Sec. & Exch. Comm'n v. Huffman, 996 F.2d 800, 802 (5th Cir.1993).
[772] *Holloway*, 368 S.W.2d at 576–77.
[773] 754 S.W.2d at 383.
[774] 202 S.W.3d at 239.
[775] *Id.* (citing Robertson v. Bland, 517 S.W.2d 676, 678 (Tex. Civ. App.—Houston [1st Dist.] 1974, writ dism'd).
[776] 997 S.W.2d 798.
[777] 279 S.W.2d at 857–58.
[778] *Id.* at 858 ("We regard this latter provision as fair and even necessary, considering the malicious character of the misconduct heretofore involved and the consequent possibility of its repetition.").
[779] Id.
[780] Int'l Bankers Life Ins. Co. v. Holloway, 368 S.W.2d 567, 584 (Tex. 1963).
[781] Commonwealth of Massachusetts v. Davis, 140 Tex. 398, 168 S.W.2d 216, 221 (1942), cert. denied, 320 U.S. 210 (1943).
[782] *Id.*; Wingate v. Hajdik, 795 S.W.2d 717, 719 (Tex. 1990); Fredericksburg Indus., Inc. v. Franklin Intl, Inc., 911 S.W.2d 518, 520–21 (Tex. App.—San Antonio 1995, n.w.h.).

wrong."[783] A derivative action is a suit brought by a plaintiff shareholder on behalf of the corporation. The plaintiff, suing in a representative capacity, asserts rights belonging to the corporation because the management of the corporation refuses to do so.[784] However, shareholder may not use the procedure of a derivative claim to seek to change corporate policies of which they merely disapprove.[785] Furthermore, the corporation's refusal to act must be the result of something more than unsound business judgment.[786]

### B. Procedure for Bringing a Derivative Action

1. Standing

In order to institute a derivative suit, the plaintiff must be a shareholder, and must have been a shareholder at the time of the act or omission complained of or have become a shareholder by operation of law (*e.g.*, inheritance) from a person that was a shareholder at the time of the act or omission complained of, and must fairly and adequately represent the interests of the corporation in enforcing the rights of the corporation.[787]

a. Continuous ownership requirement

Texas courts impose a three-part test to determine whether the plaintiff satisfies the contemporaneous ownership requirement. The plaintiff must prove that he:

(1) owned stock in the corporation at the time of the transaction of which he complains;
(2) continued to own stock at the time of the bringing of the suit; and
(3) maintained status as a stockholder during the ensuing prosecution of the derivative suit.[788]

A failure to meet this requirement may result in dismissal.[789] If a plaintiff voluntarily relinquishes his status as a shareholder during the pendency of the action, he loses his standing to further prosecute the derivative suit.[790]

i. Loss of Stock by Corporate Action

A corporation may legally deprive a shareholder of his shares either by means of a cash-out or "freeze-out" merger[791] or by a reverse stock split that results in fractional shares.[792] In either case, the shareholder would receive the fair value of his shares in cash, and may have statutory appraisal remedies regarding the amount to be paid.[793] However, the shareholder would cease to be a shareholder and would not have standing to bring derivative claims even for wrong-doing that occurred while he was a shareholder. In *Somers v. Crane*, the First Court of Appeals held that a shareholder who is cashed out by means of a cash-out merger and thus ceases to be a shareholder *before* he files his derivative suit lacks standing to institute the derivative suit.[794]

However, it would seem that a corporation could terminate a shareholder's ability to maintain a derivative suit by instituting a freeze-out transaction during the suit. In *Zauber v. Murray Sav. Ass'n*,[795] the Texas Supreme Court adopted an equitable exception designed to limited the ability to use freeze-out transactions as a defensive tactic in derivative suits.[796] The derivative plaintiff in that case was a shareholder both at the time of the alleged wrongful transaction and at the time the action was filed. During the pendency of

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[783] Wingate v. Hajdik, 795 S.W.2d at 719; see also Martin v. Martin, 363 S.W.3d 221, 237 (Tex. App.—Texarkana 2012, n.p.h.); Webre v. Sneed, 358 S.W.3d 322, 329 (Tex. App.—Houston [1st Dist.] 2011, pet. filed).

[784] Redmon v. Griffith, 202 S.W3d 225, 233–24 (Tex. App.—Tyler 2006, pet. denied) ("The individual shareholders have no separate and independent right of action for wrongs to the corporation that merely result in depreciation in the value of their stock. . . . [T]o recover for wrongs done to the corporation, the shareholder must bring the suit derivatively in the name of the corporation so that each shareholder will be made whole if the corporation obtains compensation from the wrong."); *see also* Swank v. Cunningham, 258 S.W.3d 647, 661 (Tex. App.—Eastland 2008, pet. denied); Perry v. Greanias, 95 S.W.3d 683, 697 (Tex. App.—Houston [1st Dist.] 2002, pet. denied); Gamboa v. Shaw, 956 S.W.2d 662, 666 (Tex. App.—San Antonio 1997, no pet.).

[785] Bass v. Walker, 99 S.W.3d 830, 836 (Tex. App.—San Antonio 2003, pet. denied).

[786] Pace v. Jordan, 999 S.W.2d 615, 622 (Tex. App.—Houston [1st Dist.] 1999, pet. denied).

[787] TEX. BUS. ORGS. CODE § 21.552 (West 2011).

[788] Prudential-Bache Sec., Inc. v. Matthews, 627 F. Supp. 622, 624 (S.D. Tex. 1986).

[789] *See, e.g.*, Crowley v. Coles, 760 S.W.2d 347, 3 50 (Tex. App.—Houston [1st Dist.] 1988, no writ) (summary judgment in derivative action proper where shareholder neither owned stock on date of event giving rise to suit, nor thereafter acquired the stock "by operation of law" within meaning of derivative statute).

[790] Zauber v. Murray Sav. Assn, 591 S.W.2d 932, 937–38 (Tex. Civ. App.—Dallas 1979, writ ref'd n.r.e.) per curiam, 601 S.W.2d 940 (Tex. 1980).

[791] *See* Farnsworth v. Massey, 365 S.W.2d 1, 5 (Tex.. 1963).

[792] *See* BUS. ORGS. § 21.163.

[793] Id. § 10.351 et seq.

[794] Somers v. Crane, 295 S.W.3d 5, 13 (Tex. App.—Houston [1st Dist.] 2009, pet. denied).

[795] 591 S.W.2d 932.

[796] Id. at 938.

the suit, however, the corporation authorized a reverse stock split, which reduced plaintiff's ownership to less than one share, and tendered a cash payment to plaintiff for his fractional share. The Court noted:

> [W]hen a shareholder sues, he is protecting his own interests as well as those of the corporation. If a shareholder voluntarily disposes of his shares after instituting a derivative action, he necessarily destroys the technical foundation of his right to maintain the action. If, on the other hand, a shareholder's status is involuntarily destroyed, a court of equity must determine whether the status was destroyed without a valid business purpose; for example, was the action taken merely to defeat the plaintiff's standing to maintain the suit?[797]

The court remanded the case for a determination of whether the plaintiff had voluntarily relinquished his shareholder status. In the event the trial court determined that the disposition was involuntary, the court stated that the plaintiff would be allowed to proceed with the suit, unless the reverse split was intended to accomplish a valid business purpose.

In 2005, the legislature amended section 21.552 of the Business Organizations Code to be consistent with with the holding in *Zauber*: "To the extent a shareholder of a corporation has standing to institute or maintain a derivative proceeding on behalf of the corporation immediately before a merger, Subchapter J or Chapter 10 [which deal with fundamental business transactions] may not be construed to limit or terminate the shareholder's standing after the merger." However, in 2011, the legislature repealed that provision. "It is now clear that the Code does not grant derivative standing to every pre-merger shareholder who would have had such standing but for the merger. However, the 2011 amendment may also reverse the result in Zauber and preclude equitable exceptions to the contemporaneous ownership rule."[798]

The *Somers* opinion had noted the case law recognizing an equitable exception, but held that it did not apply and did not take a position on whether the exception was Texas law.[799] In light of the recent legislative action, the corporation may be able to terminate a derivative suit by depriving a shareholder of his stock.

ii. Equitable Interests

A "shareholder," for purposes of derivative suit standing includes a beneficial owner whose shares are held in a voting trust or by a nominee on the beneficial owner's behalf.[800] Others who have an equitable interest in stock may also bring derivative claims, such as a pledgee of stock.[801]

b. Adequacy of representation

The Business Organizations Code requires that the shareholder "fairly and adequately represent the interests of the corporation in enforcing the rights of the corporation."[802] The burden is on the defendant to demonstrate inadequacy of representation.[803] Relevant factors include the existence of any conflict of interest between the plaintiff and the corporation,[804] personal motivations that might cause the plaintiff to pursue the action less than vigorously or otherwise act contrary to the corporation's best interests,[805] or the fact that the shareholder participated in, agreed to, or acquiesced in the challenged transaction.[806]

Under the Federal Rules and older Texas case law, a plaintiff had to fairly and adequately represent the interests of other shareholders similarly situated in enforcing the right of the corporation.[807] Under this

[797] *Id.* at 937–38.
[798] 20A Tex. Prac., Business Organizations § 39:9 (3d ed.).
[799] 295 S.W.3d at 14 n.5.
[800] BUS. ORGS. § 21.551(2).
[801] Stubblefield v. Belco Mfg. Co., 931 S.W.2d 54, 56 (Tex. App.—Austin 1996, no writ).
[802] BUS. ORGS. § 21.552(2).
[803] *See* Eye Site, Inc. v. Blackburn, 796 S.W.2d 160, 162 (Tex. 1990); DeBord v. Circle Y of Yoakum, Inc., 951 S.W.2d 127, 132 (Tex. App.—Corpus Christi 1997), *rev'd on other grounds sub nom.* Stary v. DeBord, 967 S.W.2d 352 (Tex. 1998).
[804] *See* Sunset Management, LLC v. American Realty Investors, Inc., 2005 WL 1164181, at *1–2 (N.D. Tex. 2005) (plaintiff, which owned 10 shares, was using a derivative suit as leverage in other litigation); Ford v. Bimbo Corp., 512 S.W.2d 793, 795–96 (Tex. Civ. App.—Houston [14th Dist.] 1974, no writ) (plaintiff also sought to rescind his purchase of shares); see also Zarowitz v. BankAmerica Corp., 866 F.2d 1164, 1166 (9th Cir. 1989) (plaintiff also pursuing wrongful termination claim against corporation); Quirke v. St.Louis-San Francisco Ry. Co., 277 F.2d 705, 708 (8th Cir. 1960) (plaintiff was a competitor of the corporation on whose behalf suit was brought).
[805] *See* Fradkin v. Ernst, 98 F.R.D. 478 (N.D. Ohio 1983).
[806] *See* Stubblefield v. Belco Mfg. Co., Inc., 931 S.W.2d 54, 55 (Tex. App.—Austin 1996, no writ).
[807] *See* FED R. CIV. P. 23.1; Ford v. Bimbo Corp., 512 S.W.2d 793, 795 (Tex. Civ. App.–Houston [14th Dist.] 1974, no writ) (since derivative suit is

requirement, the question of whether a sole dissenting shareholder in a closely-held corporation may bring a derivative action when the remaining shareholders deny that the shareholder adequately represents their interests frequently arose. The Texas Supreme Court held that a sole dissenting shareholder in a closely-held corporation does have standing to pursue the corporation's claims even where the remaining shareholders deny that he represents their interests.[808] Under the formulation in § 21.552(2), no mention is made of the interests of other shareholders.

2. Demand Requirement

a. Demand Must Be Made on the Corporation

Before a derivative suit may be filed, the shareholder must make a written demand that the corporation prosecute the claim. [809] The shareholder may not file the derivative suit until the 91st day after the written demand is "filed with the corporation." Under federal and most states' laws (and Texas law before 1997), a derivative plaintiff was required to allege with particularity his efforts to have the directors bring suit for the corporation or the reasons for not making such an effort.[810] The plaintiff shareholder was required to make a serious effort to pursue the intra corporate remedy before bringing a derivative suit,[811] but the plaintiff need not make a futile demand. Far example, a demand is unnecessary where the directors are the wrongdoers and will not otherwise bring suit.[812] Under the current Texas Code provision, there is no exception for futile demands.

The demand need not be made by a shareholder but may be made on behalf of a shareholder by his attorney, or presumably any agent. [813] However, the written demand must state the name of the shareholder making the demand.[814] The demand must also set forth with particularity the act, omission or matter that is the subject of the claim or challenge and request that the corporation take suitable action.[815] The demand, at a minimum, must (1) identify the alleged wrongdoer, (2) describe the factual basis of the claim, (3) describe the corporation's injury, and (4) request remedial action.[816] The description probably should also address why the business judgment rule does not shield the transaction.[817]

The Texas Supreme Court has indicated that the requirement of particularity is to be taken seriously.[818] A written demand stating only that the board of directors should "stop the . . . merger 'in light of a superior offer . . . at $23 per share'" was insufficiently specific because it did not give any reason why the challenged offer was inferior (other than a difference in price), did not suggest how the board had failed to consider other offers, or what information it might be withholding, and did not state what the board should have done.[819] "Whether a demand is specific enough will depend on the circumstances of the corporation, the board, and the transaction involved in the complaint."[820]

The 90-day waiting period is not required if (1) the shareholder has been previously notified that the demand has been rejected by the corporation, (2) the corporation is suffering irreparable injury, or (3) irreparable injury to the corporation would result by waiting for the expiration of the 90-day period. [821] Presumably, the irreparable injury exceptions would apply only in actions seeking temporary injunctive relief to protect the corporation from irreparable harm. The running of limitations is tolled until the earlier of 90 days after the demand or 30 days after the rejection of the demand, so that limitations cannot serve as an excuse for either the failure to give notice or the shortening of the notice period.[822]

b. The Corporation's Response to the Demand

The corporation may ignore the demand and allow the 90-day period to pass. On the 91st day, the shareholder may file the derivative suit. [823] If the

per se class action, adequacy of representation must be demonstrated).

[808] Eye Site, Inc. v. Blackburn, 796 S.W.2d 160, 163 (Tex. 1990).

[809] TEX. BUS. ORGS. CODE § 21.553(a); *see also* In re Schmitz, 285 S.W.3d 451, 455 (Tex. 2009).

[810] Fed. R. Civ. P. 23. 1.

[811] Renjlrew v. Federal Deposit Ins. Corp., 773 F.2d 657, 659 (5th Cir. 1985).

[812] Muller v. Leyendecker, 697 S.W.2d 668, 676 (Tex. App. San Antonio 1985, writ ref'd n.r.e.). *See also* Stinnett v. Paramount Famous Lasky Corp., 37 S.W.2d 145,149 (Tex. Comm'n App. 1931, holding approved) (demand unnecessary when wrongdoers are in complete control of corporation); Zauber, *supra*; Carr v. York, 449 S.W.2d 842; 845 (Tex. Civ. App.—Houston [1st Dist.] 1970, no writ); Berthold v. Thomas, 210 S.W.506, 508 (Tex. Comm'n App. 1919, holding approved).

[813] *In re* Schmitz, 285 S.W.3d at 457.

[814] Id.

[815] BUS. ORGS. § 21.553(a).

[816] Pace v. Jordan, 999 S.W.2d 615, 621 (Tex. App.—Houston [1st Dist.] 1999, pet. denied).

[817] *See id.* at 622; Langston v. Eagle Publishing, 719 S.W.2d 612, 617 (Tex. App.—Waco 1986, writ ref'd n.r.e.).

[818] *See* In re Schmitz, 285 S.W.3d at 457.

[819] *Id.* at 457-58.

[820] *Id.* at 458.

[821] TEX. BUS. ORGS. CODE § 21.553(b)(West 2011).

[822] *Id.* § 21.557.

[823] *Id.* § 21.553(a).

corporation accepts the demand and determines to pursue the claim (and does so in good faith), then the plaintiff shareholder's derivative suit is not permitted to go forward, and the corporation will control any litigation and settlement. [824] Alternatively, the corporation may reject the demand, in which case the shareholder may file suit immediately.[825] In order for the corporation's rejection of the demand to have any legal validity, the determination to reject the demand must be made by independent and disinterested persons as defined in § 21.554 and after a reasonable inquiry.

If there are independent and disinterested directors on the board, then those directors may make the determination of how to proceed on the allegations in the demand by affirmative vote at a meeting of the board of directors at which any interested directors are not present, if the independent and disinterested directors constitute a quorum. [826] Even if the independent and disinterested directors on the board do not constitute a quorum, a committee of two or more disinterested directors may be appointed by an affirmative vote of a majority of the independent and disinterested directors present at a meeting of the board of directors, and that committee may make the determination as to how the corporation should proceed on the allegations in the demand.[827]

Finally, the corporation may request that the court appoint a panel of independent and disinterested persons nominated by the corporation to make the determination of how to proceed on the allegations in the demand.[828] It is not clear how this procedure would work in response to a pre-suit demand. Presumably, the corporation would have to initiate the lawsuit and request the court to appoint the panel. The request for a panel, whether made by the corporation in an existing proceeding or in a new proceeding instituted by the corporation, would necessarily trigger the stay provided for in § 21.555.

3. Filing the Derivative Lawsuit

a. Pleadings Requirements

A plaintiff in a derivative suit is the shareholder, not the corporation. However, the corporation is a necessary party and is aligned as a nominal defendant. [829] The procedural requirements of a derivative action as set for in the Texas Business Organizations Code must be pleaded.[830] Therefore, the petition should affirmatively state the plaintiff's standing compliance with the demand requirement, and the expiration of 90 days. [831] If the suit is being filed after a rejection of the demand by the corporation, then the petition must also allege "with particularity facts that establish that the rejection was not made in accordance with the requirements of Sections 21.554 and 21.558"[832]—that is that the decision makers were not independent and disinterested or did not follow the procedures required in § 21.554(a) or that there was no reasonable inquiry prior to the determination or that the determination was not made in good faith. Unless affirmatively challenged by the defendants, the plaintiffs are entitled to maintain their derivative action based on their pleadings.[833]

b. Class Certification Is Not Necessary

A derivative suit is not a class action under Texas Business Organizations Code § 42 and does not need to comply with the requirements of that Rule, and the plaintiff in a derivative suit is not required to have the court "certify" the action as is required for class actions.[834]

4. Mandatory Stay

a. Corporation's Motion for a Stay

After the filing of the derivative suit, the corporation may obtain a stay of the proceedings by providing the court with a written statement that it has commenced an inquiry into the allegations made in a demand or petition, that the inquiry is being conducted in good faith by a person or persons authorized by the statute to make a determination regarding the claim, and that the corporation agrees to advise the court and shareholder making the demand of the determination

[824] *See* Renfro v. FDIC, 773 F.2d 657, 660 (5th Cir. 1985); *see also* Mossler v. Nouri, 2010 WL 2133940 (Tex. App.—Austin 2010, pet. filed) (shareholders may not seek an individual recovery when their corporation has filed and is able to pursue its own claim).

[825] BUS. ORGS. § 21.553(b)(1).

[826] *Id.* § 21.554(a)(1).

[827] *Id.* § 21.554(a)(2).

[828] *Id.* § 21.554(a)(3).

[829] *See* Debord v. Circle Y of Yoakum, Inc., 951 S.W.2d 127, 134 (Tex. App.—Corpus Christi 1997), rev'd on other grounds sub nom. Stary v. DeBord, 967 S.W.2d 352 (Tex. 1998); Providential Inv. Corp. v. Dibrell, 320 S.W.2d 415, 418 (Tex. Civ. App.—Houston 1959, no writ); Barthold v. Thomas, 210 S.W. 506, 508 (Tex. Comm'n App. 1919).

[830] Christian v. ICG Telecom Canada, Inc., 996 S.W.2d 270, 275 (Tex. App.—Houston [1st Dist.] 1999, no pet.).

[831] Faour v. Faour, 789 S.W.2d 620, 622 (Tex. App.—Texarkana 1990, writ denied); Kaspar v. Thorne, 755 S.W.2d 151, 154 (Tex. App.—Dallas 1988, no writ); Ford v. Bimbo Corp., 512, S.W.2d 793, 796 (Tex. App.—Houston [14th Dist.] 1974, no writ); *cf.* FED. R. CIV. P. 23.1.

[832] TEX. BUS. ORGS. CODE § 21.559 (West 2011).

[833] 996 S.W.2d at 275.

[834] Christian v. ICG Telecom Canada, Inc., 996 S.W.2d 270, 274 (Tex. App.—Houston [1st Dist.] 1999, no pet.).

promptly on the completion of the review of the matter.[835] Subject to a court's determination of the corporation's good faith, there does not appear to be any restriction on the timing or number of inquiries that the corporation may commence in order to obtain a stay.

Persons authorized to make the inquiry into the allegations of the demand or petition are (1) the independent and disinterested directors of the corporation (outside of the presence of the interested directors) if the independent and disinterested directors constitute a quorum, or (2) a committee consisting of two or more independent and disinterested directors appointed by an affirmative vote of the majority of one or more independent and disinterested directors at a meeting of the board of directors, regardless of whether the independent and disinterested directors constitute a quorum, or (3) a panel of one or more independent and disinterested persons appointed by the court on a motion by the corporation listing the names of the persons to be appointed.[836] The corporation would be required to identify the independent and disinterested board members or the committee conducting the inquiry or request that the court appoint a panel to conduct the inquiry.

b. Hearing on the Motion for Stay

While the Code states that the stay is mandatory, the trial court must hold a hearing and make a determination, in its discretion, as to whether the corporation is "conducting an active review of the [shareholder's] allegations *in good faith*" and whether the persons conducting the inquiry are independent and disinterested.[837] Because the trial court is required to make factual findings regarding whether the corporation is conducting an active review, whether the corporation is acting in good faith, and whether the requirements of § 21.554 have been met, it would make sense that the plaintiff would be given discovery on these issues. At this point in the proceedings, the stay provided in § 21.555 has not yet been granted, and the discovery restrictions provided in § 21.556 do not come into play until the corporation moves to dismiss. Theoretically, the plaintiff is under no restrictions regarding discovery prior to the hearing on the stay. However, the only relevant issues before the court at this point are the elements for a stay under 21.555. The burden of proof at the hearing would be on the shareholder.[838]

c. Appointment of a Panel

If the corporation requests the court to appoint a panel of independent and disinterested persons to conduct the inquiry, then the court must hold another hearing. The corporation is required to state in its motion the names of the persons to be appointed and the representation, to the best of the corporation's knowledge, that the persons to be appointed are disinterested and qualified to make the determinations contemplated by § 21.558[839]—that is, that they are independent and disinterested, are acting in good faith, and will conduct a reasonable inquiry to determine whether continuation of the derivative proceeding is in the best interests of the corporation.[840] In *Johnson v. Jackson Walker, L.L.P.*, the corporation provided the court with the engagement letter and resume for the person nominated and also filed an affidavit by that person in support of its motion to appoint.[841]

Section 21.554(b) requires that the court make findings that the persons recommended by the corporation are independent and disinterested and are otherwise qualified with respect to the expertise, experience, independent judgment, and other factors considered appropriate by the court under the circumstances to make the determinations. Given the nature of the findings required, it would seem that the plaintiff would be given rather broad discovery

[835] BUS. ORGS. § 21.555.

[836] BUS. ORGS. § 21.554(a). If the corporation moves to have the court appoint a panel, the corporation must submit a list of names of the persons to be appointed and represent to the court that, to the best of the corporation's knowledge, the persons to be appointed are disinterested and qualified to make the determination. The court must then find that the person recommended by the corporation are independent and disinterested and are otherwise qualified with respect to expertise, experience, independent judgment, and other factors considered appropriate under the circumstances by the court. § 21.554(b). It is not clear from the statute whether the court is required to limit its review of the panel nominated by the corporation to the representations by the corporation. This seems unlikely, as the scope provided for the court's review and approval of the panel is broader than the requirements for the corporation's written representation. Presumably, the shareholder would be permitted appropriate discovery, and evidence would be presented to the court. *Cf.* Johnson v. Jackson Walker, LLP, 247 S.W.3d 765, 778 (Tex. App.—Dallas 2008, pet. denied) (providing that the shareholder would be given discovery and that the trial court would review evidence and make findings prior to entry of a stay under § 21.555, even though not explicit in the statute).

[837] *Johnson*, 247 S.W.3d at 778.

[838] *Id*.

[839] BUS. ORGS. § 21.554(a)(3).

[840] *Id.* § 21.558.

[841] 247 S.W.3d at 770.

regarding the nominated persons' background, qualifications, conflicts of interest, relationships with the corporation and potentially any other issues that the plaintiff wishes to argue to be a factor that the court should consider. The court is required to make factual findings in its discretion regarding the suitability of the nominees.[842] The court should be able to accept some, all, or none of the nominees of the corporation, but there does not appear to be any discretion on the part of the court to make its own nominations or to entertain any nominations by the plaintiff. The Code does not address the burden of proof, but given the requirement that the corporation need only tender a written representation that, to the best of its knowledge, the nominees are disinterested and qualified, it would make sense that the burden would be on the plaintiff to prove otherwise.

d. Duration of the Stay

The proceedings are to be stayed "until the review is completed and a determination is made by the person or group regarding what further action, if any, should be taken."[843] The Code is somewhat ambiguous as to the length of the stay. Sections 21.555(a) and (b) seem to indicate that the stay is of indefinite duration and continues until the review of the claim and the determination of what action the corporation will take, but that the court may review the continued existence of the stay every 60 day and terminate it. Section 21.555(b) provides that the stay, "on application" (presumably a motion by the shareholder), "may be reviewed every sixty days for the continued necessity of the stay."[844] The Code does not state what factors the court should consider in determining the continued necessity of the stay. Presumably, this determination is subject to the court's discretion and would be based on the court's determination of the corporation's continued good faith and diligence in the inquiry.

However, §21.555(c) seems to indicate that the stay is limited to a 60 period and may be renewed for successive 60-day periods. If the review and determination is not completed before the 61st day after the stay is ordered, the stay may be "renewed for one or more additional 60-day periods," if the corporation provides the court and the shareholder with a written statement of the status of the review and the reasons why a continued extension of the stay is necessary.[845] Renewal of the stay is clearly discretionary. The burden is probably on the corporation to justify each extension.

5. Dismissal

a. Motion to Dismiss

The corporation may move at any time to dismiss the derivative proceeding on the grounds that the corporation has determined that continuation of the derivative proceeding is not in the best interests of the corporation.[846] Dismissal is mandatory if the court determines that the decision that the derivative suit was not in the best interests of the corporation was made (1) by a person or persons authorized to make the determination by Section 21.554(a)[847], (2) in good faith, (3) after conducting a reasonable inquiry, and (4) based on factors the person or group considers appropriate under the circumstances.[848] The basis of the corporation's determination regarding the claim is not subject to any objective standards but "is an inquiry unique to each allegation" with the "widest possible inquiry, limited only by the independence, disinterestedness, good faith, and reasonableness factors."[849] The decision-makers may consider the "chances for a successful suit, the costs of maintaining a suit, and other factors" relevant to the decision to maintain an action.[850]

b. Limitation on Discovery

If the corporation moves to dismiss the action, then discovery is limited to the independence and disinterestedness of the decision-maker, good faith of the inquiry and review, and the reasonableness of the procedures followed in conducting the review.[851] The

[842] *Id.* at 778.
[843] TEX. BUS. ORGS. CODE § 21.555(a) (West 2011).
[844] *Id.* § 21.555(b).
[845] *Id.* § 21.555(c).
[846] *Id.* § 21.558.
[847] This decision must be made by (1) a majority vote of independent and disinterested directors at a meeting of the board of directors at which the interested directors are not present at the time of the vote and at which the disinterested directors constitute a quorum; or (2) a majority vote of a committee consisting of two or more independent and disinterested directors appointed by a majority vote of one or more independent and disinterested directors (whether or not these directors make up a quorum); or (3) a panel of one or more independent and disinterested persons appointed by the court on motion by the corporation where the panel is selected from names submitted to the court by the corporation after a finding by the court that the members are independent and disinterested and otherwise qualified.
[848] BUS. ORGS. § 21.558(a).
[849] *Johnson*, 247 S.W.3d at 778.
[850] Zauber v. Murray Sav. Ass'n, 591 S.W.2d at 936.
[851] BUS. ORGS. § 21.556(a). "Commensurate with his burden of proof, the shareholder is permitted discovery on the independence, disinterestedness, good faith, and reasonable inquiry issues. Accordingly, the statute provides that there will

Code prohibits expanding discovery "to include a fact or substantive matter regarding the act, omission, or other matter that is the subject matter of the derivative proceeding.[852] In *Johnson v. Jackson Walker LLP*, the plaintiff was provided with the court-appointed panel's report and appendices and was allowed to depose the decision maker.[853]

c. Hearing on the Motion

i. Burden of Proof

The Code contemplates an evidentiary hearing at which the trial court must find whether the motion to dismiss satisfies the statutory elements, presumably by a preponderance of the evidence.[854] The plaintiff shareholder has the burden of proof to "negate the statutory elements"[855] if the determination was made by a panel appointed by the court,[856] in which case the court would have already made finding on the issue of the panel's independence and disinterestedness. The plaintiff also bears the burden of proof if the majority of board of directors at the time the determination is made consists of independent and disinterested directors.[857] It is not clear from the statute which party has the burden of proof if the independence and disinterestedness of the majority of the directors is in dispute. In all likelihood, the corporation would bear the burden on the independence and disinterestedness issues and the burden would then shift to the shareholder on good faith and reasonable inquiry.[858]

If the determination is made by a committee, then the corporation must present prima facie evidence that demonstrates that the directors on the committee are independent and disinterested; thereafter, the burden shifts to the plaintiff.[859] In any other circumstance, the burden is on the corporation;[860] however, the only other circumstance that would comply with § 21.554 would be where the decision was made by a majority of the disinterested board members at a meeting where the interested board members were absent and where the disinterested board members constituted a quorum, but not a majority of the board.

ii. Disinterestedness

The decision-makers must be both disinterested and independent. A person is "disinterested" with respect to consideration of the disposition of a claim if neither the person nor that person's associate (1) is a party to the contract or transaction being challenged or materially involved in the conduct that is the subject of the claim, and (2) does not have a material financial interest in the outcome of the contract or transaction or the disposition of the claim.[861] A person's "associate" means an entity for which the person is an officer or governing person or beneficially owns 10% or more of a class of voting ownership interests, a trust or estate in which the person has a substantial beneficial interest or is the trustee or similar fiduciary, the person's spouse or a relative who resides with the person, or a governing person or an affiliate or officer of the person.[862] An "affiliate" is a person who controls, is controlled by, or is under common control with another person.[863]

A person is not materially involved in a contract or transaction that is the subject of a claim or have a material financial interest in the disposition of a claim *solely* because that person was elected or nominated by a person who is interested in the transaction or alleged to have engaged in the conduct that is the subject of the claim, or because the person receives normal fees, compensation, reimbursement of expenses or benefits as a governing person of the entity, or because the person has an equity interest in the entity, or because the person or an associate of the person receives ordinary and reasonable compensation for reviewing or deciding on the disposition of the claim.[864] In *Johnson v. Jackson Walker, LLP*, the court rejected the argument that the corporation should not be permitted to nominate a "friendly person" to conduct the inquiry.[865]

A director is not disinterested *solely* because he is named as a defendant in the lawsuit or is alleged to have been involved in the conduct or even because he, in the capacity as a governing person, approved, voted for, or acquiesced in the act being challenged.[866] However, the director will not be disinterested if he

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be no stay or dismissal without a trial court's review and approval, with the burden of proof on the shareholder to negate the statutory factors, and with reasonable discovery available to the shareholder concerning the issue." *Johnson*, 247 S.W.3d at 778.

[852] BUS. ORGS. § 21.556(b). Discovery can only be expanded if the court denies the motion to dismiss because "the court determine after notice and hearing that a good faith review of the allegations for purposes of Section 21.558 has not been made by an independent and disinterested person or group in accordance with that section."

[853] 247 S.W.3d at 774.

[854] *See* BUS. ORGS. § 21.558.

[855] Johnson v. Jackson Walker, LLP, 247 S.W.3d 765, 778 (Tex. App.—Dallas 2008, pet. denied).

[856] BUS. ORGS. § 21.558(b)(1)(B).

[857] *Id.* §21.558(b)(1).

[858] *See Id.* §21.558(b)(2); *cf.* § 21.558(b)(1)(c).

[859] *Id.* § 21.588(B)(1)(C).

[860] *Id.* § 21.558(b)(2).

[861] *Id.* § 1.003(a).

[862] *Id.* § 1.002(2).

[863] *Id.* § 1.002(1).

[864] *Id.* § 1.003 (b)(1)–(5).

[865] 247 S.W.3d at 777.

[866] BUS. ORGS. § 1.003(b)(6).

received a material person or financial benefit from the transaction or challenged conduct or the petition alleges particular facts that, if true, raise a significant prospect that the governing person would be held liable to the entity or its owners or members as a result of the conduct.[867]

iii. Independence

To be "independent" for purposes of considering the disposition of a claim, the person may not be an associate or member of the immediate family of a party to the challenged transaction or of a person who is alleged to have engaged in the conduct that is the subject of the claim, other than as an officer or director of the corporation or the subsidiaries or associates of the corporation.[868] The person may not have a business, financial, or familial relationship with a party to the challenged transaction or with a person alleged to have engaged in the conduct that is the subject of the claim that could reasonably be expected to materially and adversely affect the judgment of the person in favor of the party or other person with respect to the consideration of the matter.[869] Finally, a person is not independent if it is shown by a preponderance of the evidence that the person is under the controlling influence of a party to the challenged transaction or a person who is alleged to have engaged in the conduct that is the subject of the claim.[870]

However, evidence of lack of independence is insufficient if the proof is solely that the person has been nominated or elected as a governing person by one of the defendants, or that the person receives normal fees, compensation, reimbursement of expenses or other benefits as a governing person, or that the person has a direct or indirect equity interest in the corporation, or that the corporations or its subsidiaries have an interest in the challenged transaction or are affect by the alleged conduct, or that the person or his associate receive ordinary and reasonable compensation for reviewing or determining the disposition of the claim, or that the person or his associate or immediate family member has a continuing business relationship with the entity that is not material to the person, his associate, or family member.[871]

iv. Good Faith

One court has defined the "good faith" element as "[a] state of mind consisting in (1) honesty of belief or purpose, (2) faithfulness to one's duty or obligation, ... or (4) absence of intent to defraud or to seek unconscionable advantage."[872] The court upheld the determination to dismiss the claim where there was no evidence of "a lack of honesty of belief or purpose …, unfaithfulness to his duty …, or an intent to defraud or seek unconscionable advantage."[873] Absent extreme circumstances, arguments that the person reviewing the claim failed drew incorrect conclusions from the evidence "relate to 'substantive matters' not the 'good faith of the inquiry and review' and 'the reasonableness of the procedures followed' … [and] are irrelevant to the trial court's decision on the motion to dismiss."[874]

6. Settlement or Non-Suit

A derivative suit may not be discontinued or settled without court approval, and notice is required to be given to all other shareholders if the court determines that a proposed settlement or discontinuance may substantially affect the interests of other shareholders.[875]

In reviewing a proposed settlement, the trial court must determine whether the settlement is "fair, adequate and reasonable."[876] The burden of showing that a proposed settlement of a shareholders' derivative action is fair, reasonable, and adequate, and that acceptance of its terms is in the best interest of the Corporation and its shareholders, is on the proponents of the settlement.[877] Among the factors to be considered in reviewing the settlement are:

(a) The size of the settlement in light of probability of success on the merits;[878]
(b) The degree to which shareholders intervened to object to the settlement;[879]
(c) The extent to which the settlement was the product of arm's-length bargaining,[880] and
(d) The existence of fraud or risk of collusion between the settling parties.[881]

7. Payment of the Recovery

The general rule is that a monetary recovery in a derivative suit is payable to the corporation rather than

[867] *Id.*
[868] BUS. ORGS. § 1.004(a)(2).
[869] BUS. ORGS. §1.004(a)(3).
[870] BUS. ORGS. §1.004(a)(3).
[871] BUS. ORGS. § 1.004(b).
[872] *Johnson*, 247 S.W.3d at 772 (quoting BLACK'S LAW DICTIONARY 701 (7th ed. 1999)).
[873] 247 S.W.3d at 776.
[874] Id.
[875] BUS. ORGS. § 21.560.
[876] Terrazas v. Ramirez, 829 S.W.2d 712, 719 (Tex. 1991).
[877] Maher v. Zapata Corp., 714 F.2d 436, 454 (5th Cir. 1983).
[878] *See id.* at 455 n.31.
[879] *Id.* at 456.
[880] *Id.* at 457.
[881] I*d.* at 455.

to individual shareholders on a pro rata basis.[882] Nevertheless, the court has the power to decree a pro rata recovery where equity requires.[883] Pro rata recoveries have been allowed to prevent wrongdoers from participating in the recovery.[884]

8. Recovery of Fees and Expenses

The plaintiff may recover his expenses, including attorneys' fees, if the court finds that "the proceeding has resulted in a substantial benefit to the . . . corporation."[885] The "substantial benefit" is not necessarily restricted to a recovery of monetary damages, but may include an injunction against the officers and directors of a corporation engaging in improper conduct.[886] Even if the plaintiff does not obtain a settlement or judgment, he may be entitled to recover fees and expenses if the lawsuit results in the corporation taking action to rectify the improper conduct.[887] On the other hand, the plaintiff risks being required to pay the defendants' expenses if the court finds that the action was "instituted or maintained without reasonable cause or for an improper purpose." Such expenses include attorney's fees, investigation costs, and indemnification costs.[888]

### C. Separate Procedure for Small Corporations

A completely different set of rules apply to "closely held corporations,"[889] which the statute defines as corporations with less than 35 shareholders and with no shares listed on any national securities exchange or over-the-counter market.[890] Shareholders in closely-held corporations are exempted from the standing requirements (although they must still be a shareholder), the requirement to make a demand,[891] the stay of the proceedings and limitation on discovery, the right of the corporation to make a determination of how to proceed on a derivative claim and to have the claim dismissed. Plaintiffs bringing a derivative suit on behalf of a closely-held corporation are still subject to the requirements that the court approve the settlement and to the provisions for recovery or payment of expenses. A plaintiff must plead that the corporation is a closely held corporation within the meaning of section 21.563(a) of the Business Organizations Code.[892]

Section 21.563 also permits shareholders of closely-held corporations to bring their derivative claims as direct actions for their own if the court determines that justice so requires, the derivative action may be treated as a direct action by the shareholder for his own benefit, and any recovery may be paid directly to the plaintiff.[893] The provision allowing direct recovery to the shareholders, however, solves an important problem in derivative litigation-double taxation. If the corporation receives the recovery, the recovery is likely to be taxed at the corporate level and again when distributed to the shareholders as a dividend. Even though the statute permits the trial court to "treat" the action as a direct action, it remains a derivative action.[894] The judicial

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[882] Redmon v. Griffith, 202 S.W.3d 255, 234 (Tex. App.—Tyler 2006, pet. denied) ("to recover for wrongs done to the corporation, the shareholder must bring the suit derivatively in the name of the corporation so that each shareholder will be made whole if the corporation obtains compensation from the wrongdoer.").

[883] 20A TEX. PRAC., BUSINESS ORGANIZATIONS § 39:13 (3d ed.).

[884] *See* Atkinson v. Marquart, 541 P.2d 556, 559 (Ariz. 1975); Lynch v. Patterson, 701 P.2d 1126, 1130–31 (Wyo. 1985). *See also* Rankin v. Frebank Co., 121 Cal. Rptr. 348, 361–62 (Ct. App. 1975) (court possesses power to decree pro rata recovery to prevent windfall to a 50% stockholder who had already received his pro rata share of profits that were unfairly usurped by another stockholder). Similarly, shareholders who participated in or ratified the defendant's conduct should not benefit from the recovery. *See, e.g.*, Joyce v. Congdon, 195 P. 29, 30 (Wash. 1921); Chounis v. Laing, 23 S.E.2d 628, 640 (W. Va. 1942); Young v. Columbia Oil Co., 158 S.E. 678, 685 (W. Va. 1931).

[885] BUS. ORGS. § 21.561(b)(1).

[886] *See* Libhart v. Copeland, 949 S.W.2d 783, 803–04 (Tex. App.—Waco 1997, no writ); Modern Optics, Inc. v. Buck, 336 S.W.2d 857 (Tex. Civ. App.—Waco 1960, writ ref'd n.r.e.); Continental Oil Co. v. Henderson, 180 S.W.2d 998 (Tex. Civ. App.—Fort Worth 1944, writ ref'd).

[887] *See* O'Neill v. Church's Fried Chicken, Inc., 910 F.2d 263 (5th Cir. 1990) (applying Texas law); Prudential Bache Sec. Inc. v. Matthews, 627 F. Supp. 622 (S.D. Tex. 1986) (applying Texas law).

[888] BUS. ORGS. § 21.561(b)(2)–(3).

[889] *See* BUS. ORGS. § 21.563(b).

[890] BUS. ORGS. § 21.563(a).

[891] *See* Webre v. Sneed, 358 S.W.3d 322, 334 (Tex. App.—Houston [1st Dist.] 2011, pet. filed) (holding that a shareholder of a closely held corporation is not required to make a demand on the board of directors).

[892] *See* DDH Aviation, L.L.C. v. Holly, No. Civ. A. 3:02-CV-2598-P, 2005 WL 770595, at *5 (N.D. Tex. Mar. 31, 2005) (applying Texas law) (dismissing derivative claim for failure to make a demand on the board where the plaintiff did not allege that the corporation was closely held in accordance with statutory requirements but granting leave to replead).

[893] BUS ORGS. § 21.563(c).

[894] Swank v. Cunningham, 258 S.W.3d 647, 665 (Tex. App.—Eastland 2008, pet. denied).

treatment of the derivative action is an additional remedy, which the plaintiff must request and which the trial court may or may not grant.[895] Furthermore, the plaintiff is under no obligation to seek to have his derivative claim treated as a direct claim.[896]

### D. Examples of Suits That Must be Brought Derivatively

A cause of action against one who has injured a corporation belongs to the corporation and not to the shareholders. [897] A corporate stockholder cannot recover damages personally for a wrong done solely to the corporation, even though he may be injured by that wrong.[898] A cause of action for injury to the property of a corporation or for impairment or destruction of its business is vested in the corporation, as distinguished from its shareholders, even though the harm may result indirectly in the loss of earnings to the shareholders.[899] The individual shareholders have no separate and independent right of action for wrongs to the corporation that merely results in depreciation in the value of their stock. As a result, to recover for wrongs done to the corporation, the shareholder must bring the suit derivatively in the name of the corporation so that each shareholder will be made whole if the corporation obtains compensation from the wrongdoer.[900]

1. Breach of Fiduciary Duty or Fraud

An action against directors and officers for breaching their fiduciary duties belongs to the corporation and must be asserted derivatively by a shareholder.[901] The rationale for this rule is that the directors' duties of loyalty and care run to the corporation, not to the individual shareholders.[902] If the corporation is unwilling to join the suit as a plaintiff because it is controlled by the defendants, it may be named as a nominal defendant.[903]

2. Sale of Control

An action to recover the premium obtained by certain shareholders through the wrongful sale of corporate control may be asserted derivatively. Unlike the usual derivative action, however, the benefit of any recovery will accrue only to the minority shareholders who were harmed by the wrongful sale and not to the selling shareholders or their successors in interest.[904]

3. Other Rights Belonging to the Corporation

A cause of action for fraud, breach of confidential relationship and conspiracy must be brought derivatively if the injuries alleged were suffered by the corporation and not the shareholder in his individual capacity.[905] It has also been held that a cause of action for failure to assert a legal malpractice claim by the officers and directors of the corporation is properly a derivative action.[906]

### E. Interplay Between Derivative Actions and Shareholder Oppression Actions

Texas case law is clear that acts that might otherwise give rise to direct claims owned by the corporation can also constitute evidence of a pattern of oppressive behavior. In *Ritchie v. Rupe*, the Dallas Court of Appeals stated that "oppressive conduct does not require a showing of fraud, illegality, mismanagement, wasting of assets, or deadlock, although these factors are often present."[907] *Davis v. Sheerin* held that waste of corporate assets was a

[895] In Rogers v. Alexander, 244 S.W.3d 370 (Tex. App.—Dallas 2007, no pet.), the court permitted three shareholders of a closely held corporation to sue in their individual capacities to recover damages to the corporation caused by the fraud of outside parties. By contrast, in Swank v. Cunningham, 258 S.W.3d 647 (Tex. App.—Eastland 2008, pet. denied), the court refused to permit a direct suit against the corporation's law firm to protect a nonparty-shareholder's interest in any potential recovery. In Vasilj v. Duzich, 2010 WL 476684 (N.D. Ill. 2010) (applying Texas law), a court denied an unusual request by defendants to allow derivative litigation to proceed as a direct action.

[896] In Webre v. Sneed, 358 S.W.3d 322, 337 (Tex. App.—Houston[1st Dist.] 2011, pet. filed), the court held that a plaintiff's lack of entitlement to a direct, non-corporate recovery does not deny him standing to bring a derivative suit on behalf of a closely held corporation.

[897] Swank v. Cunningham, 258 S.W.3d 647, 661 (Tex. App.—Eastland 2008, no pet.).

[898] Wingate v. Hajdik, 795 S.W.2d 717, 719 (Tex.1990).

[899] Redmon v. Griffith, 202 S.W.3d 225, 233 (Tex. App.—Tyler 2006, pet. denied).

[900] *See Swank*, 258 S.W.3d at 661; *Redmon*, 202 S.W.3d at 234.

[901] Gearhart Indus., Inc. v. Smith Int'l, Inc., 741 F.2d 707, 721 (5th Cir. 1984); Wingate v. Hajdik, 795 S.W.2d 717, 719 (Tex. 1990); Providential Invest. Corp. v. Dibrell, 320 S.W.2d 415 (Tex. Civ. App.—Houston [1st Dist.] 1959, no writ).

[902] *Gearhart*, 741 F.2d at 721.

[903] *Id.*

[904] Perlman v. Feldmann, 219 F.2d 173 (2d Cir.), cert. denied, 349 U.S. 952 (1955).

[905] Steven's v. Lowder, 643 F.2d 1078, 1089, reh'g denied, 652 F.2d 1001 (5th Cir. 1981).

[906] *See* Federal Deposit Ins. Corp. v. Shrader & York, 777 F. Supp. 533, 535 (S.D. Tex. 1991), *aff'd*, 991 F.2d 216 (5th Cir. 1993).

[907] Ritchie v. Rupe, 339 S.W.3d 275, 294 (Tex. App.—Dallas 2011, pet. granted)

critical part of the pattern of oppressive conduct.[908] *Redmon v. Griffith* held that improper loans from the company, payment of personal expenses from corporate funds, excessive compensation, and usurpation of corporate opportunities were all part of a pattern of oppressive conduct.[909] In *Willis v. Donnelly*, the court of appeals held that a majority shareholder's "purposeful actions to dilute the value of the shares while employing the business and its assets solely for [the majority shareholder's] benefit"[910] constituted shareholder oppression. Although duties against self-dealing, diversion of corporate funds, and usurpation of corporate opportunities are owed to the corporation itself, these courts held that these same acts were properly part of a shareholder oppression claim by the minority shareholder. The same reasoning would apply to a majority shareholder's breach of a contract with the corporation that indirectly harms the minority shareholders—only the corporation can sue for breach of contract directly, but that same wrongful conduct by the majority may be used as evidence to support a shareholder oppression claim by the minority.

Most shareholder oppression cases involve small corporations that fit the definition of "closely-held" in § 21.563. In those cases, claims for violations of duties to the corporation usually should be asserted as both shareholder oppression claims and derivative claims (with the request that the court treat the derivative claims as direct). However, in some instances shareholders will bring oppression claims involving larger corporations and will not be able to assert derivative claims, or shareholders will lose the ability to assert derivative claims as a result of a bankruptcy. It is well established in Texas that shareholder oppression is a direct, not a derivative, claim.[911] Therefore, shareholders who are unable to assert derivative claims will still be able to assert oppression claims. In those cases, conduct for which only the corporation could recover damages, such as looting assets, may still be an important part of the proof of a pattern of oppression, for which the plaintiff will be seeking a remedy other than damages caused by such conduct.[912]

### F. Conflicts Issues in Derivative Litigation

1. Dual Representation of the Corporation and Management in Derivative Suits

When a shareholder brings an derivative action on behalf of the corporation, it is well-established in Texas that the corporation is not only a proper party to a derivative claim, but is an indispensable party to a shareholder's lawsuit.[913] Ordinarily, the plaintiff is required to name the corporation as a "nominal" defendant, notwithstanding the fact that the plaintiff shareholder purports to represent the interests of the corporation.[914] "In a derivative action, a plaintiff shareholder is a nominal plaintiff and the corporation on behalf of which the action is brought is merely a nominal defendant."[915] As the Court stated in *Miller v. American Telephone and Telegraph Co*., "(a)lthough . . . any corporation involved in a stockholders' derivative action . . . is properly made a nominal defendant, it

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[908] 754 S.W.2d at 384.

[909] 202 S.W.3d at 235.

[910] 118 S.W.3d 10, 32 (Tex. App.—Houston [14th Dist.] 2003) *aff'd in part, rev'd in part on other grounds*, 199 S.W.3d 262 (Tex. 2006) (reversing shareholder oppression judgment because the "minority shareholder" never actually became a shareholder in the company).

[911] *See Ritchie*, 339 S.W.3d at 295 (stating, in light of the Appellants argument that the business judgment rule protects corporate directors from personal liability in operating the corporation unless the actions are *ultra vires* or tainted by fraud, that the shareholder oppression case before them "is not a derivative suit for breach of care owed to the corporation."). S*ee also Redmon*, 202 S.W.3d at 234, 242 (holding that minority shareholders had standing to sue for shareholder oppression and breach of fiduciary duty by way of shareholder oppression); *DeBord v. Circle Y of Yoakum, Inc*., 951 S.W.2d 127, 133 (Tex. App.—Corpus Christi 1997) (stating that claims of oppressive conduct arising out of fiduciary duties owed by the majority shareholders to the minority shareholders are individual claims of the minority shareholders), *rev'd on other grounds sub nom.*, *Stary v. DeBord*, 967 S.W.2d 352 (Tex. 1998).

[912] *See In re* Trockman, No. 07-11-0364-CV, WL 2012 554999 at *3 n.2 (Tex. App.—Amarillo Feb. 21, 2012, orig. proceeding) (stating that authority exists illustrating that self-dealing by those in control of the corporation may also constitute indicia of shareholder oppression).

[913] *See* Barthold v. Thomas, 210 S.W. 506, 507–08 (Tex. Comm'n App. 1919, jmt adopted); Providential Inv. Corp. v. Dibrell, 320 S.W.2d 415, 418 (Tex. Civ. App.—Houston 1959, no writ). Accord In re Marriage of Scott, 117 S.W.3d 580, 583 (Tex. App.—Amarillo 2003, no pet.); DeBord v. Circle Y of Yoakum, Inc., 951 S.W.2d 127, 134 (Tex. App.—Corpus Christi 1997), *rev'd on other grounds sub nom.*, Stary v. DeBord, 967 S.W.2d 352 (Tex. 1998); Texas Soc. v. Fort Bend Chapter, 590 S.W.2d 156, 160 (Tex. Civ. App.—Texarkana 1979, writ ref'd n.r.e.); Motorola, Inc. v. Chapman,761 F. Supp. 458 (S.D. Tex. 1991).

[914] *See* Meyer v. Fleming, 327 U.S. 161, 168 (1946); Bell Atlantic Corp. v. Bolger, 2 F.3d 1304, 1315 (3d Cir. 1993).

[915] Clark v. Lomas & Nettleton Fin. Corp., 79 F.R.D. 658, 659 (N.D. Tex. 1978).

must realistic ally be considered to be the complainant in the action."[916]

The usual situation in a shareholder derivative suit is that the shareholder is bringing a claim against those in control of the corporation (officers, directors and/or controlling shareholders) for damage done to the corporation through a breach of their fiduciary duties, such as looting the corporation's assets through excessive compensation. Because the defendants being accused of harming the corporation also control the corporation, the paradox almost invariably arises that the "corporation" thinks the lawsuit brought on its behalf is a very bad idea and actively opposes the effort. Because the plaintiff shareholder is required to join the corporation as a "nominal" defendant (even though it is the real plaintiff in interest), very frequently the corporation's regular counsel, paid by the corporation, undertakes the joint representation of the corporation and of the individual defendants in opposition to the plaintiff's derivative claim. Therefore, the defendants' attorney, at least theoretically, is in the awkward position of representing the corporation in trying to prevent the corporation from obtaining damages from individuals accused of looting the corporation. This situation presents a very real conflict of interest. As the United States District Court for the Northern District of Texas wrote in *Clark v. Lomas & Nettleton Fin. Corp*.:

> In fact, the corporation is the real plaintiff and any finding of liability would redound to its benefit, not to its detriment. And, obviously, in this action any finding of liability on the part of the 'inside' directors, controlling stockholder and the controlled corporations would result in a recovery for Booth, Inc. The interests of Booth, Inc. and the other Director defendants are clearly adverse, and the representation by one law firm of Booth, Inc. and the Directors, except under very limited circumstances, would be improper under the Canons of Ethics.[917]

a. Dual Representation is Usually a Conflict of Interest.

Although no Texas court has addressed the issue, a many decisions in other jurisdictions have held that, in general, the same attorney may not represent both the corporation and the individual defendants accused of serious breach of fiduciary duties to that corporation. The first case to seriously address the issue was *Lewis v. Shaffer Stores Co*.,[918] which held:

> [T]he interests of the officer, director and majority stockholder defendants in this action are clearly adverse, on the face of the complaint, to the interests of the stockholders of [the corporation] other than defendants. I have no doubt that [the attorneys] believe in good faith that there is no merit to this action. Plaintiff, of course, vigorously contends to the contrary. The court cannot and should not attempt to pass upon the merits at this stage. Under all the circumstances, including the nature of the charges, and the vigor with which they are apparently being pressed and defended, I believe that it would be wise for the corporation to retain independent counsel, who have had no previous connection with the corporation, to advise it as to the position it should take in this controversy.

In *Cannon v. U.S. Acoustics Corp*.,[919] the court disqualified a law firm from representing a corporation and its board of directors in a derivative action, where the complaint alleged a misappropriation of corporate funds by the Directors. The court reached its decision based upon both the conflict of interest between the corporation and its directors, and the possibility that confidences obtained from one client during the course of representation might be used to the detriment of the other. Many other courts have reached the same result.[920]

The same rule applies in a dissolution case (and therefore presumably in a shareholder oppression case).[921]

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[916] 394 F.Supp. 58, 65 (E.D. Pa.1975), *aff'd* 530 F.2d 964 (3rd Cir. 1976).

[917] 79 F.R.D. at 659–60.

[918] 218 F.Supp. 238, 239–40 (S.D.N.Y.1963).

[919] 398 F.Supp. 209 (N.D. Ill.1975), *aff'd in relevant part per curiam*, 532 F.2d 1118, 1119 (7th Cir.1976).

[920] *See* Messing v. FDI, Inc., 439 F.Supp. 776 (D. N.J.1977); In re Oracle Securities Litigation, 829 F.Supp. 1176, 1188–89 (N.D.Cal.1993); Musheno v. Gensemer, 897 F.Supp. 833, 838 (M.D.Pa. 1995) ("Rather, in cases such as this, where the potential for conflict is great, the better approach is to require the corporation to obtain independent counsel."); Forrest v. Baeza, 67 Cal. Rptr. 2d 857, 863 (Cal. App. 1st Dist. 1997); Rowen v. LeMars Mut. Ins. Co., 230 N.W.2d 905, 915 (Iowa 1975); Horowitz v. Horowitz, 151 A.D.2d 646 (1989); Tydings v. Berk Enter., 565 A.2d 390, 393 (1989); *see also* Bell Atlantic Corp. v. Bolger, 2 F.3d at 1316 ("We have no hesitation in holding that—except in patently frivolous cases—allegations of directors' fraud, intentional misconduct, or self-dealing require separate counsel.").

[921] *See* La Jolla Cove Motel and Hotel Apts. Inc. v. Superior Court, 17 Cal.Rptr.3d 467, 476 (Cal. App. 4th Dist. 2004).

b. Exceptions

Most courts have applied the conflict rule only in cases involving allegations of serious misconduct by the individual defendants. The Third Circuit held that where the claims against the individuals were merely negligence or mismanagement, that is breaches of the duty of care rather than the duty of loyalty, and then disqualification was not required.[922] Also courts do not apply the rule in derivative cases that are "patently frivolous."

Some courts have held that the early and limited representation of the individual defendants by the corporation's counsel does not present a serious conflict, such as when the corporation's attorneys file an answer or a motion to dismiss on behalf of the individual defendants but then withdraw. In *Clark v. Lomas & Nettleton Fin. Corp.*,[923] the court held that there is no conflict of interest requiring disqualification in the narrow instance when one law firm represents a derivatively sued corporation and its individually sued directors and the law firm initially files a motion to dismiss on behalf of its clients, does not otherwise participate in the lawsuit, and withdraws from representation of either the corporation or the individual directors when either the motions are overruled or when it becomes necessary to participate in the defense of the corporation and the individual directors. At this stage of the proceedings, when the court must make a determination on whether as a matter of law the defendants should be in the lawsuit, unless it can be shown that an actual conflict exists or that certain confidences are being jeopardized, I think the client's right to select the counsel of his choice outweighs any potential conflict of interest. Once that determination is made, or once it becomes necessary for active participation in the defense of the directors, then new counsel must be sought, because the potential for conflict has increased to the point where it outweighs the rights of the individual directors to select counsel.

However, other courts, although acknowledging that no real conflict exists at the outset of the lawsuit and that the defendants might be burdened by having to locate two different law firms from the outset, nevertheless held that even this limited joint representation was not permitted.[924]

The district court in *Clark v. Loman & Nettleton Fin. Corp*. also suggested, but did not actually consider, that it might be possible for the court to allow the corporation to waive the conflict.[925] One rather odd Louisiana opinion recognizes the considerable authority holding that there is a conflict in dual representation when the individuals are accused of serious misconduct, but holds that disqualification is not appropriate:

> Although the corporation appears as a party on both sides of the lawsuit, its true interest lies with the plaintiff shareholder; it is only nominally a defendant. Therefore, [the law firm] represents only the interests of the individual directors who have allegedly harmed the corporation, and the plaintiff's counsel actually represents the interests of the corporation, to which any recovery will be returned. [The law firm] is not representing adverse interests because the corporation has no interest as a defendant; it is merely required to be named as one.[926]

Therefore, the court reasoned, there is no conflict because the defendants' lawyers are not really representing the corporation—which raises an interesting question of whether the corporation is paying their legal fees and why.

c. Retaining Independent Counsel.

Generally, the choice of independent counsel belongs to the corporation, not to the court.[927] However, merely requiring the defendants to associate a second law firm does not really solve the problem. If the individual defendants control the corporation, hire counsel who take their orders from the individual defendants (even if not technically representing them), and actively engage in a joint defense with the individual defendants' counsel, then the situation with the separate counsel continues the same evils that the disqualification sought to remedy—confidential information belonging to the corporation may still be used against the best interests of the corporation, the attorneys for the corporation are still actively opposing the interests of the corporation. Therefore, courts have been careful to exercise some supervision over the selection and conduct of the new independent counsel.

In this derivative action the officers and directors who are accused of harming the interests of the policyholders will choose counsel to represent the policyholders regarding those charges unless the court does so. The issue is equitable. We can exercise our

[922] *Bell Atlantic Corp.*, 2 F.3d at 1317 (but noting that "in cases where the line is blurred between duties of care and loyalty, the better practice is to obtain separate counsel").

[923] 79 F.R.D. 658, 661 (N.D. Tex. 1978).

[924] *See* Musheno v. Gensemer, 897 F.Supp. at 838.

[925] 79 F.R.D. at 661.

[926] Robinson v. Snell's Limbs and Braces of New Orleans, Inc., 538 So.2d 1045, 1048–49 (La. App. 1989).

[927] *See* Tydings v. Berk Enters., 565 A2d 390 (1989).

discretion to permit the corporations to choose independent counsel to represent them, or we or the trial court can select the independent counsel. . . . While the first alternative would respect corporate autonomy and remove the outward appearance of dual representation, it would not eliminate the substance of the problem sought to be avoided. Counsel for the corporation would be subject to the control of those accused of wrongdoing.[928]

Some courts have ruled that the lawyer who has been engaging in the dual representation may continue to represent the corporation, while independent counsel is retained for the individuals. Defendants often favor this approach as it simplifies having the corporation pay the entire cost of the defense. However, most courts have required the corporation to retain new, independent counsel.[929]

In *Lewis v. Shaffer Stores, Co.*,[930] the district court ordered the corporation to obtain separate, independent counsel, "who have had no previous connection with the corporation," and who were to file an answer on behalf of the corporation after their own investigation of the facts. However, the court did not find the fact the independent counsel for the corporation would be selected by the same officers and directors who had been sued to "present any insuperable difficulty." The court in *Messing v. FDI, Inc.*,[931] faced with a similar situation, held that the corporation was required to obtain independent counsel, "unshackled by any ties to the directors," to advise it of its most favorable course of action.[932]

In *Rowen v. LeMars Mut. Ins. Co. of Iowa*,[933] the Iowa Supreme Court ordered the trial court to appoint independent counsel for the corporation. The Second Circuit acknowledged the court's power to do so.[934] However, a Maryland court of appeals rejected this approach.[935] In *Messing v. FDI, Inc.*,[936] the federal district court declined to appoint independent counsel for the corporation as this would "prospectively pass" on the director's willingness to comply with the court's order to associate truly independent counsel. However, the court left the door open to its future appointment of counsel if the directors requested that the court do so or if the directors failed to comply with the order. "It is the duty of the directors, in this as in other matters, to act in the corporation's best interest. If they are disqualified from acting on this or on any other matter, then it is for them, in the first instance, to devise a method to accommodate the need to continue the corporate enterprise while refraining from participating in any corporate decision in which they might have a personal interest. They act, or fail to act, at their peril."[937]

2. The Corporation's Position in Derivative Suits.

A related issue is whether the corporation, regardless of who represents it, may actively defend its management in a derivative suit. Even if the corporation and the management are represented by different lawyers, the management still control the corporation and hire, pay and direct the activities of the corporation's lawyer. If the management is being sued for damaging the corporation, then the management will be eager to have the corporation through its counsel take a position in defense of the management. The corporation, after all, is not its management, and the true interests of the corporation are not necessarily aligned with the desire of management—particularly if the management is really looting the corporation. The attorney for the corporation must be aware that the inherent conflict of interest among the management can become the attorney's conflict if he is directed to conduct the litigation so as to favor the management at the expense of the true interests of the corporation. If there are outside, disinterested directors, or a disinterested litigation committee, then the corporate attorney's job is much simpler because he can take his direction from directors who have no personal interest in the decision, although the attorney must be aware of whether the disinterested directors are exercising their valid business judgment—fully informed, independent of domination by the self-interested directors.

The overwhelming authority is that the corporation must remain neutral unless the derivative

[928] Rowen v. LeMars Mut. Ins. Co., 230 N.W.2d at 916.

[929] *See* Stepak v. Addison, 20 F.3d 398, 404 (11th Cir. 1994); *see, e.g.*, Cannon v. U.S. Acoustics Corp., 398 F.Supp. 209, 220 (N.D. Ill. 1975) (rejecting potentially conflicted counsel's offer to withdraw from representation of individual defendants but requiring the corporation to obtain independent counsel), *aff'd in relevant part*, 532 F.2d 1118, 1119 (7th Cir.1976) (per curiam); Lewis v. Shaffer Stores Co., 218 F.Supp. 238, 240 (S.D.N.Y. 1963) (requiring corporation to obtain independent counsel when corporation's general counsel had also represented the insider defendants and when the interests of the corporation and the insiders were clearly adverse on the face of the complaint).

[930] 228 F.Supp. at 240.

[931] 439 F.Supp. 776 (D.N.J.1977).

[932] *See also* Garlen v. Green Mansions, Inc., 9 A.D.2d 760 (N.Y. App. Div. 1959) (appearance by a corporation in a derivative suit "must be by independent counsel whose interests will not conflict with those of the individual defendant")

[933] 230 N.W.2d at 916,

[934] Levine v. American Export Indus., Inc., 473 F.2d 1008, 1009 (2nd Cir. 1973).

[935] Tydings v. Berk Enterp., 565 A.2d at 396.

[936] 439 F.Supp. 776, 784 (D.N.J. 1977),

[937] Id. at 783-84.

action directly threatens corporate interests (independent of whether it threatens corporate management).[938] Therefore, if disinterested directors or a disinterested special committee determine that the derivative litigation is not in the best interest of the corporation, then the corporation's attorney can and should pursue a dismissal under Texas Business Organizations Code § 21.558. If the litigation threatens a legitimate corporate interest, then the corporation's attorney may defend against the derivative suit. However, the interests that justify the corporation's active participation in the defense must be interests of the corporation, not the interests of the corporation's management. If the litigation will result in exposing the corporation to liability to a third party or will result in making public confidential information, then the corporation may oppose the lawsuit or seek relief from the court necessary to protect the corporate interests. However, the fact that litigation against the management will be distracting and expensive and will otherwise inconvenience the officers and directors who are being sued should not justify active participation in the defense by the corporation.

3. Conflicts When Representing the Shareholders in a Derivative Action

Attorneys representing plaintiff shareholders in litigation must also be aware of potential conflicts of interest because these attorneys will owe duties both to their individual client and to the corporation on whose behalf the lawsuit was brought. These interests are not always perfectly aligned.

a. Joining individual and derivative claims

Very frequently, the shareholder will have individual claims, such as shareholder oppression, that arise out of or relate to the transactions and occurrences that gave rise to the derivative claims, and which are properly brought in the same lawsuit. At a very theoretical level, there is some conflict of interest inherent in the simultaneous pursuit of individual and derivative claims.[939]

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[938] *See* Patrick v. Alacer Corp., 167 Cal.App.4th 995, 84 Cal.Rptr.3d 642 (2008); Sobba v. Elmen, 462 F.Supp.2d 944, 950 (E.D. Ark. 2006); Int'l Bhd. of Teamsters, Chauffeurs, Warehousemen & Helpers of Am. v. Hoffa, 242 F.Supp. 246, 253 (D.D.C.1965); Alleghany Corp. v. Kirby, 218 F.Supp. 164, 186 (S.D.N.Y.1963) ("New York allows a corporation to expend funds in defense of a derivative action presumptively brought in its behalf when some interest of the corporation is threatened."); Fuller v. Am. Mach. & Foundry Co., 91 F.Supp. 710, 711 (S.D.N.Y.1950) ("The corporation can actively defend where the interests of the corporation are threatened with injury by the relief sought in the complaint."); Leven v. Birrell, 92 F.Supp. 436, 444 (S.D.N.Y.1949); Otis & Co. v. Penn. R.R. Co., 57 F.Supp. 680, 682 (E.D. Pa.1944) (holding that corporation can file an answer when the plaintiff's "cause of action is such as to endanger rather than advance corporate interests," but not where the cause of action is fraud against the corporate directors); Esposito v. Riverside Sand & Gravel Co., 287 Mass. 185, 191 N.E. 363 (1934); Meyers v. Smith, 190 Minn. 157, 159, 251 N.W. 20, 21 (1933) (striking the corporation's answer where defendants who controlled the corporation sought "to impose on the corporation the burden of fighting their battle"); Slutzker v. Rieber, 28 A.2d 528, 530 (N.J. Ch. 1942) (granting motion to strike the corporation's answer that controverted the merits of the complaint's claims); Solimine v. Hollander, 129 N.J. Eq. 264, 266–68, 19 A.2d 344, 345–46 (N.J. Ch. 1941); Chaplin v. Selznick, 186 Misc. 66, 58 N.Y.S.2d 453, 455 (Sp. Term 1945) ("The corporation itself can take no position in a derivative stockholder's suit which is fundamentally antagonistic to the claim asserted on its behalf. That is the whole theory which is behind a derivative stockholders' action."); Kirby v. Schenck, 25 N.Y.S.2d 431, 432–33 (Sp. Term 1941) (allowing corporation to defend action where plaintiff sought to enjoin corporation from carrying out personal service contracts because "interests of the corporation [were] injuriously threatened" by plaintiff's suit); Godley v. Crandall & Godley Co., 181 A.D. 75, 78, 168 N.Y.S. 251 (N.Y. App. Div.1917); Swenson v. Thibaut, 250 S.E. 2d 279, 294 (1978); Nat'l Bankers Life Ins. Co. v. Adler, 324 S.W.2d 35, 37 (Tex. Civ. App. 1959) ("If the derivative action threatens rather than advances the corporate interests, the corporation may actually defend the action."); *see also* Corey v. Indep. Ice Co., 115 N.E. 488 (1917) (holding that corporation was allowed to defend suit challenging corporate reorganization); Apfel v. Auditore, 223 A.D. 457, 458, (N.Y. App. Div.1928) ("We regard it as inequitable that the corporations should be called upon to pay for the defense of this action brought for their benefit and resulting in a judgment in favor of the plaintiff as a representative of the corporate interests."); *cf.* Lewis v. Shaffer Stores Co., 218 F.Supp. 238 (S.D.N.Y.1963) (striking corporation's answer where it was represented by same counsel representing the defendant directors and officers of the corporation); Weiland v. N.W. Distilleries, 281 N.W. 364 (1938) (finding that corporation could defend suit where plaintiff's suit sought the corporation to cancel and void 375 shares of stock); McHarg v. Commonwealth Fin. Corp., 44 S.D. 144, 182 N.W. 705 (1921) (finding that corporation could challenge venue where plaintiff sought the appointment of a receivership).

[939] See Tuscano v. Tuscano, 403 F.Supp.2d 214, 223 (E.D.N.Y. 2005) ("Any individual claims

In bringing the derivative claims on behalf of the corporation, the plaintiff and his attorney are acting in a representative capacity and owe the corporation fiduciary duties of loyalty. If the plaintiff shareholder is also suing on individual claims, then that plaintiff and his attorney might be tempted to devote greater resources and attention to the individual claims or to favor the individual claims in settlement negotiations. Courts have recognized that the conflict between a plaintiff's derivative and individual claims is more "theoretical than real."[940] In assessing this "theoretical" conflict, courts look beyond the "surface duality" and determine whether an actual conflict exists.[941]

Notwithstanding this theoretical possibility of a conflict (and bearing in mind that the court must pass on the fairness and adequacy of the settlement), courts have almost universally held that it is permissible for a plaintiff shareholder to join individual and derivative claims.[942] Nor does it matter that the derivative and individual claims arise from the same facts.[943]

b. Suing the Corporation

A much more difficult issue is presented when an attorney represents a plaintiff shareholder that joins claims against the corporation with derivative claims on behalf of the corporation. Take a fairly typical shareholder oppression scenario. The controlling shareholder initiates a campaign to squeeze out a minority shareholder. This campaign involves looting the corporation, misappropriating assets, excessive compensation, firing the plaintiff, and causing the corporation to withhold compensation due to the plaintiff under a contract. While all of this conduct is supports a claim of oppressive conduct against the controlling shareholder, claims for damages resulting from the looting, misappropriation, and excessive compensation can only be asserted as derivative claims. Joining these derivative claims against the controlling shareholder with a shareholder oppression claim against the same defendant arising in part from the same conduct should not present a problem; however, the claim for damages from withholding compensation can only be asserted against the corporation. The reason that the corporation breached the contract was that the controlling shareholder caused the corporation to do so as part of a campaign of oppression, but because the party to the contract is the corporation and not the controlling shareholder, the claim must be brought only against the corporation. There is no logical inconsistency and no actual conflict of interest, but the plaintiff and his attorney are, in fact, suing the corporation at the same time as they are supposed to be representing it. In derivative suit, the corporation is the real plaintiff.[944]

Whether this is a matter of form over substance or not, simultaneously suing and representing the same party is an ethical issue that the law takes very seriously. Texas Disciplinary Rule of Professional Conduct 1.06 plainly states that a "lawyer shall not represent opposing parties to the same litigation." The term "opposing parties" contemplates the situation where a judgment favorable to one party will have a direct negative impact on the other.[945] "Unquestionably, the national standards of attorney conduct forbid a lawyer from bringing a suit against a current client without the consent of both clients."[946]

The issue of whether a lawyer may be disqualified from representing a plaintiff on both her derivative claims on behalf of the corporation and on her individual claims against the corporation has come up very few times in reported case law. However, in the context of determining the suitability of lead counsel in class action lawsuits, the issue arises fairly frequently. These cases typically involve class action claims for security fraud against a corporation in which derivative claims against the officers and directors arising out of

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raised by a shareholder in a derivative action present an impermissible conflict of interest.").

[940] First American Bank & Trust v. Frogel, 726F.Supp. 1292, 1298 (S.D. Fla. 1989) (denying a motion to dismiss derivative claims on the basis of Rule 23.1 where the plaintiff was bringing a derivative claim to recover money for the corporation, while at the same time bringing a class action to obtain monetary damages against the same corporation).

[941] *Id*.; Keyser v. Commonwealth Nat'l Fin. Corp., 120 F.R.D. 489, 492 (M.D. Pa 1988); *see* Jordan v. Bowman Apple Products Co., 728 F.Supp. at 413 (denying a motion to dismiss derivative claims on the basis of Rule 23.1 where the plaintiff was also suing for the dissolution of the corporation); *see also* Shoberg v. Clearmediaone, Inc., 2006 WL 2709269, at *4 (S.D. Tex. Sept. 20, 2006) (rejecting defendants' argument that plaintiff's simultaneous class, derivative and individual claims created a conflict).

[942] *See* Moffatt Enters., Inc. v. Borden, Inc., 807 F.2d 1169, 1176 (3rd Cir. 1986) (noting that this proposition is "hornbook law").

[943] *See* G.A. Enterprises, Inc. v. Leisure Living Communities, Inc., 517 F.2d 24, 27 (1st Cir. 1975); Ohio-Seally Mattress Mfg. Co. v. Kaplan, 90 F.R.D. 21, 25 (N.D. Ill. 1980); Robinson v. Computer Servicenters, Inc., 75 F.R.D. 637, 643 (N.D. Ala. 1976).

[944] Clark v. Lomas & Nettleton Fin. Corp., 79 F.R.D. 658, 659 (N.D. Tex. 1978).

[945] Cmt. 2.

[946] *In re* Dresser Indus., Inc., 972 F.2d 540, 545 (5th Cir. 1992) (granting disqualification motion barring counsel from suing client in concurrent litigation).

the same facts are also pending. In determining the suitability of class counsel in such situations, courts have taken a very dim view of any lawyer seeking to represent the class of defrauded investors against the company when that lawyer also owes a duty of loyalty to the corporation and its current shareholders as a result of prosecuting a derivative claim. The procedural issue is really not the same as the one we are considering here, but the same interests are at stake, and the dicta in opinions dealing with this situation clearly argues for the existence of an impermissible conflict of interest. In *Hawk Indus., Inc. v. Bausch & Lomb, Inc.*,[947] the district court disqualified plaintiffs' co-lead counsel in a federal securities class action suit (a direct action) against Bausch & Lomb because the same lawyers represented the plaintiff in a derivative suit brought on behalf of Bausch & Lomb in state court litigation. The court held that this presented a conflict because co-counsel is bound to pursue two actions to the best of his ability and as vigorously as possible. If both are successful, one action would result in a recovery for the corporation; the other would result in a detriment to the corporation. It is difficult to see how counsel could retain his independence of professional judgment and loyalty to his clients and their interests in both suits. While [the firm] is counsel for a plaintiff suing derivatively on behalf of Bausch & Lomb in the state court, it cannot furnish adequate representation to the plaintiff class here. It is, therefore, estopped from acting as co-lead counsel in this case.[948]

The rationale of *Hawk Industries* is consistent with one of the basic tenets on which attorney client relationships are based, namely that the attorney owes his client an undivided duty of loyalty:

> A lawyer owes his current litigation client a duty of zealous advocacy. . . . Indeed, an attorney "should not put himself in a position where, even unconsciously, he will be tempted to 'soft pedal' his zeal in furthering the interests of one client in order to avoid an obvious clash with those of another."[949]
>
> Other courts considering this issue have taken a more flexible approach, noting the "surface appeal" of the argument but rejecting it as elevating form over substance.[950]

In the case of *In re Dayco Corporation Derivative Securities Lit*, the court actually dealt with a motion to disqualify plaintiff's lawyer due to the alleged conflict between suing a corporation and bringing a derivative claim. The court agreed with the plaintiffs that the "case law is virtually unanimous in holding that one counsel can represent a stockholder bringing both an individual and a derivative action." The Court noted that "theoretical conflict of interest" was "not rooted in the realities of most individual and derivative suits." The Court in *Dayco* held that no per se rule of disqualification existed, and then did a factual analysis of the circumstances of the representation holding that "the asserted conflict of interest is not so apparent so as to justify, at least at this time, disqualification."

In *Gonzalez v. Chillura*,[951] a Florida Court of Appeals overturned a trial court's disqualification of the plaintiff-shareholder's lawyer that had been based on a conflict between suing a corporation and bringing a derivative claim on its behalf. The Court held that there is no attorney-client relationship between the corporation and the plaintiff's counsel even though the plaintiff and her counsel technically represent the corporation on the derivative claim. "If the mere fact of pursuing a derivative claim that belongs to a corporation, but which the corporation has refused to bring, were enough to establish an attorney-client relationship between the corporation and the lawyer for the derivative plaintiff, there would be no way for the derivative plaintiff to ever have conflict-free counsel."

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[947] 59 F.R.D. 619 (S.D.N.Y. 1973),

[948] *Id.* at 624; *accord*, Ruggiero v. American Bioculture, Inc., 56 F.R.D. 93 (S.D.N.Y. 1972) (refusing to permit attorneys in derivative action on behalf of corporation to serve as lead counsel in class action against corporation because of conflict between recovery "for" and "against" the corporation). *See also* Int'l. Bus. Mach. Corp. v. Levin, 579 F.2d 271 (3d Cir. 1978) (antitrust plaintiff firm disqualified from representing a party adverse to a client who had firm on retainer); Cinema 5, Ltd. v. Cinerama, Inc. 528 F.2d 1384, 1387 (2d Cir. 1976) (prima facie improper for attorney to simultaneously represent a client and another party with interests directly adverse to client).

[949] Selby v. Revlon Consumer Prod. Corp., 6 F. Supp. 2d 577, 581 n.5 (N.D. Tex. 1997) (citing ABA Comm. on Ethics and Prof. Responsibility, Formal Op. 92-367 (1992)).

[950] *See In re* Dayco Derivative Sec. Litigation, 102 F.R.D. at 630–31; *In re* TransOcean Tender Offer Sec. Litigation, 455 F.Supp. 999, 1014 (N.D. Ill. 1978); Kane Assoc. v. Clifford, 80 F.R.D. 402, 407–08 (E.D.N.Y. 1978); Bertozzi v. King Louie Int'l, Inc., 420 F.Supp. at 1179–80; Miller v. Fisco, Inc., 63 F.R.D. 132, 134 (E.D. Pa. 1974); Heilbrunn v. Hanover Equities Corp., 259 F.Supp. 936, 939 (S.D.N.Y. 1966).

[951] 892 So.2d 1075, 1077–78 (Fla. App. 2004).