

**FIDUCIARY DUTIES AND MINORITY SHAREHOLDER  
OPPRESSION FROM THE DEFENSE PERSPECTIVE:**

**DIFFERING APPROACHES IN TEXAS, DELAWARE, AND  
NEVADA**

George Parker Young, Vincent P. Circelli, & Kelli L. Walter

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## I. INTRODUCTION

Suits by minority shareholders in Texas are on the rise and represent an expanding, cutting-edge area of civil litigation in this state and across the country. While the Texas Supreme Court and several appellate courts in Texas have yet to recognize a cause of action for shareholder oppression or to define its parameters, a growing number of courts have upheld claims for shareholder oppression or at least recognized it as a viable claim. But these courts' justifications for recognizing a broad shareholder oppression claim are questionable, because they rely on: (1) a Texas Supreme Court case that never blessed shareholder oppression as a valid claim; (2) a Texas receivership statute that allows relief from oppression only in limited and extreme circumstances; and (3) a Texas appellate court case that relied on the previous two faulty grounds and on inapplicable case law from other jurisdictions. The Texas Supreme Court recently granted review to a shareholder oppression case (*Ritchie v. Rupe*), and will confront this issue in the very near future. Argument was heard on February 26, 2013.

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

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

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

## II. BREACH OF FIDUCIARY DUTY

### A. Fiduciary Duties in Texas and Delaware

In Texas, fiduciary duties arise in one of two ways: (1) a formal fiduciary relationship can exist as a matter of law between two parties; or (2) an informal fiduciary relationship may arise from the facts of the case.<sup>2</sup> As discussed below, officers, directors, and majority shareholders owe formal fiduciary duties to the corporations they serve. But fiduciary duties may exist between other corporate actors if the facts support an informal fiduciary relationship.

Informal fiduciary duties arise under Texas law “from a confidential relationship ‘where one person trusts in and relies upon another, whether the relation is moral[,] social, domestic[,] or merely personal.’”<sup>3</sup> Mere subjective trust, however, is insufficient to create such a duty.<sup>4</sup> Rather, the reliance must be justified.<sup>5</sup> To impose an informal fiduciary relationship in a business transaction, “the relationship must exist prior to, and apart from the agreement made the basis of the suit.”<sup>6</sup> Creation of an informal fiduciary relationship is a fact-specific inquiry.<sup>7</sup>

Officers and directors owe fiduciary duties to the corporations they serve as a matter of law.<sup>8</sup> Officers and directors do not, however, owe formal fiduciary duties to the corporation’s shareholders.<sup>9</sup>

In 2003, the Texarkana Court of Appeals created confusion on this point by stating, “It has been well established that the directors of a corporation stand in a fiduciary relationship to the corporation *and its stockholders . . .*”<sup>10</sup> *Pinnacle Data Services* should not be interpreted, however, to impose fiduciary duties on officers and directors to individual shareholders. First, the case on which *Pinnacle Data Services* relies to support this proposition does not indicate

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<sup>2</sup> *Hoggett v. Brown*, 971 S.W.2d 472, 487 (Tex. App.—Houston [14th Dist.] 1997, pet. denied) (quoting *Crim Truck & Tractor Co. v. Navistar Int’l Transp. Corp.*, 823 S.W.2d 591, 593–94 (Tex. 1992)).

<sup>3</sup> *Id.* (quoting *Crim Truck & Tractor*, 823 S.W.2d at 593–94, and *Hallmark v. Port/Cooper*, 907 S.W.2d 586, 592 (Tex. App.—Corpus Christi 1995, no writ)).

<sup>4</sup> *Schlumberger Tech. Corp. v. Swanson*, 959 S.W.2d 171, 177 (Tex. 1997).

<sup>5</sup> See *Hoggett*, 971 S.W.2d at 488 (“A person is justified in placing confidence in the belief that another party will act in his or her best interest only where he or she is accustomed to being guided by the judgment or advice of the other party, and there exists a long association in a business relationship, as well as personal friendship.”).

<sup>6</sup> *Willis v. Donnelly*, 199 S.W.3d 262, 277 (Tex. 2006) (quoting *Schlumberger Tech. Corp.*, 959 S.W.2d at 177).

<sup>7</sup> See *id.* (stating that an informal fiduciary duty may arise from the facts of the case) (citing *Schlumberger Tech. Corp.*, 959 S.W.2d at 177).

<sup>8</sup> See *Int’l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 576 (Tex. 1963); *Landon v. S&H Marketing Group, Inc.*, 82 S.W.3d 666, 672 (Tex. App.—Eastland 2002, no pet.).

<sup>9</sup> *Myer v. Cuevas*, 119 S.W.3d 830, 836 (Tex. App.—San Antonio 2003, no pet.) (“Corporate officers do not owe fiduciary duties to individual shareholders unless a contract or special relationship exists between them in addition to the corporate relationship.”); *Hoggett*, 971 S.W.2d at 48 (“A director’s fiduciary duty runs only to the corporation, not to individual shareholders or even to a majority of the shareholders.”).

<sup>10</sup> *Pinnacle Data Servs. v. Gillen*, 104 S.W.3d 188, 198 (Tex. App.—Texarkana 2003, no pet.) (emphasis added).

that such a duty exists.<sup>11</sup> Second, this statement in *Pinnacle Data Services* should be interpreted consistent with an earlier decision by the same court, where it held, “[a] corporate officer [and director] owes a fiduciary duty to the shareholders collectively, [i.e.] the corporation, but he does not occupy a fiduciary relationship with an *individual* shareholder.”<sup>12</sup> Such an interpretation brings *Pinnacle Data Services* in line with the wealth of other Texas cases holding that officers and directors do not owe fiduciary duties to individual shareholders absent an informal fiduciary relationship.

### 1. *Fiduciary Duties Under Texas Law*

Three broad duties stem from officers’ and directors’ roles as fiduciaries in Texas: duties of obedience, loyalty, and due care.<sup>13</sup>

#### a. *Duty of Obedience*

The duty of obedience “requires a director to avoid committing *ultra vires* acts, [i.e.], acts beyond the scope of the powers of a corporation as defined by its charter or the laws of the state of incorporation.”<sup>14</sup> An officer or director will only be personally liable for such *ultra vires* acts if his actions are also illegal.<sup>15</sup>

#### b. *Duty of Loyalty and the Safe Harbor Defense*

The duty of loyalty “requires an extreme measure of candor, unselfishness, and good faith on the part of the officer or director.”<sup>16</sup> Stated another way, the duty of loyalty “dictates that a corporate officer or director must act in good faith and must not allow his or her personal interest to prevail over the interest of the corporation.”<sup>17</sup> An officer or director is considered “interested” when he “makes a personal profit from a transaction by dealing with the corporation or usurps a corporate opportunity.”<sup>18</sup> A corporate opportunity “arises when a corporation has a legitimate interest or expectancy in, and the financial resources to take advantage of, a particular business opportunity.”<sup>19</sup> In addition, an officer or director is considered “interested” when he “buys or sells assets of the corporation,” “transacts business in his director’s capacity with a second corporation of which he is also a director or significantly financially associated,” or “transacts business in his director’s capacity with a

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<sup>11</sup> Compare *id.* with *Duncan v. Bushey*, 263 S.W.2d 148, 151–52 (Tex. 1953) (allowing shareholders to challenge directors’ actions, because the corporate charter had been forfeited).

<sup>12</sup> *Faour v. Faour*, 789 S.W.2d 620, 621 (Tex. App.—Texarkana 1990, writ denied).

<sup>13</sup> *Gearhart Indus., Inc. v. Smith Int’l, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984) (applying the duties to directors, but recognizing that the fiduciary duties of officers are generally identical to those of directors); *Landon*, 82 S.W.3d 666, 672–73 (Tex. App.—Eastland 2002, no pet.) (applying the duties to officers and directors alike).

<sup>14</sup> *Gearhart*, 741 F.2d at 719.

<sup>15</sup> *Id.*

<sup>16</sup> *Pinnacle*, 104 S.W.3d at 199.

<sup>17</sup> *Landon*, 82 S.W.3d at 672.

<sup>18</sup> *Id.* at 673 (citing *Gearhart*, 741 F.2d at 719–20).

<sup>19</sup> *Icom Sys., Inc. v. Davies*, 990 S.W.2d 408, 410 (Tex. App.—Texarkana 1999, no writ) (citing *Dyer v. Shafer*, 779 S.W.2d 474, 477 (Tex. App.—El Paso 1989, writ denied)).

family member.”<sup>20</sup>

When an officer or director enters into a contract with the corporation he serves, he should ensure that the transaction satisfies one of the safe harbor provisions contained in the Texas Business Organizations Code.<sup>21</sup> Specifically, such a transaction will be found valid in the following instances:

1. Upon the affirmative, good faith vote of a majority of disinterested directors provided that the material facts of the contract or transaction is disclosed to or known by the board;
2. Upon the affirmative, good faith vote of the shareholders provided that the material facts of the contract or transaction is disclosed to or known by the shareholders; or
3. The contract or transaction is fair as to the corporation as of the time that it is authorized, approved, or ratified by the board of directors or shareholders.<sup>22</sup>

*c. Duty of Care and the Business Judgment Rule Defense*

Texas courts have defined the duty of care to prohibit an officer’s or director’s negligent management of a corporation.<sup>23</sup>

Other courts, while appearing to affirm this general standard of the duty of care, have defined the business judgment rule in such a way that completely obliterates the duty of care:

This principle is known as the business judgment rule and it is a defense to accusations of breach of the duty of care . . . . Texas courts to this day will not impose liability upon a noninterested corporate director unless the challenged action is *ultra vires* or is tainted by fraud. Such is the business judgment rule in Texas.<sup>24</sup>

In other words, the business judgment rule shields a director from claims alleging a breach of the duty of care *unless* the director holds an interest and the decision was *ultra vires* or

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<sup>20</sup> *Landon*, 82 S.W.3d at 673 (citing *Gearhart*, 741 F.2d at 719–20).

<sup>21</sup> See TEX. BUS. ORGS. CODE ANN. § 21.418 (West Supp. 2010).

<sup>22</sup> See *Landon*, 82 S.W.3d at 673 (describing safe harbors found in TEX. BUS. CORP. ACT ANN. art. 2.35-1 (West Supp. 2002), which are substantially similar to those found in TEX. BUS. ORGS. CODE ANN. § 21.418).

<sup>23</sup> See, e.g., *Meyers v. Moody*, 693 F.2d 1196, 1209 (5th Cir. 1983) (“Texas law imposes on corporate officers and directors a duty to exercise due care in the management of the corporation’s affairs. If they breach that duty, they are liable to the corporation for any loss it may suffer as a result of their neglect. ‘Due Care’ is that degree of care which a person of ordinary prudence would exercise under the same or similar circumstances.”) (citations omitted).

<sup>24</sup> *Gearhart*, 741 F.2d at 721 (citations omitted); see also *Campbell v. Walker*, No. 14-96-01425-CV, 2000 WL 19143, at \*10 (Tex. App.—Houston [14th Dist.] June 13, 2000, no pet.) (“[F]or over a hundred year[s]—since 1889—Texas courts have refused to impose liability upon a non-interested corporate director who breached a fiduciary duty unless the challenged action is *ultra vires* or is tainted by fraud.”) (emphasis added).

involved fraud.<sup>25</sup> But if any of these elements exists, the director will be liable for breach of another duty. If a director is interested with respect to the transaction, then the case implicates the duty of loyalty. If the challenged conduct is *ultra vires*, then the case implicates the duty of obedience. If the challenged conduct involves fraud, then the case implicates the duty of good faith component of the duty of loyalty or some other direct claim for fraud. Therefore, under *Gearhart's* formulation of the business judgment rule, it is unclear how a plaintiff could assert a valid breach of fiduciary duty claim related to the fiduciary's duty of care that is distinct from a duty of loyalty or obedience claim. Thus, the way some Texas courts have described the business judgment rule strips the duty of care of all substance, essentially absolving directors and officers of all liability for duty of care claims.

Determining whether a director is "noninterested" involves a multi-part test. An "interested director" for purposes of the business judgment rule is one who: (1) makes a personal profit from a transaction dealing with the corporation or usurps a corporate opportunity; (2) buys or sells assets of the corporation; (3) transacts business in his director's capacity with a second corporation of which he is also a director or significantly financially associated; or (4) transacts business in his director's capacity with a family member.<sup>26</sup> Even then, such transactions are permitted if disclosed and approved by disinterested directors.

Additionally, other Texas courts have allowed the business judgment rule as a defense to decisions that were made with "due care."<sup>27</sup> Under this formulation, the business judgment rule provides great protection to directors and little or no protection to shareholders asserting duty of care claims.

Despite the lack of clarity on the duty of care and the business judgment rule under Texas law, Texas allows corporations to exculpate directors for duty of care claims.<sup>28</sup> Texas companies with exculpation clauses can avoid the uncertainty of Texas law regarding the duty of care and the business judgment rule by exculpating directors for all claims premised on the duty of care.

#### *d. Majority Shareholder Fiduciary Duties*

Several Texas courts have indicated that majority shareholders owe formal fiduciary duties to the corporations they control.<sup>29</sup> A majority shareholder does not owe formal fiduciary duties to other shareholders.<sup>30</sup> Indeed, the Texas Supreme Court has never recognized a formal

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<sup>25</sup> *Gearhart*, 741 F.2d at 721.

<sup>26</sup> *Gearhart*, 741 F.2d at 719–20; *see also* TEX. BUS ORGS. CODE, §§ 1.0003–.0004 (West 2010) (defining "Disinterested Person" and "Independent Person").

<sup>27</sup> *See, e.g.,* *Van Bavel v. Oasis Design, Inc.*, No. 03-97-00434-CV, 1998 WL 546342, at \*11 (Tex. App.—Austin Aug. 31, 1998, no pet.) (jury instructed that under the business judgment rule "a director will not be held liable for an honest mistake if he acted with *due care*["]) (emphasis added).

<sup>28</sup> *See* TEX. BUS. ORGS. CODE ANN. § 7.001 (West Supp. 2010).

<sup>29</sup> *See* *Hoggett v. Brown*, 971 S.W.2d 472, 488, n.13 (Tex. App.—Houston [14th Dist.] 1997, pet. denied) ("[A] majority shareholder's fiduciary duty ordinarily runs to the corporation." (citing *Schautteet v. Chester State Bank*, 707 F. Supp. 885, 889 (E.D. Tex. 1988))).

<sup>30</sup> *Id.* at 488.

fiduciary relationship between shareholders.<sup>31</sup> Thus, a majority shareholder only owes fiduciary duties to another shareholder when the facts of the case justify creating an informal fiduciary relationship.<sup>32</sup> Courts have frequently declined to extend such a duty to minority shareholders.<sup>33</sup>

In determining if such a relationship exists, some courts have considered the degree to which the majority shareholder exercises control over the corporation.<sup>34</sup> In *Redmon v. Griffith*, the court indicated that corporate control, combined with oppressive conduct, was sufficient to allege the existence of informal fiduciary duties owed by the majority shareholder to the minority shareholder.<sup>35</sup> The court explained:

The Redmons further allege facts indicating a great deal of control over the business exercised by Ralph Griffith. Such allegations combined with allegations in the Redmons' pleadings that the Griffiths engaged in wrongful conduct and a lack of fair dealing with regard to the company's affairs to the prejudice of the Redmons sufficiently alleges a breach of fiduciary duty by way of oppressive conduct.<sup>36</sup>

Because *Redmon* was a summary judgment case, the Tyler Court of Appeals did not have an opportunity to develop what evidence was sufficient to impose a fiduciary duty, since the plaintiff there only had to present "some evidence" to raise a fact issue concerning the alleged breach of fiduciary duty. Moreover, the court's reference to "fair dealing" implicates a duty of good faith and fair dealing between shareholders, which the Texas Supreme Court has been reluctant to adopt. *Redmon* also ignores the well-established requirements that must exist for an informal fiduciary relationship to be found in a business context, namely trust, justified reliance, and a relationship that existed prior to and apart from the agreement that forms the basis of the suit.

Ultimately, a majority shareholder cannot know with certainty if he owes fiduciary duties to a minority shareholder, because the relationship is determined on a case-by-case basis. But when a long-lasting relationship of trust and reliance exists, or when the majority shareholder exercises significant control over the corporation and engages in oppressive conduct, a court may conclude that a fiduciary relationship exists.

Even if there is no direct fiduciary duty owed to the minority shareholder, the minority shareholder can still bring a derivative claim on behalf of the close corporation for violation of duties owed the corporation.<sup>37</sup>

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<sup>31</sup> See *Willis v. Donnelly*, 199 S.W.3d 262, 276 (Tex. 2006) (declining to decide whether a majority shareholder owes a fiduciary duty to a minority shareholder as a matter of law).

<sup>32</sup> See *Hoggett*, 971 S.W.2d at 488. ("[A] co-shareholder in a closely held corporation does not as a matter of law owe a fiduciary duty to his co-shareholder. Instead, whether such a duty exists depends on the circumstances.")

<sup>33</sup> See *Willis*, 199 S.W.3d at 276.

<sup>34</sup> See, e.g., *Hoggett*, 971 S.W.2d at 488 n.13 ("[I]n certain limited circumstances, a majority shareholder who dominates control over the business may owe such a duty to the minority shareholder.")

<sup>35</sup> *Redmon v. Griffith*, 202 S.W.3d 225, 238 (Tex. App.—Tyler 2006, pet. denied).

<sup>36</sup> *Id.*

<sup>37</sup> See TEX. BUS. ORGS. CODE ANN. § 21.563 (West Supp. 2010) (formerly TEX. BUS. CORP. ACT ANN. art.

## 2. *Fiduciary Duties Under Delaware Law*

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.<sup>38</sup> Under Delaware law, much like Texas, directors and officers owe the fiduciary duties of due care, loyalty, and good faith to the corporation.<sup>39</sup> However, under Delaware law, *unlike* Texas, directors owe fiduciary duties not only to the corporation but also directly to the shareholders.<sup>40</sup> In Texas, officers, directors, and controlling shareholders do not owe fiduciary duties directly to individual shareholders simply by virtue of their status as shareholders.<sup>41</sup> Delaware has clearly established that "a shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation."<sup>42</sup> Delaware courts have therefore stated that a "majority shareholder owes a fiduciary duty to the minority shareholders."<sup>43</sup>

### a. *The Duty of Care*

The duty of care in Delaware imposes upon a director an obligation to exercise due care in the process of decision making as well as all other aspects of a director's responsibilities (i.e. delegation and oversight functions). The standard requires that a director, "in managing corporate affairs[,] [is] bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances."<sup>44</sup> Directors are held to this standard under gross negligence considerations, which equates to "reckless indifference to or a deliberate disregard of the whole body of stockholders" or actions which are "without the bounds of reason."<sup>45</sup>

Although requirements to comply with the duty of care vary depending upon the facts of a particular action, the duty is breached by the following board actions: (1) haste in decision making;<sup>46</sup> (2) lack of board preparation;<sup>47</sup> (3) lack of questioning or involvement by the board;<sup>48</sup> (4) lack of a paper record—reliance on officers or experts;<sup>49</sup> and (5) lack of care in

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5.14 (West Supp. 2002)).

<sup>38</sup> See *Nixon v. Blackwell*, 626 A.2d 1366, 1380–81 (Del. 1993).

<sup>39</sup> See, e.g., *N. Am. Catholic Educ. Programming Found. v. Gheewalla*, 930 A.2d 92, 99 (Del. 2007).

<sup>40</sup> *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001).

<sup>41</sup> See *Massachusetts v. Davis*, 168 S.W.2d 216, 221 (Tex. 1942); see also *Cotten v. Weatherford Bancshares, Inc.* 187 S.W.3d 687, 698 (Tex. App.—Fort Worth 2006, pet. denied) (holding that corporate officers do not owe fiduciary duties to individual shareholders unless a contract or confidential relationship exists between them).

<sup>42</sup> *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1344 (Del. 1987).

<sup>43</sup> *Unocal Corp. v. Mesa Petroleum*, 493 A.2d 946, 958 (Del. 1985) (citing *Allied Chem. & Dye Corp. v. Steel & Tube Co. of Am.*, 120 A. 486, 491 (Del. Ch. 1923)).

<sup>44</sup> *Graham v. Allis-Chalmers Manuf. Co.*, 188 A.2d 125, 130 (Del. 1963).

<sup>45</sup> *Tomczak v. Morton Thiokol, Inc.*, C.A. No. 7861, slip op. at 31 (Del. Ch. Apr. 5, 1990).

<sup>46</sup> *McMullin v. Beran*, 765 A.2d 910, 922 (Del. 2000) ("The imposition of time constraints on a board's decision[.]making process may compromise the integrity of its deliberative process."); *Smith v. Van Gorkom*, 488 A.2d 858, 870 (Del. 1985).

<sup>47</sup> *Smith*, 488 A.2d at 870.

<sup>48</sup> *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1267 n.7 (Del. 1988); *Smith*, 488 A.2d at 870.

<sup>49</sup> *Smith*, 488 A.2d at 870. Section 141(e) of the Delaware Code sets out three requirements which must be met for a director to rely on expert or officer reports: (1) good faith; (2) reasonable belief in the professional or expert

dealing with documents.<sup>50</sup> Commentators have noted that for each action taken by a board, the board must scrutinize the transaction as critically as practicable under the circumstances, take as much time as feasible and consider all reasonably available information.<sup>51</sup>

In addition, many Delaware corporations have an exculpatory provision in their corporate charters absolving corporate directors of liability for suits brought on behalf of the corporation for violations of the duty of care.<sup>52</sup> A proper exculpatory clause that complies with section 102(b)(7) of the Delaware Code prohibits suits on behalf of the company premised on gross negligence or the duty of care.<sup>53</sup> Section 102(b)(7), however, does not permit exculpatory provisions for “among other things, breaches of the duty of loyalty or actions or omissions not in good faith or that involve intentional misconduct or a knowing violation of the law.”<sup>54</sup> Because many corporations have a section 102(b)(7) exculpatory clause, plaintiffs often attempt to turn duty of care claims into bad faith claims that are not precluded by an exculpatory provision. The Delaware Supreme Court has concluded that conduct that violates the duty of care likely also violates the requirement of good faith.

[T]he universe of fiduciary misconduct is not limited to either disloyalty in the classical sense ([i.e., preferring the adverse self-interest of the fiduciary or of a related person to the interest of the corporation) or gross negligence. Cases have arisen where corporate directors have no conflicting self-interest in a decision, yet engage in a misconduct that is more culpable than simple inattention or failure to be informed of all the facts material to the decision. To protect the interests of the corporation and its shareholders, fiduciary conduct of this kind, which does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence, should be proscribed. A vehicle is needed to address such violations doctrinally, and that doctrinal vehicle is the duty to act in good faith.<sup>55</sup>

#### *b. The Duty of Loyalty*

The duty of loyalty mandates that the best interests of the corporation and its shareholders take precedence “over any interest possessed by a director, officer[,] or controlling shareholder and not shared by the stockholders generally.”<sup>56</sup> It requires strict compliance and restraint from self-dealing.

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competence of the person furnishing the report; and (3) that the expert has been selected with reasonable care “by or on behalf” of the corporation. DEL. CODE ANN. tit. 8, § 141(e).

<sup>50</sup> *Smith*, 488 A.2d at 870.

<sup>51</sup> See R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, 1 DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS, § 4.34, at 4-240 (3d ed. 2006 supp.).

<sup>52</sup> See DEL. CODE ANN. tit. 8, § 102(b)(7) (West 2013).

<sup>53</sup> *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 47 n.37, 67 (Del. 2006).

<sup>54</sup> *In re Citigroup Inc. S’holder Derivative Litig.*, 964 A.2d 106, 124 (Del. Ch. 2009).

<sup>55</sup> *In re Walt Disney Co.*, 906 A.2d at 66.

<sup>56</sup> *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993).

A foundational Delaware case involving the duty of loyalty is *Guth v. Loft, Inc.*<sup>57</sup> In *Guth*, The Delaware Supreme Court held that a corporate officer violated his fiduciary duty to his corporation because the business opportunity presented to the officer was one which the corporation was financially able to undertake and was in the line of the corporation's business. Charles Guth ("Guth") was the president of Loft, Inc., which made a cola drink. Loft's soda fountains purchased cola syrup from Coca Cola, but Guth decided it would be less expensive to buy the syrup from Pepsi after Coca Cola declined to give him a discount. While negotiating the switch, Pepsi went bankrupt. Guth bought Pepsi's trademark and its syrup recipe, (which he had Loft chemists reformulate) and then purported to sell the syrup himself to Loft, Inc. Subsequently, Loft, Inc. filed a lawsuit against Guth, alleging that he had breached his fiduciary duty of loyalty to the corporation for failing to offer that opportunity to his company instead appropriating it to himself.

The Delaware Supreme Court laid out three principal factors to consider in evaluating a corporate opportunity issue: (1) whether or not the corporation has the financial ability to undertake the opportunity; (2) whether or not the opportunity is in the corporation's line of business and is of practical advantage to it; and (3) whether or not the corporation has an interest or reasonable expectancy in the opportunity.

The court concluded that the opportunity to acquire the Pepsi trademark and formula belonged to Loft, Inc. and that Guth violated his fiduciary duty to the corporation by taking the business opportunity for himself. When presented with a business opportunity that could be advantageous to the corporation, an officer is required to make that opportunity available to the corporation before pursuing the opportunity for himself. Otherwise, the self-interest of the officer would be brought into conflict with that of the corporation. The court stated that the officer could not receive a benefit from his breach of his fiduciary duty.

In certain circumstances, a board of directors may protect itself from potential breaches of this duty by individual directors through compliance with section 144 of the Delaware Code.<sup>58</sup> However, the Delaware Supreme Court stated:

There is no "safe harbor" for . . . divided loyalties in Delaware. When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain . . . . The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of scrutiny by the courts.<sup>59</sup>

Thus, while an interested director transaction is not necessarily void or voidable, it is still subject to exacting court review.

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<sup>57</sup> *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939).

<sup>58</sup> See DEL. CODE ANN. tit. 8, § 144 (2013).

<sup>59</sup> *Weinberger v. U.O.P., Inc.*, 457 A.2d 701, 710 (Del. 1983).

c. *The “Duty” of Good Faith and the Business Judgment Defense*

Although the duty of good faith “may be described colloquially as part of a ‘triad’ of fiduciary duties” together with the duties of care and loyalty, the Delaware Supreme Court does not recognize good faith as an “independent fiduciary duty that stands on the same footing as the duties of care and loyalty.”<sup>60</sup>

Rather than being an independent duty, the Delaware Supreme Court has clarified that good faith “is a subsidiary element, [i.e.], a condition, of the fundamental duty of loyalty.”<sup>61</sup> Therefore, “a failure to act in good faith” does not result “*ipso facto*, in the direct imposition of fiduciary liability,” though it is essential to impose liability for violation of the duty of loyalty.<sup>62</sup>

Delaware courts have also noted the interrelated working of the duty of good faith and the contractual responsibility of directors and members to act with “good faith and fair dealing” under an organization’s formation documents.<sup>63</sup> The *Bay Center* court noted that “part of a corporate manager’s proper performance of their contractual obligations is to use the discretion granted to them in the company’s organizational documents in good faith.”<sup>64</sup> It should be noted that the Delaware Supreme Court has recently undercut the rarely successful implied duty of good faith and fair dealing claims by repeating that “[w]e will only imply contract terms when the party asserting the implied covenant proves that the other party has acted arbitrarily or unreasonably, thereby frustrating the fruits of the bargain that the asserting party reasonably expected.”<sup>65</sup> Importantly, the court went on to state that a “party does not act in bad faith by relying on contract provisions for which that party bargained, where doing so simply limits advantages to another party.”<sup>66</sup>

Like Texas, the business judgment rule in Delaware protects officers and directors acting in good faith from liability in certain contexts.<sup>67</sup> Under Delaware law, the business judgment rule “is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company.”<sup>68</sup> The party challenging the board’s decision has the burden of establishing facts rebutting the presumption.<sup>69</sup> “If the business judgment rule is not rebutted, a court will not substitute its judgment for that of the board if the board’s decision can be

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<sup>60</sup> See *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

<sup>61</sup> *Id.* at 369–370 (citing *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)).

<sup>62</sup> *Id.*

<sup>63</sup> See, e.g., *Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC*, No. 3658-VCS, 2009 WL 1124451 (Del. Ch. April 20, 2009).

<sup>64</sup> *Id.* at \*7.

<sup>65</sup> *Nemec v. Shrader*, 2010 WL 1320918 (Del. Apr. 6, 2010).

<sup>66</sup> *Id.*

<sup>67</sup> See, e.g., *Robotti & Co. LLC v. Liddell*, No. 3128-VCN, 2010 WL 157474 (Del. Jan. 14, 2010); STEPHEN RADIN, *The Business Judgment Rule: Fiduciary Duties for Corporate Directors*, (6th Ed. 2009).

<sup>68</sup> *MM Cos. v. Liquid Audio*, 813 A.2d 1118, 1127 (Del. 2003) (internal quotations omitted).

<sup>69</sup> *Id.*

attributed to any rational purpose.”<sup>70</sup> In the context of a motion to dismiss based on the business judgment defense “the pled facts must support a reasonable inference that in making the challenged decision, the board of directors breached either its duty of loyalty or its duty of care.”<sup>71</sup>

The business judgment rule in Delaware focuses on the reasonableness of the *process* by which a board came to a particular decision and is not concerned with *substance* of the decision:

What should be understood, but may not widely be understood by courts or commentators who are not often required to face such questions, is that compliance with a director’s duty of care can never appropriately be judicially determined by reference to *the content of the board decision* that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed. That is, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through “stupid” to “egregious” or “irrational”, provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporation interests. To employ a different rule—one that permitted an “objective” substantive second guessing by ill-equipped judges or juries, would, in the long-run, be injurious to investor interests. Thus, the business judgment rule is process oriented and informed by a deep respect for all good faith board decisions.<sup>72</sup>

Thus, the plaintiff must show gross negligence in the process by which corporate directors or officers made a decision to rebut the presumption of the business judgment rule.<sup>73</sup>

The Delaware Supreme Court has recently held that one particular decision protected by the business judgment rule is the decision to accept or reject a merger.<sup>74</sup> The *Gantler* court stated that in the context of mergers the board is entitled to a strong presumption in its favor, because implicit in the board’s statutory authority to propose a merger is also the power to decline to do so.<sup>75</sup> In another application of the business judgment rule, a Delaware Chancery Court cited the rule to dismiss claims against directors who chose not to put their company into bankruptcy.<sup>76</sup> As one commentator noted, ultimately “[d]ecisions such as *Citigroup* remind us that when the prerequisites of the business judgment rule are satisfied, the Delaware courts will not second-guess business decisions that in retrospect could have been decided differently.”<sup>77</sup>

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<sup>70</sup> *Id.* (internal quotations and brackets omitted).

<sup>71</sup> *Gantler v. Stephens*, 965 A.2d 695, 706 (Del. 2009).

<sup>72</sup> *In re Caremark Int’l Inc.*, 698 A.2d 959, 967–69 (Del. Ch. 1996) (footnotes omitted).

<sup>73</sup> *In re Citigroup, Inc.*, 964 A.2d 106, 124 (Del. Ch. 2009) (“The standard of director liability under the business judgment rule is predicated upon concepts of gross negligence.”) (internal quotations omitted).

<sup>74</sup> *See Gantler*, 965 A.2d at 706.

<sup>75</sup> *Id.*

<sup>76</sup> *See Binks v. DSL.net, Inc.*, No. 2823-VCN, 2010 WL 1713629 (Del. Ch. Apr. 29, 2010).

<sup>77</sup> Kevin F. Brady and Francis Pileggi, *Recent Delaware Corporate and Commercial Decisions*, 6 N.Y.U. J. LAW & BUS. 421 (Spring 2010).

Irrespective of the business judgment rule, this “duty” of good faith and fair dealing is unique under Delaware in that it may not be waived in corporate charter documents.

*d. Imputation of “General Fiduciary Duties”*<sup>78</sup>

Delaware law states that in the absence of an agreement to the contrary, a “manager of an LLC owes the **traditional fiduciary duties** of loyalty and care to the members of the LLC.”<sup>79</sup> In applying the “traditional fiduciary duties” to managers of LLCs, Delaware courts apply the same specific standards applied to corporate directors.<sup>80</sup>

Delaware law similarly imputes the “fiduciary duties of care and loyalty” to members and officers of Delaware corporations.<sup>81</sup> Both officers and directors of corporations owe these “identical” traditional fiduciary duties to their corporations.<sup>82</sup>

Delaware courts apply the “default” fiduciary duties even in the absence of statutory mandates. In fact, the “Delaware LLC Act is silent on what fiduciary duties members of an LLC owe each other,” which Delaware courts interpret to mean “the matter [is] to be developed by the common law.”<sup>83</sup> Moreover, “in the absence of developed LLC case law,” Delaware courts “often [decide] cases by looking to analogous provisions in limited partnership law.”<sup>84</sup> The Delaware LLC cases have to date, “in the absence of provisions in the LLC agreement explicitly disclaiming the applicability of default principles of fiduciary duty,” treated LLC members as owing each other the traditional fiduciary duties that directors owe a corporation.<sup>85</sup>

These same “traditional fiduciary duties” are also applied to limited partnerships. In the limited partnership context, Delaware courts have again established that “absent a contrary provision in the partnership agreement, the general partner of a Delaware limited partnership owes the traditional fiduciary duties of loyalty and care to the Partnership and its partners.”<sup>86</sup> Moreover, even “those affiliates of a general partner who exercise control over

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<sup>78</sup> The authors wish to express their gratitude to Walker C. Friedman and Leza Kerr of Friedman, Suder & Cooke, P.C. for their substantial contributions and assistance with this Section.

<sup>79</sup> *Bay Ctr. Apartments Owners, LLC v. Emery Bay PKI, LLC*, C.A. No. 3658-VCS, 2009 WL 1124451, at \*8 (Del. Ch. April 20, 2009) (emphasis added).

<sup>80</sup> See, e.g., *Metro Commc’ns Corp. BVI v. Advanced MobileComm Tech.*, 854 A.2d 121, 155–56 (Del. Ch. 2004) (“[I]t is unsurprising that our law of fiduciary duty has evolved to the point in which there are specific standards that govern the liability of entity fiduciaries, such as managers of LLCs or more commonly corporate directors, for disclosures or non-disclosures to entity owners”); *VGS, Inc. v. Castiel*, C.A. No. 17995, 2000 WL 1277372 at \*4 (Del. Ch. Aug. 31, 2000), *aff’d* 781 A.2d 696 (Del. 2001) (two malfeasant managers “each owed a duty of loyalty to the LLC, its investors and Castiel, their fellow manager and majority member”).

<sup>81</sup> See *Gantler v. Stephens*, 965 A.2d 695, 708–09 (Del. 2009).

<sup>82</sup> *Id.* at 709, n.36.

<sup>83</sup> *Bay Ctr. Apartments Owners*, 2009 WL 1124451, at \*8, n.33.

<sup>84</sup> *Id.* at \*9.

<sup>85</sup> *Id.* (quoting *Douzinis v. Am. Bureau of Shipping, Inc.*, 888 A.2d 1146, 1149–50 (Del. Ch. 2006); *Metro Commc’n Corp. BVI*, 854 A.2d at 153; *VGS, Inc.*, 2000 WL 1277372, at \*4–5).

<sup>86</sup> *Gotham Partners, LP v. Hallwood Realty Partners, LP*, 2000 WL 1476663, at \*10 (Del. Ch. Sept. 27, 2000); see also Martin I. Lubaroff & Paul M. Altman, *Delaware Limited Partnerships* § 11.2.2 at 11-5 to 11-7 (2003).

the partnership's property may find themselves owing fiduciary duties to both the partnership and its limited partners."<sup>87</sup>

In yet another application of the traditional fiduciary duties, "an attorney-in-fact generally assumes the obligations of a fiduciary."<sup>88</sup> This fiduciary relationship, comparable to that created in a formal trust, "subjects the holder of a power of attorney to a **duty of loyalty** obligating her to act in the best interests of her principal in exercising such power."<sup>89</sup>

While the vast majority of Delaware case law has consistently applied these default duties in the absence of explicit contractual language, the Chief Justice of the Supreme Court of Delaware authored an article that harshly criticized default fiduciary duties in the LLC context. Chief Justice Steele does not embrace what he calls "the commonly accepted puritanical default fiduciary duty norm," but argues that courts should simply look to the entity's formation documents and only apply the duties found therein.<sup>90</sup> Chief Justice Steele calls the imputation of default fiduciary duties "Byzantine," and notes that a single case, *Fisk Ventures LLC v. Segal*, has questioned whether default fiduciary duties really do exist as a matter of common law.<sup>91</sup>

The *Fisk* court examined claims made by a principal against the members of his failed LLC. The principal claimed that the members of the LLC breached their fiduciary duties when the board came to a stalemate. The court ultimately dismissed the principal's claims under Federal Rule of Civil Procedure 12(b)(6) because he failed to show that the members owed the LLC *any* fiduciary duties.<sup>92</sup> The court reasoned that "[i]n the context of limited liability companies, which are creatures not of the state but of contract, those duties or obligations must be found in the LLC Agreement or some other contract."<sup>93</sup> Because the plaintiff failed to "allege breaches of duties found" in the LLC Agreement, the court concluded that it "must dismiss" the plaintiff's claims.<sup>94</sup>

The *Fisk* case represents a departure from the common application of "default" fiduciary duties, and the Steele article advocates for the removal of default duties in the LLC context.

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<sup>87</sup> *Bay Ctr. Apartments Owners*, 2009 WL 1124451, at \*9.

<sup>88</sup> *Coleman v. Newborn*, 948 A.2d 422, 429 (Del. Ch. 2007).

<sup>89</sup> *Id.* (emphasis added). Texas courts sometimes apply the same "default" or "traditional" fiduciary duties borrowed from Delaware. For example, Texas law imputes the same common law fiduciary duties as Delaware in the context of attorneys-in-fact, holding that "[A] power of attorney creates an agency relationship, which is a fiduciary relationship as a matter of law." *Vogt v. Warnock*, 107 S.W.3d 778, 782 (Tex. App.—El Paso 2003, pet. denied); *see also* *Plummer v. Estate of Plummer*, 51 S.W.3d 840, 842 (Tex. App.—Texarkana 2001, pet. denied); *Sassen v. Tanglegrove Townhouse Condominium Ass'n*, 877 S.W.2d 489, 492 (Tex. App.—Texarkana 1994, writ denied). A fiduciary in this context "owes her principal a high duty of good faith, fair dealing, honest performance, and strict accountability." *Id.*

<sup>90</sup> Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 AM. BUS. L. J. 221, 222 (2009).

<sup>91</sup> *Id.* (citing *Fisk Ventures, LLC v. Segal*, No. 3017-CC, 2008 Del. Ch. LEXIS 158, 2008 WL 1961156 (Del. Ch. May 7, 2008)).

<sup>92</sup> *Fisk*, 2008 Del. Ch. LEXIS 158, at \*28.

<sup>93</sup> *Id.*

<sup>94</sup> *Id.* at \*29.

However, another recently published article argues against the removal of default fiduciary duties, contending that allowing contractual waiver of fiduciary duties is, at a minimum, bad policy, and perhaps unconstitutional.<sup>95</sup>

### 3. *Waiver of Fiduciary Duties Under Delaware Law*

Delaware law permits exculpatory provisions to absolve corporate directors of all monetary breach of fiduciary duty claims except those involving bad faith, intentional misconduct, or the duty of loyalty.<sup>96</sup> Thus an exculpatory provision permissibly eliminates all liability for breaches of the duty of care, including grossly negligent acts.<sup>97</sup>

Under Section 102(b)(7) of the Delaware Code, a certificate of incorporation may contain a provision limiting or eliminating personal financial liability of a director to the corporation or its stockholders.<sup>98</sup> This safe harbor, however, does not limit the duty owed by directors to the corporation or its stockholders and transactions undertaken by the board remain subject to remedies such as injunction and rescission.<sup>99</sup>

As noted, fiduciary duties in Delaware exist by default in the limited liability company context “in the absence of a contrary provision in the LLC agreement.”<sup>100</sup> The Chancery Court’s statement derives from Section 18-1101 of the Delaware Limited Liability Company Act:

- (c) To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member’s or manager’s or other person’s duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company

<sup>95</sup> See Lyman Johnson, *Delaware’s Non-Waivable Duties*, 91 BOSTON U. L. REV. 701, 702–03 (2011).

<sup>96</sup> Del. Code tit. 8, § 102(b)(7) (2011).

<sup>97</sup> *AIG, Inc. v. Greenburg*, 965 A.2d 763, 795 n.113 (Del. Ch. 2009) (“The AIG certificate of incorporation has a [section] 102(b)(7) clause that insulates AIG’s directors from liability for monetary damages for any harm flowing from their gross negligence.”); *Wayne County Employees’ Ret. v. Corti*, 2009 WL 2219260, at \*19 (Del. Ch. July 24, 2009) (“[T]he exculpatory provision in Activision’s certificate even eliminates the personal liability of the Director Defendants for monetary damages for breaches of the duty of care, including actions that constitute gross negligence.”).

<sup>98</sup> DEL. CODE ANN. tit. 8, § 102(b)(7).

[Articles of incorporation may include a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as director, provided that such provision shall not eliminate or limit the liability of a director: (i) for any breach of the director’s duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law; (iii) under [section] 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.

<sup>99</sup> Balotti & Finkelstein, *supra* note 51, § 4.34, at 4-240.

<sup>100</sup> *Bay Ctr. Apartments Owners, LLC v. Emery Bay PKI, LLC*, C.A. No. 3658-VCS, 2009 WL 1124451, at \*8 & n.33 (Del. Ch. April 20, 2009).

agreement may not eliminate the implied contractual covenant of good faith and fair dealing.

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- (e) A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.<sup>101</sup>

A Delaware LLC that wishes to restrict or eliminate liability for fiduciary duties thus has the statutory power to do so—but only in a clearly expressed way: “the drafters of chartering documents **must make their intent to eliminate fiduciary duties plain and unambiguous.**”<sup>102</sup> Thus, under Delaware law, an LLC agreement may eliminate certain fiduciary duties, but for such elimination to be effective, the company agreement must do so plainly and unambiguously.

The Delaware Legislature’s allowance for waiver of fiduciary duties in the LLC context led to a boom in new LLC formations in Delaware since the Limited Liability Company Act’s amendment in 2004. One commentator notes that “[a]s evidence of the Delaware limited liability company’s . . . prowess, the Delaware Secretary of State reports that nearly 112,000 new LLCs were formed in 2007, compared to just 43,000 new formations in 2001.”<sup>103</sup>

In addition many Delaware corporations have an exculpatory provision in their corporate charters absolving corporate directors of liability for suits brought on behalf of the corporation for violations of the duty of care.<sup>104</sup> A proper exculpatory clause that complies with section 102(b)(7) prevents suits on behalf of the company premised on gross negligence or the duty of care.<sup>105</sup> Section 102(b)(7), however, does not permit exculpatory provisions for “among other things, breaches of the duty of loyalty or actions or omissions not in good faith or that involve

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<sup>101</sup> 6 DEL. C. § 18-1101 (2013) (emphasis added).

<sup>102</sup> *Bay Ctr. Apartments Owner, LLC*, 2009 WL 1124451, at \*9 (emphasis added); *see also* *Miller v. Am. Real Estate Partners, LP*, 2001 WL 1045643, at \*8 (Del. Ch. Sept. 6, 2001) (“[D]efault principles of fiduciary duty will apply unless a partnership agreement plainly provides otherwise.”); *Sonet v. Timber Co., LP*, 722 A.2d 319, 322 (Del. Ch. 1998); *cf* *Kahn v. Icahn*, 1998 WL 832629, at \*3 (Del.Ch. Nov.12, 1998) (holding that limited partners could not bring a duty of loyalty claim where the partnership agreement contained “clear and unambiguous modifications of fiduciary duties”).

<sup>103</sup> Steele, *supra* note 90, at 222. Chief Justice Steele notes that over this same time period, the perannum number of new corporations formed in Delaware has decreased. *Id.* at n.2.

<sup>104</sup> *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2013).

<sup>105</sup> *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 47 n.37, 67 (Del. 2006).

intentional misconduct or a knowing violation of the law.”<sup>106</sup> Because many corporations have a section 102(b)(7) exculpatory clause, plaintiffs often attempt to turn duty of care claims into bad faith claims that are not precluded by an exculpatory provision. The Delaware Supreme Court has concluded that good faith violations encompass similar conduct to duty of care violations though they are more culpable.

[T]he universe of fiduciary misconduct is not limited to either disloyalty in the classical sense ([i.e.], preferring the adverse self-interest of the fiduciary or of a related person to the interest of the corporation) or gross negligence. Cases have arisen where corporate directors have no conflicting self-interest in a decision, yet engage in a misconduct that is more culpable than simple inattention or failure to be informed of all the facts material to the decision. To protect the interests of the corporation and its shareholders, fiduciary conduct of this kind, which does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence, should be proscribed. A vehicle is needed to address such violations doctrinally, and that doctrinal vehicle is the duty to act in good faith.<sup>107</sup>

Moreover Delaware entities may not waive implied contractual covenants of good faith and fair dealing, no matter how explicit the corporate charters.<sup>108</sup> In the context of choice of law provisions being interpreted by Texas courts, a “choice of law provision in a contract that applies only to the interpretation and enforcement of the contract does not govern tort claims.”<sup>109</sup>

Adding to the clear weight of Delaware authority imposing such individual fiduciary duties absent a clear intent to alter or abolish them, the Delaware Chancery Court very recently reaffirmed that proposition in *Kelly v. Blum*.<sup>110</sup> The court in *Kelly v. Blum* held again that “in the absence of a contrary provision in the LLC agreement,” LLC managers and members owe “traditional fiduciary duties of loyalty and care” to each other and to the company.<sup>111</sup>

Whether waivable or not, traditional fiduciary duty concepts also arise in the context of minority shareholder rights, which are discussed in the section, “Minority Shareholder Oppression.”

### III. INTERNAL AFFAIRS DOCTRINE

Texas recognizes the internal affairs doctrine as a conflicts of law principle through both statute and common law. Delaware applies the internal affairs doctrine as both a conflicts of

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<sup>106</sup> *In re Citigroup Inc. S’holder Derivative Litig.*, 964 A.2d 106, 124 (Del. Ch. 2009).

<sup>107</sup> *In re Walt Disney Co.*, 906 A.2d at 66.

<sup>108</sup> *See* 6 DEL. C. § 18-1101 (2013).

<sup>109</sup> *Red Roof Inns, Inc. v. Murat Holdings, LLC*, 223 S.W.3d 676, 684 (Tex. App.—Dallas 2007, pet. denied) (citing *Stier v. Reading & Bates Corp.*, 992 S.W.2d 423, 433 (Tex. 1999)).

<sup>110</sup> *Kelly v. Blum*, 2010 WL 629850 at \*10–11 (Del. Ch. Feb. 24, 2010).

<sup>111</sup> *Id.* at \*10, n.69.

law principle and a constitutional mandate, but does not require it by specific statute. Both jurisdictions cite the same United States Supreme Court cases to explain the doctrine's rationale.

### A. Internal Affairs Doctrine in Texas

Texas law dictates that any claims involving a foreign entity's internal affairs will be governed by the state in which the entity was incorporated.<sup>112</sup> The internal affairs doctrine is based on the principle that "only one State should have the authority to regulate a corporation's internal affairs."<sup>113</sup> The "internal affairs of an entity include: the rights, powers, and duties of its governing authority, governing persons, officers, owners, and members" as well as "matters relating to its membership or ownership interests."<sup>114</sup>

To apply the internal affairs doctrine in Texas, "a preliminary motion must be filed asking the court to apply another state's laws."<sup>115</sup>

### B. Internal Affairs Doctrine in Delaware

Delaware enforces the internal affairs doctrine as both a conflict of laws principle and a constitutional mandate.<sup>116</sup> The internal affairs doctrine is "a long-standing choice of law principle which recognizes that only one state should have the authority to regulate a corporation's internal affairs – the state of incorporation."<sup>117</sup> Internal affairs include "those matters that pertain to the relationships among or between the corporation and its officers, directors, and shareholders."<sup>118</sup>

Delaware also considers the internal affairs doctrine to be a constitutional mandate "except in the rarest of situations."<sup>119</sup> Pursuant to the Fourteenth Amendment Due Process

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<sup>112</sup> TEX. BUS. ORGS. CODE ANN. § 1.102 (West 2006) (when an entity is formed through a foreign governmental body, "the law of the state or other jurisdiction in which that foreign governmental authority is located governs the formation and internal affairs of the entity"). The internal affairs doctrine was governed by Article 1528(n) of the Texas Limited Liability Company Act and Article 8.02(A) of the Texas Business Corporation Act before being repealed and replaced by the Texas Business Organizations Code in 2006.

<sup>113</sup> *State Farm Mut. Auto. Ins. Co. v. Lopez*, 156 S.W.3d 550, 557 n.7 (Tex. 2004) (citing *Edgar v. MITE Corp.*, 457 U.S. 624, 645 (1982)).

<sup>114</sup> TEX. BUS. ORGS. CODE ANN. § 1.105 (West 2006).

<sup>115</sup> *Progressive Child Care Sys., Inc. v. Kids 'R' Kids Int'l, Inc.*, 2-07-127-CV, 2008 Tex. App. LEXIS 8416, 2008 WL 4831339, at \*2 (Tex. App.—Fort Worth Nov. 6, 2008, pet. denied); *see also* TEX. R. EVID. 202 (stating that on a party's motion, courts shall take notice of another state's laws); *Burlington Northern & Santa Fe Ry. v. Gunderson, Inc.*, 235 S.W.3d 287, 290 (Tex. App.—Fort Worth 2007, pet. withdrawn) ("A preliminary motion is necessary to assure the application of the law of another jurisdiction, and absent a motion by a party, Texas law may be applied to a dispute.").

<sup>116</sup> *McDermott Inc. v. Lewis*, 531 A.2d 206, 215 (Del. 1987).

<sup>117</sup> *Vantagepoint Venture Partners v. Examen, Inc.*, 871 A.2d 1108, 1112 (Del. 2005) (citing *Edgar*, 457 U.S. at 645).

<sup>118</sup> *Vantagepoint Venture Partners*, 871 A.2d at 1113 (quoting *McDermott Inc.*, 531 A.2d at 214).

<sup>119</sup> *Id.* The only example the Delaware Supreme Court gives of a rare circumstance when the internal affairs doctrine would not be constitutionally mandated is where "the law of the state of incorporation is inconsistent with a

Clause, directors and officers of corporations have a right to know the law that will be applied to their actions and stockholders are entitled to know by what standards of accountability they may hold those managing the internal affairs.<sup>120</sup> “By providing certainty and predictability, the internal affairs doctrine protects the justified expectations of the parties with interests in the corporation.”<sup>121</sup> Additionally, the Commerce Clause dictates that a state “has no interest in regulating the internal affairs of foreign corporations.”<sup>122</sup>

### C. Internal Affairs Doctrine and Fiduciary Duty

An entity’s internal affairs have been widely held to include claims involving fiduciary duties.<sup>123</sup>

Texas courts also apply the internal affairs to fiduciary duty claims based on a *defendant’s* status as a shareholder. In Texas, “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, are governed by the laws of the jurisdiction of incorporation.”<sup>124</sup>

### D. Summary of Internal Affairs Doctrine

Texas and Delaware use the same definition of the internal affairs doctrine: the law of the state of an entity’s incorporation shall govern a corporation’s internal affairs—including in the context of fiduciary duty liability. Both states also rely on the doctrine as a conflicts of law principle. However, where Texas requires the doctrine’s application through a state statute, Delaware relies on common law and a constitutional mandate.

## IV. MINORITY SHAREHOLDER OPPRESSION

### A. Introduction

As will be seen, Texas and Delaware courts take radically different approaches to dealing with conduct that might be described as “minority shareholder oppression.” Texas has a

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national policy on foreign or interstate commerce.” *Id.* (quoting *CTS Corp. v. Dynamics*, 457 U.S. 69, 90 (1987)).

<sup>120</sup> *Id.* (citing *McDermott Inc.*, 531 A.2d at 216–17).

<sup>121</sup> *Id.*

<sup>122</sup> *Id.* (quoting *Edgar*, 457 U.S. at 645–46).

<sup>123</sup> *E.g.*, *In re World Health Alternatives, Inc.*, 385 B.R. 576, 589 (Bankr. D. Del. April 9, 2008) (“A breach of fiduciary duty claim involves the internal affair of a corporation.” (citation omitted)); *In re Circle Y of Yoakum, Texas*, 354 B.R. 349, 359 (Bankr. D. Del. 2006) (same); *LaSala v. Bodier et Cie*, 519 F. 3d 121, 131 n. 13 (3rd Cir. 2008) (“The parties agree that Delaware law applies to the breach-of-fiduciary-duty counts. This is clearly correct, as the claims involve the corporation’s internal affairs, and the state of incorporation is Delaware.”); *Ayres v. AG Processing, Inc.*, 345 F. Supp. 2d 1200, 1206 (D. Kan. 2004) (holding that minority LLC members’ claim for breach of fiduciary duty against majority LLC member and LLC’s managers involved “internal affairs” and thus law of state where LLC was organized would apply).

<sup>124</sup> *Hollis v. Hill*, 232 F.3d 460, 465 (5th Cir. 2000) (quoting TEX. BUS. CORP. ACT ANN. art. 8.02(A); *Enigma Holdings, Inc. v. Gemplus Int’l, S.A.*, 3: 05-CV-1168-B ECF, 2006 WL 2859369 at \*7–8; *see also Sommers Drug Stores Co. Emp. Profit Sharing Trust v. Corrigan*, 883 F.2d 345, 354 (5th Cir. 1989).

receivership statute that mentions, but does not define, “shareholder oppression” as a ground for receivership.<sup>125</sup> Some Texas courts of appeals have applied this statute outside of the receivership context to create a vague cause of action with poorly-defined parameters sometimes referred to as “shareholder oppression.” Delaware has no similar statute, and has developed a limited set of remedies (often mirroring statutory appraisal rights) to apply in circumstances that are described as having oppressive characteristics. The need for these remedies often arises in the context of “squeeze-out” mergers and “freeze-outs.” While sometimes invoking Delaware courts’ “equitable” powers and equitable doctrines, analyzed as a group, these cases result in a more carefully defined category of “minority shareholder oppression,” which is applied in more limited circumstances than Texas lower courts’ use of the doctrine.

The Texas courts have characterized oppression broadly, leading to imprecise boundaries of what constitutes oppressive actions requiring remedy. Notably, in Texas, “[t]here is no set standard for determining whether shareholder oppression has occurred.”<sup>126</sup> Instead, courts “must examine the facts as a whole and determine whether the corporation’s conduct has deprived a minority shareholder of the shareholders’ reasonable expectations as an equity holder of the corporation.”<sup>127</sup> This section of the paper will first look at the vague and ill-defined parameters of the Texas “cause of action,” and then discuss three standards by which Delaware courts evaluate oppressive action in the shareholder context. It will briefly discuss several Delaware cases that touch on shareholder “oppression,” including several interesting cases protecting the *majority* shareholder(s) from oppression.

## B. Shareholder Oppression Law in Texas<sup>128</sup>

Texas Courts have rarely allowed relief for shareholder oppression. Only seven cases since the statute’s adoption over fifty years ago have allowed narrowly limited relief for oppression.<sup>129</sup> Eleven held there was *no* oppression.<sup>130</sup> Five merely reversed dispositive

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<sup>125</sup> TEX. BUS. CORP. ACT ANN. art. 7.05(A)(1)(c) (recodified at TEX. BUS. ORGS. CODE ANN. § 11.404 (West 2010)).

<sup>126</sup> *In re White*, 429 B.R. 201, 213 (Bankr. S.D. Tex 2010).

<sup>127</sup> *Id.*

<sup>128</sup> Special thanks to David Harper and Michelle Jacobs of Haynes and Boone, LLP for their substantial contribution to this Section from their recent publication *Corporate Fiduciary Duties and Shareholder Oppression in Texas*, Advanced In-House Counsel Course, State Bar of Texas, July 2010.

<sup>129</sup> See *Cardiac Perfusion Servs., Inc. v. Hughes*, No. 05-10-00286-CV, at \*3–5 (Tex. App.—Dallas July 26, 2012); *Ritchie v. Rupe*, 339 S.W.3d 275, 281 (Tex. App.—Dallas 2011, pet. filed) (FMV of stock); *Devji v. Keller*, No. 03-99-436-CV, 2000 Tex. App. LEXIS 8491, at \*14 (Tex. App.—Austin Dec. 21, 2000, no pet.) (\$39,000 capital contribution return); *Advance Marine, Inc. v. Kelley*, No. 01-90-645-CV, 1991 Tex. App. LEXIS 1614, at \*2 (Tex. App.—Houston [1st Dist.] June 27, 1991, no writ) (buyout); *Davis v. Sheerin*, 754 S.W.2d 375, 383 (Tex. App.—Houston [1st Dist.] 1988, writ denied) (buyout); *In re White*, 429 B.R. at 214 (bonus if any dividends *or* buyout); *In re Rosenbaum*, No. 08-43029, 2010 Bankr. LEXIS 1509, at \*19–20 (Bankr. E.D. Tex. May 7, 2010) (return of \$325,000 stock purchase price); see also *Patton*, 279 S.W.2d at 854 (pre-statutory case with dividend relief).

<sup>130</sup> See *ARGO Data Resource Corp. v. Shagrithaya*, 380 S.W.3d 249 (Tex. App.—Dallas 2012, pet. filed); *Allen v. Devon Energy Holdings, LLC*, 367 S.W.3d 355, 398–99 (Tex. App.—Hous. [1st Dist.] 2012); *Guerra v. Guerra*, No. 04-10-00271-CV, WL 3715051, at \*11 (Tex. App.—San Antonio August 24, 2011); *Art v. Schmart Eng’g, Inc.*, No. 13-02-00621-CV, 2008 Tex. App. LEXIS 7540 (Tex. App.—Corpus Christi Oct. 9, 2008, no pet.);

motions.<sup>131</sup> And twelve mentioned oppression but did not address it for a variety of reasons.<sup>132</sup>

The seven cases that allowed relief did so only because extreme circumstances justified intervention with corporate governance, e.g., (1) a refusal to recognize the minority's stock ownership at all;<sup>133</sup> (2) disguised dividends or other asset diversions intended to exclude the plaintiff shareholder from proportionate profit sharing;<sup>134</sup> (3) capital calls or contributions solicited from the minority shareholder while majority shareholders transferred assets to themselves, usurped corporate opportunities, or purposefully and actually rendered the minority's shares worthless;<sup>135</sup> and (4) a wrongful interference with the sale of stock to a third party.<sup>136</sup>

The Texas Supreme Court has yet to recognize a cause of action for shareholder oppression or to define its parameters.<sup>137</sup> While a number of Texas courts of appeals have also never recognized the cause of action, some have upheld claims for shareholder oppression or at least recognized it as a viable claim. But these courts' justifications for recognizing a broad shareholder oppression claim are questionable, because they rely on: (1) a Texas Supreme Court case that never acknowledged shareholder oppression as a valid claim; (2) a Texas

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*Gibney v. Culver*, No. 13-06-112-CV, 2008 Tex. App. LEXIS 2954, at \*57–58 (Tex. App.—Corpus Christi Apr. 10, 2008, pet. denied); *Allchin v. Chemic, Inc.*, No. 14-01-0043-CV, 2002 Tex. App. LEXIS 5125, at \*25 (Tex. App.—Houston [14th Dist.] July 18, 2002, no pet.); *Willis v. Bydalek*, 997 S.W.2d 798, 801 (Tex. App.—Houston [1st Dist.] 1999, pet. denied); *Pinnacle Data, Inc. v. Gillen*, 104 S.W.3d 188 (Tex. App.—Texarkana 2003, no pet.); *Christians v. Stafford*, No. 14-99-0038-CV, 2000 Tex. App. LEXIS 6423 (Tex. App.—Houston [14th Dist.] Oct. 26, 2000, no pet.); *Tex. Coll. Bowl, Inc. v. Phillips*, 408 S.W.2d 537 (Tex. Civ. App.—Texarkana 1966, no writ).

<sup>131</sup> *Redmon v. Griffith*, 202 S.W.3d 225 (Tex. App.—Tyler 2006, pet. denied) (reversing summary judgment); *Cotten v. Weatherford Bancshares, Inc.*, 187 S.W.3d 687, 707–08 (Tex. App.—Fort Worth 2006, pet. denied) (reversing directed verdict); *Coates v. Parnassus Sys., Inc.*, No. 03-01-00549-CV, 2002 Tex. App. LEXIS 2545 (Tex. App.—Austin 2002, no pet.) (reversing summary judgment); *Joseph v. Koshy*, No. 01-98-01432-CV, 2000 Tex. App. LEXIS 810 (Tex. App.—Houston [1st Dist.] Feb. 3, 2000, no pet.) (reversing summary judgment based on failure to adequately address claims in traditional motion); *Bulacher v. Enowa, LLC*, 2010 U.S. Dist. LEXIS 27784, at \*4 (N.D. Tex. 2010) (reversing grant of motion to dismiss).

<sup>132</sup> *Swett v. At Sign, Inc.*, No. 02-08-315-CV, 2009 Tex. App. LEXIS 3579 (Tex. App.—Fort Worth May 21, 2009, no pet.); *Flores Star Cab Coop. Ass'n*, 2008 Tex. App. LEXIS 6582 (Tex. App.—Amarillo Aug. 28, 2008, pet. denied); *Warren v. Warren Equip. Co.*, 189 S.W.3d 324 (Tex. App.—Eastland 2006, no pet.); *Boondoggles Corp. v. Yancey*, 2006 Tex. App. LEXIS 6896 (Tex. App.—Houston [1st Dist.] Aug. 3, 2006, no pet.); *Gonzalez v. Greyhound Lines, Inc.*, 181 S.W.3d 386 (Tex. App.—El Paso 2005, pet. denied); *Willis v. Donnelly*, 118 S.W.3d 10 (Tex. App.—Houston [14th Dist.] 2003), *rev'd*, 199 S.W.3d 262 (Tex. 2006); *In re Profanchik & Conversant Tech., Inc.*, 31 S.W.3d 381 (Tex. App.—Corpus Christi 2000, orig. proceeding); *Hoggett v. Brown*, 971 S.W.2d 472 (Tex. App.—Houston [14th Dist.] 1997, pet. denied); *Debord v. Circle Y of Yoakum*, 951 S.W.2d 127 (Tex. App.—Corpus Christi 1997), *rev'd*, 967 S.W.2d 352 (Tex. 1998); *Alexander v. Sturkie*, 909 S.W.2d 166 (Tex. App.—Houston [14th Dist.] 1995, writ denied); *Faour v. Faour*, 789 S.W.2d 620 (Tex. App.—Texarkana 1990, writ denied); *Duncan v. Lichtenberger*, 671 S.W.2d 948 (Tex. App.—Fort Worth 1984, writ ref'd n.r.e.).

<sup>133</sup> *Patton*, 279 S.W.2d at 854; *Davis*, 754 S.W.2d at 383; *In re White*, 429 B.R. at 214.

<sup>134</sup> *Kelley*, 1991 Tex. App. LEXIS 1614, at \*2; *In re White*, 429 B.R. at 214.

<sup>135</sup> *Devji*, 2000 Tex. App. LEXIS 8491, at \*14; *In re White*, 429 B.R. at 214; *Rosenbaum*, 2010 Bankr. LEXIS 1509, at \*19–20.

<sup>136</sup> *Ritchie v. Rupe*, 339 S.W.3d 275, 304–05 (Tex. App.—Dallas 2011, pet. filed).

<sup>137</sup> As discussed in the subsequent section, the Texas Supreme Court in *Patton v. Nicholas*, 279 S.W.2d 848, 849, 859 (Tex. 1955) did not describe the minority shareholder's claim as one for "oppression," did not define any elements of the claim, and did not explicitly recognize a claim for "shareholder oppression."

receivership statute that allows relief from oppression only in limited and extreme circumstances; and (3) a Texas appellate court case that relied on the previous two faulty grounds and on inapplicable case law from other jurisdictions. Given this weak foundation, when the Texas Supreme Court confronts the issue in *Ritchie v. Rupe*, it is uncertain whether it will recognize a claim for shareholder oppression beyond the purview of the receivership statute. Because some Texas courts of appeals have recognized the claim, however, it is necessary to understand its scope and application.

### 1. *Existence of the Cause of Action*

Two key cases and a receivership statute have laid the foundation for some courts of appeals to recognize a cause of action for shareholder oppression. The following is a summary of these sources and a discussion of why each fails to support a claim for shareholder oppression.

#### a. *Patton v. Nicholas: Laying the Groundwork for a Shareholder Oppression Claim*

In *Patton v. Nicholas*, the Texas Supreme Court reversed an order of liquidation in a suit brought by a minority shareholder for certain domineering conduct by the defendant, who was the president, director, and majority shareholder of the corporation.<sup>138</sup>

The defendant, in a malicious effort to prevent the minority shareholders from recognizing any returns on their ownership, effectively forced the resignation of the minority shareholders from the company's employ and also prevented dividends from being issued.<sup>139</sup> In addition, the defendant sought to "otherwise lower[] . . . the value of the stock" of the minority shareholders and to dominate the board of directors.<sup>140</sup>

Evaluating the defendant's conduct, the court determined that the defendant's domination of the board, by itself, was not problematic because, as "the founder of the business, president, owner of a clear majority of the stock and the only substantial stockholder on a board composed largely of employees," the defendant "could hardly avoid imposing his personal views on the other members, whatever his intentions."<sup>141</sup> But the defendant's conduct, viewed as a whole, convinced the court to rule in favor of the minority shareholders:

[C]oupling all the circumstances indicating the petitioner's intent to eliminate the respondents from every connection with the business, and at an unfair sacrifice on their part, with the fact that no dividends were paid in the face of an accumulation of surplus . . . at the rate of almost 10% per annum, the findings of malicious suppression of dividends must be sustained.<sup>142</sup>

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<sup>138</sup> 279 S.W.2d 848, 849, 859 (Tex. 1955).

<sup>139</sup> *Id.* at 852–53.

<sup>140</sup> *Id.* at 853.

<sup>141</sup> *Id.*

<sup>142</sup> *Id.* at 854.

Although the court determined that liquidation might be appropriate in certain “extreme” cases like the one before it, the court did not find it appropriate to liquidate the corporation.<sup>143</sup> Instead, it granted injunctive relief to the minority shareholder, requiring the defendant to issue reasonable present and future dividends.<sup>144</sup>

The court never described the minority shareholder’s claim as one for “oppression,” nor did it define any elements of the claim. Thus, while *Patton* provided relief for extreme conduct that denied even the existence of the minority shareholders, it did not explicitly recognize a claim for “shareholder oppression.” Likewise, the court also did not recognize a cause of action for malicious suppression of dividends. It simply found that, under the extreme facts of the case, relief was justified, in part, based on the adopted—but not yet effective—receivership statute.

*b. Texas Receivership Statute: Legislative Foundation for Shareholder Oppression Claim*

The Business Organizations Code authorizes a rehabilitative receivership if an owner of a domestic entity establishes that “the actions of the governing persons of the entity are *illegal, oppressive, or fraudulent*.”<sup>145</sup> “[G]overning persons” includes the board of directors of a corporation; it “does not include an officer who is acting in the capacity of an officer.”<sup>146</sup> Relief is allowed only if: (1) necessary to conserve the property and business of the corporation and to avoid damage to interested parties; and (2) all other available legal and equitable remedies are inadequate.<sup>147</sup> Additionally, the statute provides that any relief awarded under the statute be “terminated immediately” when the condition necessitating the relief ends.<sup>148</sup>

The rehabilitative statute contemplates relief if (1) wrongdoing (“illegal, oppressive[,] or fraudulent” conduct); (2) at the board level; (3) affects the well-being of the corporate entity and damages an interested party for which; (4) there continues to be a need for the relief; and (5) there is no other adequate remedy at law or in equity.<sup>149</sup> Unfortunately, the statute does not define “oppressive” conduct.

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<sup>143</sup> *Id.* at 856–57.

<sup>144</sup> *Id.* at 857.

<sup>145</sup> TEX. BUS. ORGS. CODE ANN. § 11.404(a)(1)(C) (West Supp. 2010) (emphasis added) (formerly TEX. BUS. CORP. ACT ANN. Art. 7.05 (West Supp. 2002)). Article 7.05 was recodified into Texas Business Organizations Code § 11.404, mandatorily effective in 2010. Although not using the phrase “governing persons,” the no-longer-effective Business Corporations Act contained similar language that rested on corporate level inquiries of insolvency, deadlock, illegality or waste, the “acts of the directors or those in control of the corporation,” conservation of corporate assets and affairs, lack of other adequate remedy, and termination of any receivership upon removal of the condition. TEX. BUS. CORP. ACT art. 7.05 (West 2009). “Those in control of the corporation” under the meaning and purpose of the statute is the Board of Directors. *Id.* The expired statute thus carried the same requirements as the statute that now applies.

<sup>146</sup> *Id.* § 1.002(35).

<sup>147</sup> *Id.* § 11.404(b).

<sup>148</sup> *Id.* § 11.404(c).

<sup>149</sup> TEX. BUS. ORGS. CODE § 11.404; TEX. BUS. CORP. ACT art. 7.05 (West 2009).

Since *Patton* referred to the precursor to this statute to justify the relief ordered in that case, courts that have recognized shareholder oppression treat this statute as the legislative foundation for a “shareholder oppression” claim.

The recent Dallas Court of Appeals case, *Richie v. Rupe*,<sup>150</sup> made clear that shareholder oppression claims are statutory in nature.<sup>151</sup>

*c. Davis v. Sheerin: Texas Courts’ First True Attempt at Defining Oppression*

In *Davis v. Sheerin*, the plaintiff sued the defendants for their oppressive conduct toward him as a minority shareholder.<sup>152</sup> The defendants claimed that the trial court improperly ordered a “buy-out” of the minority shareholder’s interest.<sup>153</sup> In evaluating this claim, the court looked to *Patton*, the receivership statute, and case law from other jurisdictions.<sup>154</sup>

The court upheld the ordered “buy-out,” despite recognizing that the Texas receivership statute “does not expressly provide for the remedy of a ‘buy-out’ for an aggrieved minority shareholder.”<sup>155</sup> The court determined that because the receivership statute allowed the appointment of a liquidating receiver for oppressive conduct, a court could always impose a less drastic remedy.<sup>156</sup> Thus, because a buyout is less burdensome than a forced liquidation, it is within a court’s equitable powers.<sup>157</sup> The *Davis* court further acknowledged that the receivership statute “does not define oppressive conduct.”<sup>158</sup> The court then crafted its own standard for oppression based on case law from other jurisdictions.<sup>159</sup> These out-of-state cases are of minimal precedential value in Texas, however, because they impose a fiduciary relationship between close corporation shareholders.<sup>160</sup> But Texas recognizes no such duty. Thus, relying on shaky legal grounds, *Davis* recognized shareholder oppression as a cause of action greater in scope than that explicitly authorized by the receivership statute or Texas case law.

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<sup>150</sup> *Ritchie v. Rupe*, 339 S.W.3d 275 (Tex. App.—Dallas 2011, pet. filed).

<sup>151</sup> *Id.* at 289 (“Statutes like article 7.05 providing remedies for oppression rarely define the term.”); *see also* *Davis v. Sheerin*, 754 S.W.2d 375, 381, 383 (Tex. App.—Houston [1st Dist.] 1988, writ denied) (article 7.05 “provides a cause of action based on oppressive conduct”); *In re White*, 429 B.R. 201, 214 (Bankr. S.D. Tex. 2010) (the Business Organizations Code “informs” when a court should impose equitable relief); *Patton v. Nicholas*, 279 S.W.2d 848, 851–52 (Tex. 1955) (adopted-but-not-yet effective article 7.05 represents “approach” to extreme oppression complaint).

<sup>152</sup> *Davis*, 754 S.W.2d at 377.

<sup>153</sup> *Id.* at 378.

<sup>154</sup> *See id.* at 378–80, 83–84.

<sup>155</sup> *Id.* at 378.

<sup>156</sup> *In re White*, 429 B.R. at 215 (citing *Davis*, 754 S.W.2d at 384).

<sup>157</sup> *Id.*

<sup>158</sup> *Davis*, 754 S.W.2d at 381.

<sup>159</sup> *See id.*

<sup>160</sup> *See id.* (citing *McCauley v. Tom McCauley & Son, Inc.*, 724 P.2d 333, 356 (N.M. Ct. App. 1986), and *Baker v. Commercial Body Builders, Inc.*, 507 P.2d 387 (Or. 1973)).

*d. Post-Davis cases*

Despite these questionable foundations, cases post-dating *Davis* continue to rely directly or indirectly on the post-*Patton* receivership statute, *Davis*, and out-of-state law in recognizing a minority shareholder claim for “oppression.”<sup>161</sup> In particular, courts have repeatedly cited *Davis* for its definition of oppression, since no other definition can be found in Texas jurisprudence.

Until the Texas Supreme Court provides guidance in *Rupe*, Texas courts will likely continue to entertain shareholder oppression as a cause of action, despite the vagueness of the term “oppression.”<sup>162</sup> Thus, the following section examines standards or requirements necessary to show “oppression” in Texas.

**2. Shareholder Oppression Standards in Texas**

The Texas lower courts that have recognized a claim for shareholder oppression have defined it as follows:

1. majority shareholders’ conduct that substantially defeats the minority’s expectations that, objectively viewed, were both reasonable under the circumstances and central to the minority shareholder’s decision to join the venture (“Reasonable Expectations”); or
2. burdensome, harsh, or wrongful conduct; a lack of probity and fair dealing in the company’s affairs to the prejudice of some members; or a visible departure from the standards of fair dealing and a violation of fair play on which each shareholder is entitled to rely (“Fair Dealing”).<sup>163</sup>

The second definition is particularly subject to criticism,<sup>164</sup> because it is extremely vague and appears grounded in a majority shareholder fiduciary duty or duty of good faith and fair

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<sup>161</sup> See, e.g., *Redmon v. Griffith*, 202 S.W.3d 225 (Tex. App.—Tyler 2006, pet. denied) (citing *Davis* in reversing summary judgment on shareholder oppression claim); *Cotten v. Weatherford Bancshares, Inc.*, 187 S.W.3d 687 (Tex. App.—Fort Worth 2006, pet. denied) (citing *Pinnacle Data Servs., Inc. v. Gillen*, 104 S.W.3d 188 (Tex. App.—Texarkana 2003, no pet.), which cites *Davis*, in holding that preferred stockholder may have “oppression” claim against directors); *Hoggett v. Brown*, 971 S.W.2d 472 (Tex. App.—Houston [14th Dist.] 1997, pet. denied) (citing *Davis* in discussing “fiduciary duty” owed amongst shareholders).

<sup>162</sup> See, e.g., Brief of Appellants, *DeNucci v. Matthews*, No. 04-11-00680-CV, 2011 Tex. App. Ct. Briefs 680 (Tex. App.—Austin [3rd Dist.] 2012) (appealing trial court’s summary judgment denying plaintiffs’ claims of minority shareholder oppression).

<sup>163</sup> See, e.g., *Willis v. Bydalek*, 997 S.W.2d 798, 801 (Tex. App.—Houston [1st Dist.] 1999, pet. denied) (citing *Davis*, 754 S.W.2d at 381–82); *Ritchie v. Rupe*, 339 S.W.3d 275, 290 (Tex. App.—Dallas 2011, pet. filed); *Guerra v. Guerra*, No. 04-10-00271-CV, at \*11 (Tex. App.—San Antonio Aug. 24, 2011).

<sup>164</sup> *But see* Amicus Curiae letter, submitted on behalf of Respondent, dated Jan. 15, 2013 (stating, “Therefore, the [*Ritchie*] court was on sound footing in adopting its definition of shareholder oppression. Its definition should be endorsed by the Supreme Court of Texas.”).

dealing, neither of which is recognized in Texas.<sup>165</sup>

Cases discussing shareholder oppression also inevitably focus on the defendant's malice. For example, in *Gibney v. Culver*,<sup>166</sup> the court evaluated whether there was sufficient evidence that the defendant *maliciously* allowed excessive salaries, *maliciously* withheld dividends, or *maliciously* refused access to books and records to uphold the trial court's finding of shareholder oppression. To the extent that *Patton* is relied on to support a claim for shareholder oppression, it also indicates that malice is a necessary element of the claim.<sup>167</sup> Although Texas courts have never specifically identified malice as an element of shareholder oppression, for practical purposes, a plaintiff must likely prove malice to prevail on this claim.

### 3. *Recent Minority Shareholder Oppression Cases*

Shareholder oppression claims are on the rise in Texas. Below are some of the recent key cases decided by Texas courts of appeals.

#### a. *Ritchie v. Rupe: 2011 Dallas Court of Appeals Opinion; Pending Texas Supreme Court Opinion*

In accordance with *Davis*, the Dallas Court of Appeals recently recognized a cause of action for minority shareholder oppression. In *Richie v. Rupe*, the plaintiff, a minority shareholder in Rupe Investment Corporation ("RIC") brought claims of shareholder oppression against the other shareholders and directors of RIC.<sup>168</sup> In an effort to sell her stock, the plaintiff first approached RIC to purchase the stock.<sup>169</sup> When the plaintiff and RIC were unable to settle on a price satisfactory to both parties, the plaintiff proceeded to market the stock to third parties.<sup>170</sup> The plaintiff encountered difficulty in obtaining the interest of investors because most investors wanted to meet with RIC's board before making a decision to invest in the close corporation, and RIC's board refused to meet with any prospective purchasers.<sup>171</sup> The trial court found that the plaintiff was the victim of shareholder oppression and ordered the corporation to buyout the plaintiff's stock.<sup>172</sup> The defendants argued that: (1) Court-mandated

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<sup>165</sup> See *City of Midland v. O'Bryant*, 18 S.W.3d 209, 215–16 (Tex. 2000) (no good faith duty in employment context); *Formosa Plastics Corp. v. Presidio Engineers and Contractors, Inc.*, 960 S.W.2d 41, 52 (Tex. 1998) (no good faith duty in "ordinary, arms-length commercial transactions"); *Crim Truck and Tractor, Co. v. Navistar Int'l Trans. Corp.*, 823 S.W.2d 591 (Tex. 1992) (no general duty of good faith and fair dealing in all contracts); *FDIC v. Coleman*, 795 S.W.2d 706, 708–09 (Tex. 1990) (no good faith duty in lender/borrower relationship); *English v. Fischer*, 660 S.W.2d 521, 522 (Tex. 1983) (unwilling to let each fact finder decide what is "fair and in good faith").

<sup>166</sup> *Gibney v. Culver*, No. 13-06-112-CV, 2008 Tex. App. LEXIS 2954, at \*56–64 (Tex. App.—Corpus Christi April 24, 2008, pet. denied) (mem. op., not designated for publication).

<sup>167</sup> See *Patton v. Nicholas*, 279 S.W.2d 848, 853 (Tex. 1955) (noting the jury's finding of malice and explaining that "the evidence as to the wrongful state of mind of the petitioner seems quite adequate, and while proof of connection between this state of mind and actual conduct is both small in volume and inferential in character (as it would almost necessarily be) we think it is enough").

<sup>168</sup> *Rupe*, 339 S.W.3d 275, 282 (Tex. App.—Dallas 2011, orig. proceeding [mand. pending]).

<sup>169</sup> *Id.*

<sup>170</sup> *Id.*

<sup>171</sup> *Id.*

<sup>172</sup> *Id.*

buyback of the stock is not an available remedy for shareholder oppression in Texas; (2) As a matter of law, their actions did not constitute shareholder oppression; and (3) The buyout remedy is unduly harsh and inappropriate under the circumstances.<sup>173</sup>

Citing *Davis*, on the first question of whether a buyout is available under Texas law, the court determined that a buyout can be an appropriate remedy ““where less harsh remedies are inadequate to protect the rights of the parties.””<sup>174</sup> On the second question—the heart of the case—the court looked at whether the actions of the defendants constituted oppression. Applying the two definitions of oppression discussed above, i.e., “Reasonable Expectations” or “Fair Dealing,” the court concluded that the defendants acted oppressively toward the plaintiff under both definitions.<sup>175</sup> While the rights of the shareholder and obligations of those in control of the corporation are not boundless, the court determined that the board’s actions in refusing to meet with investors substantially defeated the plaintiff’s right to sell her stock to a third party.<sup>176</sup> Finally, on the third question of whether ordering a buyout was an unduly harsh remedy, the court concluded that the trial court’s ordered buyout was not so harsh as to constitute an abuse of discretion.<sup>177</sup>

i. Petition to the Texas Supreme Court Granted

The Texas Supreme Court granted the defendants’ Petition for Review. In presenting the importance of the court’s review of this case, the petitioners highlighted the rise of shareholder oppression claims, and the lower courts’ need for guidance on evaluating these claims. The petitioners further argued that the court of appeals erred by: (1) holding that the petitioners oppressed the minority shareholder by refusing to meet with prospective purchasers; (2) awarding a remedy beyond those provided in the statute; (3) awarding a remedy that is more burdensome than necessary; and (4) applying the reasonable expectations test.

Thus, the principal issues facing the court include: (1) whether the controlling shareholders and principals of a closely held corporation oppressed a minority shareholder by refusing to meet with potential buyers of her stock; (2) whether shareholder oppression should be proved by a “reasonable expectations” standard or by one showing “burdensome, harsh or wrongful conduct”; (3) whether the Texas receivership statute authorizes a court to order other shareholders to buy the oppressed minority shareholder’s stock; and, if so, (4) whether such a stock-buyout remedy was appropriate in this case.

ii. Oral Argument to the Texas Supreme Court

Oral argument was heard by the court on February 26, 2013. The Texas State Bar displayed the following statement of facts and issues during oral argument to the Texas Supreme Court:

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<sup>173</sup> *Id.* at 285.

<sup>174</sup> *Id.* at 286 (quoting *Davis v. Sheerin*, 754 S.W.2d 375, 380, (Tex. App.—Houston [1st Dist.] 1988, writ denied)).

<sup>175</sup> *Id.* at 293–97.

<sup>176</sup> *Id.* at 297.

<sup>177</sup> *Id.* at 299.

The principal issues are (1) whether shareholders and principals controlling a closely held corporation oppressed a minority shareholder by refusing to meet with potential buyers of stock she controlled; (2) whether shareholder oppression should be proved by a “reasonable expectations” standard or by one showing “burdensome, harsh or wrongful conduct”; (3) whether the Texas statute addressing oppression authorizes a court to order other shareholders to buy the minority shareholder’s stock; and, if so, (4) whether such a stock-buyout remedy was appropriate in this case. This dispute involves stock in a family company, Rupe Investment Corp. of Dallas. All stock in Rupe Investment is held by descendants of Dallas businessmen Dallas Gordon Rupe Jr. (“Pops”) and Robert Ritchie or by trusts for their descendants. Ann Rupe, in charge of a trust her late husband established to hold his shares (“Buddy’s Trust”), sued Ritchie and other Rupe Investment directors because they refused to meet with potential buyers of the stock she controlled. The other directors cited liability problems they might face by meeting with would-be buyers. Rupe hired a broker to sell the stock after she refused the directors’ offers to buy her stock for as much as \$1.7 million. The broker priced it as high as \$3.4 million, but testified no purchaser would buy it without meeting with the directors. Finding oppression, the trial court ordered Rupe Investment to buy the stock for \$7.3 million after a jury determined that to be its fair market value. The court of appeals affirmed the trial court’s oppression finding, but reversed to revalue the stock. The appeals court held that jurors should have been instructed to account for Ann Rupe’s minority-shareholder status and the lack of a ready market for the stock.

The court questioned counsel on the standards on which the court should evaluate the allegedly oppressive conduct, the scope of the cause of action, appropriate remedies, and what conduct can constitute oppression. Petitioner’s counsel argued for a limited cause of action with a “burdensome and harsh” standard (rather than the “reasonable expectation” standard) that encompasses only narrow statutory remedies, i.e., a rehabilitative receivership. Respondent’s counsel urged oppressive acts separate from the board’s failure to meet and argued that the court should consider the totality of the circumstances when making the oppression determination. Respondent’s counsel also argued that a confidentiality agreement and release drafted by the company and signed by the prospective purchasers relieved the company from any risk for misrepresentation or securities fraud, and so any reliance on a business judgment justification was not warranted.

In closing, the court asked Petitioner’s counsel for guidance on the contours of the term “oppression” in the statute. He advised the court to exercise “judicial restraint,” and confine itself only to the language currently present in the statute, which, by his submission, provides only for the sole remedy of a rehabilitative receivership. Providing a buyout remedy, in his view, merely incentivizes more shareholder oppression cases (counsel cited an increase in oppression litigation at the same point that a buyout remedy was recognized by judicial opinions and statutes).

How the court will rule on this case is anyone’s guess. Hopefully its ruling provides appropriate guidance to assist Texas courts of appeals in handling future oppression claims

equitably and uniformly.

b. *Cardiac Perfusion Servs., Inc. v. Hughes, No. 05-10-00286-CV (Tex. App.—Dallas 2012, pet. filed).*

In another recent shareholder oppression case, the court ignored otherwise binding terms of a shareholder buy-sell agreement, and instead ordered an “equitable” buyout remedy on completely different terms.<sup>178</sup> In *Cardiac Perfusion*, Joubran (plaintiff) and Hughes (defendant) worked as cardiac perfusionists (i.e., they operated heart-lung machines during open-heart surgery).<sup>179</sup> Plaintiff founded Cardiac Perfusion Services (“CPS”) and hired defendant as his employee.<sup>180</sup> Defendant accepted an opportunity to purchase stock in CPS, and the parties entered into a Buy-Sell Agreement.<sup>181</sup> The Agreement provided that, if a shareholder is terminated, the other shareholders of CPS must buy his stock based on book value of the shares the previous year.<sup>182</sup> A dispute arose between the parties years later, and defendant was terminated.<sup>183</sup>

Plaintiffs sued defendant for breach of fiduciary duty and tortious interference with a contract, and defendant counterclaimed for shareholder oppression.<sup>184</sup> The jury found in favor of defendant on all claims.<sup>185</sup> With respect to defendant’s counterclaim, the jury found that Joubran: (1) withheld payment or profit distribution to defendant; (2) paid himself excessive compensation; (3) improperly used funds to pay personal expenses and pay family members; (4) lowered the value of defendant’s stock; and (5) concealed books and records from defendant.<sup>186</sup>

Despite an enforceable Buy-Sell Agreement,<sup>187</sup> the trial court ordered the redemption of the minority shareholder’s shares at fair value.<sup>188</sup> While noting that “Texas courts have held that a party to a contract cannot recover equitable relief inconsistent with that contract,” the appellate court considered the minority shareholder’s claim that the book value of his shares was reduced by the oppressive conduct, and because the shareholder “sued for shareholder oppression, not breach of contract,” the court exercised its “equitable power to order a buy-out at fair value.”<sup>189</sup>

At first glance, the appellate court’s decisions in *Rupe* and *Cardiac Perfusion* suggest that

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<sup>178</sup> *Cardiac Perfusion Servs., Inc. v. Hughes, No. 05-10-00286-CV (Tex. App.—Dallas 2012, pet. filed).*

<sup>179</sup> *Id.* at \*1.

<sup>180</sup> *Id.*

<sup>181</sup> *Id.*

<sup>182</sup> *Id.*

<sup>183</sup> *See id.*

<sup>184</sup> *Id.*

<sup>185</sup> *Id.* at \*2.

<sup>186</sup> *Id.*

<sup>187</sup> The Buy-Sell Agreement stated that the purchase price was “calculated using the book value of the shares as of the fiscal year preceding the termination.” *Id.* at \*1.

<sup>188</sup> *Id.* at \*2–3.

<sup>189</sup> *Id.* at \*4–5.

the threshold for identifying acts as “oppressive” is relatively low. The majority shareholders in *Rupe* did not *thwart* the minority shareholders right to sell her stock, but merely—on the advice of counsel—refused to meet with prospective buyers, yet the court determined that the majority shareholder’s actions constituted oppression. That threshold seems to be a moving target, however, as other Texas courts have set the threshold much higher.<sup>190</sup> The Texas Supreme Court will finally weigh in when it decides *Rupe* later this year.

c. *Guerra v. Guerra*, No. 04-10-00271-CV, 2011 WL 3715051 (Tex. App.—San Antonio Aug. 24, 2011).

Yet another Texas appellate court—though ultimately holding against the minority shareholder—recently entertained a claim for shareholder oppression. In *Guerra*, a sister brought suit against her brother following their father’s death for numerous claims, including breach of fiduciary duty and minority shareholder oppression.<sup>191</sup> The trial court granted the brother’s motion for summary judgment, and the sister appealed.<sup>192</sup> The brother was appointed independent executor of their father’s estate, and had acted as president of Laredo Hardware, the family-owned company (started by their father), for the five years prior to their father’s death.<sup>193</sup> The father owned thirty-eight percent of the shares of Laredo Hardware, and the sister and brother, along with four other family members owned the remainder.<sup>194</sup> Laredo Hardware elected not to purchase the father’s shares, and offered the sister the opportunity to purchase them.<sup>195</sup> She declined, and instead offered to sell her shares to her brother.<sup>196</sup> When her brother rejected her offer, she filed suit.<sup>197</sup>

The sister claims that her brother breached his fiduciary duty as an officer and director of Laredo Hardware, and—by refusing to liquidate Laredo Hardware following their father’s death—engaged in minority shareholder oppression.<sup>198</sup> She requested that the court require her brother and Laredo Hardware to buyout her shares.<sup>199</sup> Specifically, the sister claimed that her brother breached his fiduciary duties by, among other things: (1) “usurping a corporate opportunity when he purchased the land on which Laredo Hardware is located; and (2) failing to liquidate Laredo Hardware.”<sup>200</sup> The brother defended against these claims by arguing (among other things) that he owed his sister no fiduciary duties as an officer and director or as a majority shareholder, her claims are barred by the business judgment rule, and the board of

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<sup>190</sup> See, e.g., *Allen v. Devon Energy Holdings, LLC*, 367 S.W.3d 355, 398–99 (Tex. App.—Hous. [1st Dist.] 2012, no pet.); *ARGO Data Resource Corp. v. Balkrishna Shagrithaya*, 380 S.W.3d 249 (Tex. App.—Dallas 2012, pet. filed).

<sup>191</sup> *Guerra v. Guerra*, No. 04-10-00271-CV, at \*1 2011 WL 3715051 (Tex. App.—San Antonio Aug. 24, 2011).

<sup>192</sup> *Id.* at \*1–2.

<sup>193</sup> *Id.* at \*2.

<sup>194</sup> *Id.*

<sup>195</sup> *Id.*

<sup>196</sup> *Id.*

<sup>197</sup> *Id.*

<sup>198</sup> *Id.* at \*3.

<sup>199</sup> *Id.*

<sup>200</sup> *Id.*

directors rejected the opportunity to purchase the land and approved the lease.<sup>201</sup>

The court held that the brother did not have authority to liquidate Laredo Hardware, and that he “did not have a duty to persuade shareholders in a corporation to liquidate the company.”<sup>202</sup> In response to the sister’s claim for breach of fiduciary in his capacity as director and officer, the court—citing *Redmon*—concluded that the brother owed no fiduciary duty to his sister in his capacity as director and officer because “a corporate shareholder has no individual cause of action for personal damages caused by a wrong done solely to the corporation.”<sup>203</sup>

Finally, and most crucial to this discussion, the court separately addressed the sister’s claim for shareholder oppression.<sup>204</sup> She made this claim based on allegations that her brother used Laredo Hardware for his personal gain.<sup>205</sup> The court applied the definition/standard of “oppressive conduct” as outlined below, finding no evidence of shareholder oppression under the first prong (a shareholder’s expectations when investing in the corporation) because the sister received her shares as a bequest from her father.<sup>206</sup> The court further found no evidence of oppression under the second prong (the majority shareholders’ conduct) because the evidence showed that the brother did not usurp a corporate opportunity.<sup>207</sup> The brother presented the opportunity to purchase the land to the board, and the offer was declined.<sup>208</sup> Furthermore, the board minutes also show that after the brother purchased the land, he presented the lease agreement to the board for its approval, and the board agreed.<sup>209</sup> The court held that the brother’s acts were not oppressive and affirmed that aspect of the trial court’s judgment.<sup>210</sup>

*d. ARGO Data Resource Corp. v. Shagrithaya, 380 S.W.3d 249 (Tex. App.—Dallas 2012, pet. filed).*

*ARGO* involved a claim of minority shareholder oppression brought by the plaintiff Shagrithaya (the sole minority shareholder of *ARGO*) against both *ARGO* and Max Martin (“Martin”) (the sole majority shareholder). Following a jury trial, the trial court signed a judgment in favor of Shagrithaya ordering Martin to cause *ARGO* to issue a one-time \$85 million dividend as equitable relief for Martin’s alleged oppressive conduct. The judgment further awarded Shagrithaya damages for breach of contract and attorneys’ fees. Finally, the judgment awarded *ARGO* damages and equitable relief based on acts found by the jury to constitute a breach of fiduciary duty by Martin.<sup>211</sup>

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<sup>201</sup> *Id.* at \*4–5.

<sup>202</sup> *Id.* at \*7.

<sup>203</sup> *Id.* at \*9 (citing *Redmon v. Griffith*, 202 S.W.3d 225, 236 (Tex. App.—Tyler 2006, pet. denied)).

<sup>204</sup> *See id.* at \*10.

<sup>205</sup> *Id.*

<sup>206</sup> *Id.* at \*11.

<sup>207</sup> *Id.* at \*11–12.

<sup>208</sup> *Id.* at \*12.

<sup>209</sup> *Id.* at \*13.

<sup>210</sup> *Id.*

<sup>211</sup> *ARGO Data Resource Corp. v. Shagrithaya*, 380 S.W.3d 249, 257 (Tex. App.—Dallas 2012, pet. filed).

At trial, the jury found eleven acts that plaintiff claimed supported a judicial finding of shareholder oppression. The appellate court reversed the trial court's judgment and rendered a take-nothing judgment in favor of the defendants, finding that none of Martin's alleged wrongful acts constituted oppression of the minority shareholder Shagrithaya.<sup>212</sup>

The appellate court first clarified the jury's role with regard to shareholder oppression claims, noting that "[i]t is within the province of the jury as fact finders to determine whether certain acts occurred."<sup>213</sup> However, "the determination of whether such acts constitute shareholder oppression is a question of law for the court."<sup>214</sup>

The court began its review by stating "Courts must exercise caution in determining what actions constitute oppressive conduct[.]" and reiterated that "[a] corporation's officers and directors are afforded broad latitude in conducting corporate affairs and the minority shareholder's expectations must be balanced against the corporation's need to exercise its business judgment and run its business efficiently."<sup>215</sup>

The appellate court then parsed through Martin's alleged eleven wrongful acts to determine whether (1) legally and factually sufficient evidence existed to support the jury's findings; and (2) whether the jury's factual determinations supported a legal finding of oppression.<sup>216</sup> In concluding that "Shagrithaya failed to show his entitlement to relief on any of his individual or derivative claims," the appellate court made a number of findings relating to the specific factual and legal allegations before the court.<sup>217</sup> For instance, the court found that "[t]o the extent Shagrithaya expected . . . to maintain a level of compensation [in the form of salary] equal to Martin's indefinitely regardless of circumstances or his position in the company, we conclude that, without an agreement pertaining to compensation, such an expectation was not reasonable."<sup>218</sup> The court said, "Texas law does not recognize a minority shareholder's right to continued employment without an employment contract."<sup>219</sup>

The court then addressed the plaintiff's claims related to resolutions passed by the Board over his vote, stating "the inability to control board decisions is inherent in the position of a minority shareholder," and did not form a basis for an oppression claim.<sup>220</sup> The court rejected the jury finding that Martin's action in directing ARGO to retain earnings, rather than issue dividends "resulted in lowering the value of Shagrithaya's stock."<sup>221</sup> Instead, the court found "[t]he evidence shows that the value of the company and Shagrithaya's shares continued to grow throughout the time period that Shagrithaya claims Martin was suppressing dividends. Shagrithaya directs us to no evidence that the value of his shares was affected by Martin's

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<sup>212</sup> *Id.*

<sup>213</sup> *Id.* at 264.

<sup>214</sup> *Id.*

<sup>215</sup> *Id.* at 265.

<sup>216</sup> *See id.* at 264, 270–72.

<sup>217</sup> *Id.* at 257.

<sup>218</sup> *Id.* at 266.

<sup>219</sup> *Id.*

<sup>220</sup> *Id.* at 266–67.

<sup>221</sup> *Id.* at 269.

actions [in having ARGO retain more earnings].”<sup>222</sup> The court found “[t]o the extent . . . that the jury’s findings could be read as finding that Shagrithaya was individually targeted for the purpose of preventing him from sharing in the profits of the company or that the value of his shares was depreciated by Martin’s actions, we conclude the evidence is legally insufficient to support such findings.”<sup>223</sup> Moreover, the court noted that “Texas law does not require a corporation to issue dividends,” and that “[i]t is within the discretion of the board of directors whether a dividend will issue.”<sup>224</sup> Therefore, “although Shagrithaya may disagree with the reasons behind Martin’s decision to have ARGO retain its earnings, he could have had no general reasonable expectation as a shareholder of receiving dividends.”<sup>225</sup>

The court next found that the fair market value offer Martin made to buy out Shagrithaya’s shares (which included a minority discount) did not constitute oppression, as “the mere offer to purchase the shares for fair market value cannot amount to oppression. Although Shagrithaya argues that he would be forced to accept the discounted offer because of the lack of dividends . . . he was under no financial pressure to accept the offer and, in fact, he did not accept it.”<sup>226</sup>

The court concluded that “the evidence does not support a finding of fraud or shareholder oppression, including malicious suppression of dividends,” and determined the “trial court erred in ordering the equitable remedy of an \$85 million dividend,” as well as the trial court’s remaining judgment against the defendants.<sup>227</sup>

In a pending Petition for Review to the Texas Supreme Court, the petitioner (Shagrithaya) claims that the court in *Rupe* found oppression for “far less egregious conduct” than was present in *ARGO*.<sup>228</sup> The petitioner claims that “[t]he abuse of the minority ownership in this case is more extensive and of longer duration than any ever addressed in a reported Texas opinion.”<sup>229</sup> The Petition for Review is currently pending in the Texas Supreme Court.

*e. Allen v. Devon Energy Holdings, LLC, 367 S.W.3d 355 (Tex. App.—Hous. [1st Dist.] 2012).*

Another appellate court denied a claim for shareholder oppression amidst allegations of material misrepresentations and a failure to disclose material facts in connection with the redemption of the minority shareholder’s interest.<sup>230</sup> In *Allen*, the plaintiff (“Allen”) and defendant (“Rees-Jones”) were partners at a law firm until Rees-Jones left the firm to work in

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<sup>222</sup> *Id.*

<sup>223</sup> *Id.* at 269–70.

<sup>224</sup> *Id.* at 270.

<sup>225</sup> *Id.*

<sup>226</sup> *Id.* at 272.

<sup>227</sup> *Id.* at 274.

<sup>228</sup> Pet. for Review at 3, *Shagrithaya v. Argo Data Resource Corp.*, No. 05-10-00690-CV (Tex. Dec. 14, 2012).

<sup>229</sup> *Id.* at 12.

<sup>230</sup> *Allen v. Devon Energy Holdings, LLC, 367 S.W.3d 355, 398–99 (Tex. App.—Houston [1st Dist.] 2012, pet. granted, judgment vacated w.r.m.).*

the oil and gas industry.<sup>231</sup> Years later, Rees-Jones approached Allen about investing in an oil and gas company (“Chief”).<sup>232</sup> Allen became a minority shareholder, and Chief experienced significant success.<sup>233</sup> In November 2003, Rees-Jones sent Chief’s members a letter of intent to make redemption offers, and Allen accepted and redeemed his minority interest.<sup>234</sup> The closing, however, was delayed until June 2004.<sup>235</sup>

Two years after Allen redeemed his interest, Chief sold for nearly twenty times the value used to calculate Allen’s redemption price.<sup>236</sup> Allen alleged that Rees-Jones induced him to sell his interest by making material misrepresentations and failing to disclose material information crucial to the deal.<sup>237</sup> Allen brought suit against Rees-Jones and Chief for, among other things, minority shareholder oppression.<sup>238</sup> Both the trial court and the appellate court denied Allen’s claim for shareholder oppression.<sup>239</sup>

In evaluating Allen’s claim for shareholder oppression, the court applied the two definitions of shareholder oppression commonly applied by Texas courts.<sup>240</sup> The court also discussed the need to balance the minority shareholder’s reasonable expectations with the corporation’s need to exercise its business judgment.<sup>241</sup> Ultimately the court concluded that the alleged wrongful conduct was not the typical wrongdoing in shareholder oppression cases, e.g., termination of employment, denial of access to books and records, improperly withholding dividends, wasting corporate assets, payment of excessive compensation, or refusing access to corporate offices.<sup>242</sup> The court further explained that shareholder oppression claims are unnecessary when the shareholder has non-disclosure and breach of fiduciary duty claims.<sup>243</sup> Because Allen provided no authority for allowing fraudulent conduct or breaches of fiduciary duty to form the basis of a shareholder oppression claim, the court upheld the trial court’s denial of this claim.<sup>244</sup>

The trial court granted Rees-Jones’s motion for summary judgment on Allen’s breach of fiduciary duty claim.<sup>245</sup> Allen argued that summary judgment was improper, and that both formal and informal fiduciary duties existed.<sup>246</sup> The appellate court held that Rees-Jones failed to conclusively establish that he did not owe Allen a formal fiduciary duty in connection with

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<sup>231</sup> *Id.* at 366.

<sup>232</sup> *Id.*

<sup>233</sup> *Id.* at 366.

<sup>234</sup> *Id.* at 367.

<sup>235</sup> *Id.*

<sup>236</sup> *Id.*

<sup>237</sup> *Id.*

<sup>238</sup> *Id.* at 398–99.

<sup>239</sup> *Id.* at 399.

<sup>240</sup> *Id.* at 398–99.

<sup>241</sup> *Id.* at 399 (citing *Richie v. Rupe*, 339 S.W.3d 275, 289 (Tex. App.—Dallas 2011, pet. filed)).

<sup>242</sup> *Id.*

<sup>243</sup> *Id.*

<sup>244</sup> *Id.*

<sup>245</sup> *Id.* at 388.

<sup>246</sup> *Id.*

the redemption, and thus, did not reach the issue of whether an informal fiduciary relationship existed.<sup>247</sup> The Texas Supreme Court will not weigh on this case, as the parties settled their claims while on appeal.<sup>248</sup>

#### ***4. Equitable Remedies for Oppression in Texas***

The Texas Supreme Court has held that courts of equity should impose the least restrictive equitable remedy possible.<sup>249</sup> When imposing the least restrictive remedy, the court must balance two principles: (1) the relief must provide full relief to the injured shareholder; and (2) the full relief should impose the smallest possible burden on the corporation.<sup>250</sup> One remedy for oppressive conduct by majority shareholders is a buyout of the minority shareholder's shares.<sup>251</sup> Other remedies include reinstating the position and benefits to a shareholder who was previously removed; requiring a forced declaration of mandatory dividends; full disclosure to the oppressed shareholder of meetings and documents; and finally, as the most extreme remedy, the court can order dissolution of the company.

#### ***5. Avoiding or Limiting Liability for Shareholder Oppression***

Until the Texas Supreme Court clarifies the law on shareholder oppression, practitioners must rely on indications from other cases for strategies to defend against and limit liability for such claims. The following sections discuss methods of defending against shareholder oppression claims in Texas.

##### ***a. The Business Judgment Rule***

A trial court cannot substitute its judgment for that of a proper corporate business strategy. Courts must allow proper deference to corporate decision making.<sup>252</sup> Notably, in the shareholder oppression context, the business judgment rule does not provide a complete defense, but instead requires a balancing of competing interests. To that end, courts in Texas "must exercise caution, balancing the minority shareholder's reasonable expectations against the corporation's need to exercise its business judgment and run its business efficiently."<sup>253</sup>

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<sup>247</sup> *Id.*

<sup>248</sup> Allen v. Devon Energy Holdings, LLC, No. 01-09-00643-CV, 2013 Tex. App. LEXIS 656, at \*1-2 (Tex. App.—Houston [1st Dist.] Jan. 24, 2013).

<sup>249</sup> See Patton v. Nicholas, 279 S.W.2d 848, 857 (Tex. 1955).

<sup>250</sup> *In re White*, 429 B.R. 201, 215-16 (Bankr. S.D. Tex 2010).

<sup>251</sup> Douglas K. Moll, *Shareholder Oppression in Texas Close Corporations: Majority Rule (Still) Isn't What it Used to Be*, 9 HOUS. BUS. & TAX L.J. 33, 56-57 (2008).

<sup>252</sup> See, e.g., *Gibney v. Culver*, No. 13-06-112-CV, 2008 Tex. App. LEXIS 2954, at \*58-59 (Tex. App.—Corpus Christi Apr. 24, 2008, pet. denied) (mem. op.) (recognizing that business judgment is given broad latitude to be balanced against claims of shareholder oppression); *Willis v. Bydalek*, 997 S.W.2d 798, 801 (Tex. App.—Houston [1st Dist.] 1999, pet. denied) ("Courts must exercise caution in determining what shows oppressive conduct. The minority shareholder's reasonable expectations must be balanced against the corporation's need to exercise its business judgment and run its business efficiently.") (citing *McCauley v. Tom McCauley & Son, Inc.*, 724 P.2d 232, 237 (1986); *Landstrom v. Shaver*, 561 N.W.2d 1, 8 (S.D. 1997)).

<sup>253</sup> See *ARGO Data Resource Corp. v. Shagrithaya*, 380 S.W.3d 249, 265 (Tex. App.—Dallas 2012, pet. filed); see also *Richie v. Rupe*, 339 S.W.3d 275, 295-96 (Tex. App.—Dallas 2011, pet. filed) (but stating that the "business

*b. The Limits Found in the Texas Receivership Statute Apply to All Shareholder Oppression Claims*

Because most cases that recognize a claim for shareholder oppression base the claim, at least in part, on the receivership statute, the requirements of that statute arguably should apply to all shareholder oppression claims. The statute provides relief against conduct: (1) by the *board*; (2) that affects the well-being of the *corporate* entity *and* damages an interested party; (3) for which there continues to be a need for the relief; and (4) for which there is *no other adequate remedy of law* or equity.<sup>254</sup>

Assuming these requirements apply to all shareholder oppression claims, the board may also be able to avoid liability by remedying past oppressive conduct. In doing so, the minority shareholder might encounter difficulty showing that the need for relief continues to exist.

*c. Conduct That Does Not Rise to the Level of Oppression*

When Texas courts have granted equitable relief in favor of a minority shareholder, the alleged oppression has involved malicious conduct to exclude or severely reduce the minority shareholder's expected financial or participatory role in the corporation. For example, courts have granted equitable relief for the following oppressive conduct:

- Deprivation or *denial* of the minority shareholder's stock ownership;<sup>255</sup>
- Business practices that decrease cash or profits for the purpose of avoiding payment of dividends;<sup>256</sup>
- *De facto* dividends to the majority shareholder that result in disproportionate financial participation that prejudices the minority shareholder's financial interests or rights;<sup>257</sup> and

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judgment rule has no application in this case" because "this is not a derivative suit for breach of the duty of care owed by the corporation.").

<sup>254</sup> See TEX. BUS. ORGS. CODE ANN. § 11.404 (West 2012) (emphasis added).

<sup>255</sup> See *Davis v. Sheerin*, 754 S.W.2d 375, 377 (Tex. App.—Houston [1st Dist.] 1988, writ denied) (majority shareholder denied minority shareholder "any interest or voice" by refusing to allow inspection of books unless he surrendered his stock certificate that he claimed had been gifted to him, despite corporate records to the contrary).

<sup>256</sup> See *Patton v. Nicholas*, 279 S.W.2d 848, 853–54 (Tex. 1955) (inferring that majority shareholder "pile[d] up profits in the form of property other than cash . . . to excuse withholding dividends . . ."); *Davis*, 754 S.W.2d at 382 (evidence that majority shareholders desired to *disburse surplus funds to officers* as bonuses rather than disburse dividends in which minority shareholder would participate) (emphasis added).

<sup>257</sup> See *Patton*, 279 S.W.2d at 851–52 (after firing and removing the minority shareholders as directors within months of incorporation, the majority shareholder tripled his salary but declared he "would see to it that no dividends would be paid so long as the respondents were stockholders" and "he would not buy the stock of respondents for even a small fraction of its value or sell his own at any price"); *Davis*, 754 S.W.2d at 382 (majority shareholders "received informal dividends by making profit sharing contributions for their benefit and to the exclusion of [the minority shareholder]").

- Complete expulsion of the minority shareholder from corporate governance or from actively participating in the business in contradiction of and substantially defeating his reasonable expectations in deciding to “join” the business.<sup>258</sup>

In contrast, the following situations do not support a claim for shareholder oppression:

- Frustration with corporate management;<sup>259</sup>
- Voluntary departure from a director, officer or employee position;<sup>260</sup>
- Temporarily withholding dividends from all shareholders alike;<sup>261</sup>
- Failure to pay annual employment compensation equal to other board members when there was no agreement to do so.<sup>262</sup> Without an agreement, an expectation to maintain an equal salary to other board members indefinitely is not reasonable;<sup>263</sup>
- Retaining company’s earnings to buy out minority’s interest;<sup>264</sup> and
- Misrepresentations and failure to disclose information that induces a minority shareholder to redeem his stock.<sup>265</sup>

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<sup>258</sup> See *Patton*, 279 S.W.2d at 854 (firing and removing minority shareholders as directors with “intent to eliminate the respondents from every connection with the business”); *Davis*, 754 S.W.2d at 382 (special board meeting minutes reflecting that minority shareholders’ “opinions [or actions] would have no effect on the Board’s deliberations” after the filing of the lawsuit).

<sup>259</sup> See *Texarkana College Bowl, Inc. v. Phillips*, 408 S.W.2d 537, 539 (Tex. App.—Texarkana 1966, no writ) (statute not satisfied by allegations of “dissatisfaction with corporation management”).

<sup>260</sup> See *Allchin v. Chemic, Inc.*, No. 14-01-00433-CV, 2002 Tex. App. LEXIS 5125, at \*9 (Tex. App.—Houston [14th Dist.] July 18, 2002, no pet.) (not designated for publication) (“An employee who voluntarily leaves the employment of a corporation presents a less persuasive case for concluding the majority shareholders oppressed him.”).

<sup>261</sup> See *Gibney v. Culver*, No. 13-06-112-CV, 2008 Tex. App. LEXIS 2954, at \*60–61 (Tex. App.—Corpus Christi April 24, 2008, pet. denied) (mem. op.) (two year withholding of dividends did not establish shareholder oppression when *no shareholders* received dividends during this time and minority shareholder received compensation from corporation in another form) (emphasis added); see also *ARGO Data Resource Corp. v. Shagrithaya*, 380 S.W.3d 249, 269–70 (Tex. App.—Dallas 2012, pet. filed).

<sup>262</sup> See *ARGO Data Resource Corp.*, 380 S.W.3d at 266 (“An expectation of annual employment compensation cannot be said to be a general expectation held by all shareholders of a company.”).

<sup>263</sup> *Id.*

<sup>264</sup> See *id.* at 270 (“Buying out a minority shareholder’s interest is not an improper purpose for retaining a company’s earnings[,]” and is only improper if it negatively impacts the minority shareholder’s rights, i.e., prevents him from sharing in the profits of the company or the value of his shares in the marketplace is depreciated).

<sup>265</sup> *Allen v. Devon Energy Holdings, LLC*, 367 S.W.3d 355, 399 (Tex. App.—Houston [1st Dist.] 2012, pet. granted, judgment vacated w.r.m.) (stating that no case has extended shareholder oppression to include causes of action for fraud by misrepresentation and breach of fiduciary duty).

To the extent the conduct complained of does not rise to the level of conduct described in the former set of cases and instead more closely resembles the latter set of cases, a court will be unlikely to find shareholder oppression.

*d. The Alleged Wrongful Conduct Must Relate to Shareholder Rights and Injuries*

Breach of an obligation to the corporation cannot form the predicate for an individual “shareholder oppression” claim.<sup>266</sup> Likewise, injury to the corporation by itself is insufficient to establish shareholder oppression.<sup>267</sup> Put another way, the wrongful conduct must bear a nexus to shareholder rights.<sup>268</sup>

*e. The Relief Must be Tailored to the Wrong*

The equitable relief granted for shareholder oppression must be tailored to fit the wrongful conduct.<sup>269</sup> When redressing the injury caused to the shareholder, the court must impose the least burdensome remedy possible on the corporation.<sup>270</sup>

The United States Bankruptcy Court for the Southern District of Texas hammered home this concept in its analysis in a 2010 case, *In re White*. There, the court concluded that the corporation intended to deprive and did deprive a shareholder of its reasonable expectations to share in the corporation’s profits, and such actions constituted oppression.<sup>271</sup> In determining the appropriate remedy, the court acknowledged its responsibility to provide full relief to the aggrieved shareholder, but that in doing so, it must impose the least burdensome alternative on the corporation.<sup>272</sup> The court decided two options that would remedy the corporation’s oppressive conduct, but could not determine which alternative would be the least onerous on the corporation.<sup>273</sup> Ultimately, the court presented two possible remedies to the corporation:

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<sup>266</sup> See *Wingate v. Hajdik*, 795 S.W.2d 717, 719 (Tex. 1990) (a stockholder may recover for damages caused to him by breach of an obligation “ow[ed] directly by [a wrongdoer] to the stockholder.”) (citing *Massachusetts v. Davis*, 168 S.W.2d 216, 222 (Tex. 1942), *cert. denied*, 320 U.S. 210 (1943)).

<sup>267</sup> See TEX. BUS. ORGS. CODE ANN. § 11.404 (West 2012) (requiring harm to the well-being of the corporate entity and damage to an interested party); *Wingate*, 795 S.W.2d at 719 (“[T]he 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.”) (citation omitted); see also *ARGO Data Resource Corp.*, 380 S.W.3d at 272 (holding that shareholders “have no independent cause of action and cannot recover personally for misappropriation of corporate assets”).

<sup>268</sup> See, e.g., *Patton v. Nicholas*, 279 S.W.2d 848, 854 (Tex. 1955) (detailing “wrongful conduct of the petitioner” that blocked all minority shareholders from all financial participation in corporation); *Davis v. Sheerin*, 754 S.W.2d 375, 383 (Tex. App.—Houston [1st Dist.] 1988, writ denied) (finding shareholder oppression based on a conspiracy to “deprive [the shareholder] of his interest in the corporation . . . and the undisputed evidence indicating that [the shareholder] would be denied any future voice in the corporation . . .”).

<sup>269</sup> See *Patton*, 279 S.W.2d at 857 (“Wisdom would seem to counsel tailoring the remedy to fit the particular case.”); *Davis*, 754 S.W.2d at 380 (recognizing remedy must be tailored to fit the case).

<sup>270</sup> *In re White*, 429 B.R. 201, 215 (Bankr. S.D. Tex. 2010).

<sup>271</sup> *Id.* at 214.

<sup>272</sup> *Id.* at 215–16.

<sup>273</sup> *Id.* at 216.

(1) a buyout of the minority shareholder's interest in the corporation; or (2) a permanent injunction to protect the minority shareholder's future expectations, and allowed the corporation to elect the remedy it preferred.<sup>274</sup>

*f. Actual Damages are Sufficient to Compensate the Aggrieved Shareholder*

When actual damages are sufficient to compensate the minority shareholder and no equitable relief is needed to protect his interests, the minority shareholder's remedies should be limited to actual damages.<sup>275</sup>

*g. Minority Shareholder's "Reasonable Expectations" Measured at Time Shareholder Joins the Enterprise*

Even the court of appeals' opinions adopting the cause of action require that the majority shareholder's actions must substantially defeat the reasonable financial or participatory expectations that were central to the minority shareholder's decision to become a minority shareholder *at the time of his or her investment*.<sup>276</sup> The minority shareholder's requested relief at trial is sometimes directly contrary to the shareholder's expectations at the time of the initial investment in the corporation. The *Rupe* case held that some expectations "may develop over time among the shareholders," seeming to indicate that an expectation that differs from the minority shareholder's decision to join the venture may be considered only if it is one shared "among the shareholders" as a whole.<sup>277</sup>

### C. Shareholder Oppression Law in Delaware

Although Delaware does not have a statute directly addressing shareholder oppression, it does have developed standards to evaluate a claim of breach of fiduciary duty brought by a minority shareholder for alleged oppressive conduct by the controlling shareholder or director. These standards protect not only the minority shareholders from potential oppression, but also the directors or controlling shareholders in knowing how courts will evaluate their actions. Thus, unlike Texas' amorphous and uncertain shareholder oppression cases to date, Delaware's standards provide protection and advantageous predictability.

#### 1. Standards to Determine Director/Controlling Shareholder Liability

This section illustrates the general rules that have developed in Delaware regarding

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<sup>274</sup> *Id.* at 216–19.

<sup>275</sup> See *Davis v. Sheerin*, 754 S.W.2d 375, 383 (Tex. App.—Houston [1st Dist.] 1988, writ denied) (evaluating whether remedy was adequate to "protect appellee's interest and [] rights in the corporation").

<sup>276</sup> See *Gibney v. Culver*, No. 13-06-112-CV, 2008 Tex. App. LEXIS 2954, at \*58 (Tex. App.—Corpus Christi Apr. 24, 2008, pet. denied) (mem. op.) ("... substantially defeats the minority shareholder's expectations that, objectively viewed, were both reasonable under the circumstances and central to the minority shareholder's decision to join the venture"); *Redmon v. Griffith*, 202 S.W.3d 225, 234 (Tex. App.—Tyler 2006, pet. denied); *Allchin v. Chemic, Inc.*, No. 14-01-00433-CV, 2002 Tex. App. LEXIS 5125, at \*20 (Tex. App.—Houston [14th Dist.] July 18, 2002, no pet.); *Willis v. Bydalek*, 997 S.W.2d 798, 801 (Tex. App.—Houston [1st Dist.] 1999, pet. denied); *Davis*, 754 S.W.2d at 381.

<sup>277</sup> See *Richie v. Rupe*, 339 S.W.3d 275, 291 (Tex. App.—Dallas 2011, pet. filed).

majority and minority shareholder rights, detailing the three standards of review applied by Delaware courts to evaluate director decision making. The business judgment standard remains Delaware's default standard and the standard most lenient to directors and controlling shareholders. The business judgment standard *presumes* that the directors made an educated decision in good faith and in the best interests of the company.<sup>278</sup>

The enhanced scrutiny standard is an intermediate standard of review and applies in cases where “the realities of the decision[]making context can subtly undermine the decisions of even independent and disinterested directors.”<sup>279</sup> If this standard applies, the fiduciaries bear the burden of persuasion to show that the motives behind their actions were proper.<sup>280</sup>

The final and most onerous standard is the entire fairness standard. Once the plaintiff has rebutted the applicability of the business judgment standard, which favors upholding decisions of the board, he then enjoys the more plaintiff-friendly standard of entire fairness. Notably, the Delaware Supreme Court has stated, “[i]t is often of critical importance whether a particular decision is one to which the business judgment rule applies or the entire fairness rule applies. It is sometimes thought that the decision whether to apply the business judgment rule or the entire fairness test can be outcome-determinative.”<sup>281</sup> Each of these standards and cases applying each standard are described in more detail below.

*a. The Business Judgment Standard: Delaware's Default and Most Lenient Standard*

Delaware courts approached the first claims alleging oppressive conduct by directors and controlling shareholders against minority shareholders with caution. Some of the earliest cases denied claims brought by minority shareholders, giving great deference to the director's discretion in business decisions.<sup>282</sup>

The business judgment rule is a “presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”<sup>283</sup> A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision “can be attributed to any rational business purpose.”<sup>284</sup> Some Delaware courts treat the business judgment rule as an explicit standard of review while others reject its

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<sup>278</sup> See *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 457 (Del. Ch. 2011).

<sup>279</sup> *Id.*

<sup>280</sup> *Id.*

<sup>281</sup> *Nixon v. Blackwell*, 626 A.2d 1366, 1376 (Del. 1993).

<sup>282</sup> See, e.g., *Davis v. Louisville Gas & Elec. Co.*, 142 A. 654, 659 (Del. Ch. 1928) (“The judgment of the directors of corporations enjoys the benefit of a presumption that it was formed in good faith and was designed to promote the best interests of the corporation they serve.”); see also *Mercantile Trading Co. v. Rosenbaum Grain Corp.*, 154 A. 457, 461 (Del. Ch. 1931) (“[G]enerally . . . courts will not upset the decisions of either directors or stockholders as to questions of policy and business management . . . [f]raud, actual or presumed, or illegal or *ultra vires* misconduct must be shown to justify an interference by the courts with such decisions.”).

<sup>283</sup> *Gantler v. Stephens*, 965 A.2d 695, 705–06 (Del. 2009) (citations omitted).

<sup>284</sup> *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).

characterization as a standard of review and instead view it as an abstention policy to avoid the court's involvement altogether. In all practicality, its application as a standard resembles an abstention policy, thus its function is essentially the same. The most recent Delaware Chancery Court's opinion explicitly describes the business judgment rule as a standard by which to evaluate directors and controlling shareholders' decisions.<sup>285</sup>

iii. *Davis v. Louisville Gas & Elec. Co.*, 142 A. 654 (Del. Ch. 1928).

In an early case, *Davis v. Louisville Gas & Electric Co.*, the defendant corporation, Louisville Gas and Electric Co., owned the great majority of the Class B stock, which carried the sole voting rights.<sup>286</sup> The board of directors proposed an amendment to the certificate of incorporation, with the effect that whenever Class A and Class B stocks had each received dividends of \$1.50 per share, all dividends should be declared share and share alike between the two Classes; and likewise the permission to redeem Class A stock at \$32.50 per share was eliminated.<sup>287</sup> Dissenting stockholders of Class B filed a bill against the corporation to restrain the passing of the amendment, arguing that the proposed changes were unfair and illegal, as it would take away their material and fundamental contract rights.<sup>288</sup>

The Court of Chancery denied plaintiffs' request for a restraining order.<sup>289</sup> It held that the proposed amendments to the certificate of incorporation were permitted by statute, and that the directors were *presumed* to be acting in the best interests of the corporation by proposing the changes.<sup>290</sup> The court first pointed out that the Delaware Corporation Law permitted corporations to adopt amendments of the kind proposed; and second, that the terms were not unfair and inequitable because management insisted it was for the best interests of the corporation, permitting additional capital to be obtained by sale of its Class A stock.<sup>291</sup>

Moreover, there was no evidence of fraud, since most of the directors held the Class B stock that allegedly would have been negatively affected by the changes.<sup>292</sup> The court accordingly held that *unless* it could be shown that the directors were not "acting in good faith," the amendment should be sustained.<sup>293</sup>

iv. *Revlon, Inc. v. Macandrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

*Revlon* marked the Delaware courts' modern trend in recognizing and protecting the rights

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<sup>285</sup> See *Reis v. Hazelett Strip-Casting Corp.*, C.A. No. 3552-VCL, 2011 Del. Ch. LEXIS 11, at \*23 (Del. Ch. Jan. 21, 2011).

<sup>286</sup> *Davis v. Louisville Gas & Elec. Co.*, 142 A. 654, 654 (Del. Ch. 1928).

<sup>287</sup> *Id.* at 659.

<sup>288</sup> *Id.*

<sup>289</sup> *Id.* at 660.

<sup>290</sup> *Id.* at 659.

<sup>291</sup> *Id.*

<sup>292</sup> *Id.* at 660.

<sup>293</sup> *Id.*

of minority shareholders, and a decline in the once heavily relied on business judgment rule.<sup>294</sup> In that case, the Delaware Supreme Court affirmed the Chancery Court's decision to grant a preliminary injunction precluding Revlon, Inc. from consummating a proposed transaction that effectively ended an active and ongoing auction to acquire the company.<sup>295</sup> The court held that Revlon's directors did not act in the shareholders' best interest in ending the corporate auction and allowed considerations other than maximizing shareholder profit to affect their judgment.<sup>296</sup> The court concluded that the directors' actions were not entitled to the protection of the business judgment rule.<sup>297</sup>

The trial court enjoined the transactions on the grounds that defendants had breached their duty of care by entering into such dealings, thus ending an active auction for the company.<sup>298</sup> Essentially, the breach occurred because defendants made concessions to Forstmann, rather than maximizing the sale price of the company for the shareholders' benefit.<sup>299</sup> On appeal, defendants claimed that they did not breach the business judgment rule.

The Delaware Supreme Court affirmed. The court held that: (1) lockups and related agreements are permitted under Delaware law where their adoption is untainted by director interest or other breaches of fiduciary duties; (2) actions taken by directors in the instant case did not meet that standard; (3) concern for various corporate constituencies is proper when addressing a takeover threat; (4) that principle is limited by the requirement that there be some rationally related benefit accruing to the stockholders; and (5) there were no such benefits in the instant case.<sup>300</sup>

The court declared that, in certain limited circumstances indicating that the sale or break-up of the company is inevitable, the fiduciary obligation of the directors of a target corporation are narrowed significantly; the singular responsibility of the board is to maximize the company's value by securing the highest price available for shareholders.<sup>301</sup> In such a context, that conduct is not to be judicially reviewed pursuant to the traditional business judgment rule, but instead will endure enhanced scrutiny for reasonableness in relation to this discrete obligation.<sup>302</sup> A board that takes action to favor one bidder over another in such a way as to halt an active bidding contest has not acted reasonably and has breached its duty to maximize immediate shareholder value.<sup>303</sup>

v. *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 906 A.2d 114 (Del. 2006).

Although *Revlon* slowed the trend of routine reliance on the business judgment rule, it still

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<sup>294</sup> *Revlon, Inc. v. Macandrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

<sup>295</sup> *Id.* at 175.

<sup>296</sup> *Id.* at 185.

<sup>297</sup> *Id.*

<sup>298</sup> *Id.* at 175–76.

<sup>299</sup> *Id.* at 179.

<sup>300</sup> *Id.* at 176.

<sup>301</sup> *Id.* at 182.

<sup>302</sup> *Id.*

<sup>303</sup> *Id.* at 185.

has a presence in modern cases.<sup>304</sup> In that case, defendant restaurant operator, Benihana, Inc. (“Benihana”) was a subsidiary of plaintiff holding corporation, Benihana of Tokyo, Inc. (“BOT”).<sup>305</sup> Due to financial problems and a change of corporate control, three of the members of the subsidiary’s board of directors considered the issuance of convertible stock and its sale to a potential buyer.<sup>306</sup> Ultimately, the entire board approved resolutions ratifying the execution of a stock purchase agreement with the buyer and authorizing the issuance of preferred stock with preemptive rights.<sup>307</sup> Thereafter, the plaintiff filed an action against all but one of the subsidiary’s directors, alleging breaches of fiduciary duties.<sup>308</sup> The Court of Chancery entered judgment in the defendant’s favor, holding that the board’s approval was a valid exercise of the business judgment rule, and the plaintiff appealed.<sup>309</sup>

The Delaware Supreme Court held that the subsidiary’s certificate of incorporation did not prohibit the issuance of preferred stock with preemptive rights.<sup>310</sup> In reaching its opinion, the court analyzed and interpreted the corporate charter and Delaware law (DGCL Section 144) involving safe harbors for interested transactions.<sup>311</sup> Section 144 provides that when a transaction is known to the board of directors and they, in good faith, authorize the transaction by affirmative votes of a majority of disinterested directors, the transaction will be reviewed under the business judgment rule.<sup>312</sup>

The court noted that the transaction was approved by a majority of informed, disinterested and independent directors, and that the directors did not have an improper purpose of entrenchment.<sup>313</sup> The directors otherwise acted in conformity with their fiduciary duties in the belief that the preferred equity financing represented the best means to finance the subsidiary’s operation.<sup>314</sup> Consequently, the board’s approval of the transaction was a legitimate exercise of its business judgment, for a proper corporate purpose, under Delaware Code sections 144(a)(1) and 102(b)(3).<sup>315</sup>

*b. Enhanced Scrutiny: Delaware’s Intermediate Standard of Review*

As stated above, the enhanced scrutiny standard provides an intermediate standard of review to evaluate a director’s decision making. It falls squarely between the leniency of the business judgment standard, and the stringent entire fairness standard. This standard is used “when the realities of the decision[]making context can subtly undermine the decisions of even

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<sup>304</sup> See, e.g., *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 906 A.2d 114 (Del. 2006).

<sup>305</sup> *Id.* at 116.

<sup>306</sup> *Id.* at 116–18.

<sup>307</sup> *Id.* at 118.

<sup>308</sup> *Id.* at 119.

<sup>309</sup> *Id.*

<sup>310</sup> *Id.* at 120.

<sup>311</sup> *Id.* at 120–21.

<sup>312</sup> *Id.* at 120.

<sup>313</sup> *Id.* at 121–22.

<sup>314</sup> *Id.*

<sup>315</sup> *Id.* at 120–22.

independent and disinterested directors.”<sup>316</sup> It essentially requires that “the defendant fiduciaries ‘bear the burden of persuasion to show that their motivations were proper and not selfish’ and that ‘their actions were reasonable in relation to their legitimate objective.’”<sup>317</sup>

The enhanced scrutiny standard has been employed in certain specific situations, such as (1) defensive action by a director against a hostile takeover; (2) directors facing a proxy contest; (3) directors intruding on stockholders’ right to vote; and (4) final stage transactions.<sup>318</sup>

i. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

This case involved the directors’ actions with regard to a takeover bid.<sup>319</sup> Mesa Petroleum (“Mesa”) made an unsolicited attempt to acquire a majority control of Unocal through a two-tiered, front-loaded offer for Unocal’s outstanding shares.<sup>320</sup> Mesa’s bid was structured as follows: first, there would be a cash tender offer for 37% of Unocal’s outstanding shares at \$54 each; and second, the shareholders that failed to tender in the first round would be forced to exchange their Unocal shares in the second round for highly subordinated securities that Unocal labeled as “junk bonds.”<sup>321</sup> In response, Unocal’s boards of directors proposed to have Unocal repurchase its own shares at \$72 each but excluded Mesa from the self-tender offer.<sup>322</sup> The Court of Chancery entered a preliminary injunction requested by Mesa, and the directors appealed.<sup>323</sup>

In addressing the applicable standard of review in the context of an unsolicited takeover bid and change in control, the court explained that the board faces a potential conflict between protecting its own interests versus those of the corporation and the shareholders.<sup>324</sup> As such, the directors’ actions should be subject to an enhanced level of scrutiny as a threshold test before being afforded the protections of the business judgment rule.<sup>325</sup>

The court then articulated the contours of the enhanced scrutiny review.<sup>326</sup> Enhanced scrutiny would require the board to meet its own initial two-part burden.<sup>327</sup> First, the board must show that it had reasonable grounds for its belief that a threat existed to corporate control

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<sup>316</sup> *Reis v. Hazelett Strip-Casting Corp.*, C.A. No. 3552-VCL, 2011 Del. Ch. LEXIS 11, at \*20 (Del. Ch. Jan. 21, 2011).

<sup>317</sup> *Id.* (quoting *Mercier v. Inter-Tel Inc.*, 929 A.2d 786, 810 (Del. Ch. 2007)).

<sup>318</sup> *See, e.g.*, *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985); *Aprahamian v. HBO & Co.*, 531 A.2d 1204, 1206 (Del. Ch. 1987); *Mercier*, 929 A.2d at 809–10; *Lonergan v. EPE Holdings, LLC*, 5 A.3d 1008, 1019 (Del. Ch. 2010).

<sup>319</sup> *Unocal Corp.*, 493 A.2d 946.

<sup>320</sup> *Id.* at 949.

<sup>321</sup> *Id.* at 949–50.

<sup>322</sup> *Id.* at 951.

<sup>323</sup> *Id.* at 951–52.

<sup>324</sup> *Id.* at 955.

<sup>325</sup> *Id.* at 954.

<sup>326</sup> *Id.* at 955.

<sup>327</sup> *Id.*

or policy.<sup>328</sup> This determination would be made based on the board's showing of good faith and having conducted a reasonable investigation.<sup>329</sup> Second, the board must show that the defensive measures selected by the board were reasonable and proportionate in relation to the threat posed.<sup>330</sup>

The board presented evidence to persuade the court that the actions it took were reasonably related to the threat posed.<sup>331</sup> Specifically, the court stated that:

[T]he board's decision to offer what it determined to be the fair value of the corporation to the 49% of its shareholders, who would otherwise be forced to accept highly subordinated "junk bonds," is reasonable and consistent with the directors' duty to ensure that the minority stockholders receive equal value for their shares.<sup>332</sup>

Once the board met this burden, its action was entitled to be measured by the standards of the business judgment rule.<sup>333</sup> The Delaware Supreme Court ultimately held that the directors had the power and duty to oppose a takeover threat they reasonably perceived as being harmful to the corporation, and that the action taken was entitled to protection under the business judgment rule.<sup>334</sup>

ii. *Mercier v. Inter-tel (Del.) Inc.*, 929 A.2d 786 (Del. Ch. 2007).

*Mercier* involved a merger and acquisition. In that case, Inter-Tel (Delaware), Incorporated ("Inter-Tel") announced that it had reached an agreement with Mitel Networks Corporation ("Mitel"), pursuant to which Mitel would acquire Inter-Tel. On May 29, 2007, Inter-Tel gave notice that a special meeting to consider the Mitel merger would be held a month from that date, with a record date of May 25th.<sup>335</sup> The majority shareholder responded by sending a letter to Inter-Tel's stockholders expressing his opposition to the merger.<sup>336</sup> On June 19th, Institutional Shareholder Services ("ISS") recommended that stockholders vote "no" with respect to the Mitel merger and expressed its dissatisfaction with the purported failure of the Inter-Tel board to run a full-fledged auction prior to striking a deal with Mitel.<sup>337</sup> As the June 29th meeting date approached, a Special Committee of Inter-Tel's board of directors considered a number of factors that potentially supported rescheduling of the meeting.<sup>338</sup> Additionally, several stockholders had indicated a preference for the postponement, and ISS had indicated that its recommendation could change if the vote was

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<sup>328</sup> *Id.*

<sup>329</sup> *Id.*

<sup>330</sup> *Id.*

<sup>331</sup> *Id.* at 956–57.

<sup>332</sup> *Id.* at 957.

<sup>333</sup> *Id.* at 958.

<sup>334</sup> *Id.* at 954.

<sup>335</sup> See *Mercier v. Inter-tel (Del.) Inc.*, 929 A.2d 786 (Del. Ch. 2007).

<sup>336</sup> *Id.*

<sup>337</sup> *Id.* at 793.

<sup>338</sup> *Id.* at 795.

postponed and Inter-Tel disclosed additional financial information.<sup>339</sup> On the morning of the June 29th meeting date, Inter-Tel's directors knew that the merger would fail to achieve approval if the meeting went forward, and "believed the stockholders were about to make a huge mistake" in voting down the transaction. The Special Committee therefore announced that the meeting would be rescheduled, and offered a new meeting date.<sup>340</sup> Significantly, after the meeting was rescheduled and additional information was disclosed, ISS changed its recommendation from "no" to "yes" on the proposed merger agreement.<sup>341</sup> The Mitel merger was approved by an overwhelming majority of Inter-Tel's stockholders at the rescheduled special meeting.<sup>342</sup>

The court stated that the appropriate standard of review should be "a reasonableness standard consistent with the *Unocal* standard," i.e., the enhanced scrutiny standard, which is typically invoked in the context of board defensive action.<sup>343</sup> Applying a modified *Unocal* standard to the facts of *Inter-Tel*, the court stated that the Special Committee retained the burden of first identifying a "legitimate corporate objective" served by its decision to reschedule the special meeting, thus requiring that the directors demonstrate that "their motives were proper and not selfish."<sup>344</sup> Inter-Tel's directors, who would be replaced if the Mitel merger were consummated, satisfied this first requirement because they believed that the Mitel merger was in the best interests of stockholders, and that stockholders would benefit from additional information and time to consider the transaction.<sup>345</sup>

Having shown that the meeting postponement met a legitimate corporate objective, the Inter-Tel Special Committee was then required to demonstrate that its objective in rescheduling the meeting was reasonable, and that the postponement would neither preclude stockholders from exercising their voting rights, nor coerce stockholders into voting for or against the proposed merger.<sup>346</sup> The court concluded that the Special Committee had acted reasonably in delaying the vote for a short period of time in order to provide additional information to stockholders prior to the merger vote.<sup>347</sup> The court also determined "summarily" that the postponement was neither preclusive nor coercive to stockholder voting rights, since stockholders of record remained free to vote either for or against the merger at Inter-Tel's rescheduled meeting.<sup>348</sup> The decision of the Inter-Tel Special Committee to postpone an imminent stockholder vote therefore met intermediate scrutiny under the court's reformulated *Unocal* test.<sup>349</sup>

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<sup>339</sup> *Id.*

<sup>340</sup> *Id.* at 798.

<sup>341</sup> *Id.* at 801.

<sup>342</sup> *Id.* at 803.

<sup>343</sup> *Id.* at 810.

<sup>344</sup> *Id.*

<sup>345</sup> *Id.* at 813.

<sup>346</sup> *Id.* at 810.

<sup>347</sup> *Id.* at 814–19.

<sup>348</sup> *Id.* at 817.

<sup>349</sup> *Id.* at 821.

- iii. *In re Del Monte Foods Co. Shareholders Litigation*, 25 A.3d 813 (Del. Ch. 2011).

This case involves unscrupulous behavior by Del Monte Foods Company's ("Del Monte") financial advisor, Barclays Capital ("Barclays"). Del Monte entered into a merger agreement with Blue Acquisition Group (owned by Kohlberg, Kravis, Roberts & Co. ("KKR"), Centerview Partners ("Centerview"), and Vestar Capital Partners ("Vestar").<sup>350</sup> The plaintiffs sought to postpone the vote on the merger, asserting claims for breach of fiduciary duty against the Del Monte board for "failing to act reasonably to pursue the best transaction reasonably available."<sup>351</sup>

A review of the evidence showed that Barclays deceitfully manipulated the sale process and devised a highly self-serving transaction that allowed Barclays to obtain buy-side financing fees.<sup>352</sup> At the outset, Barclays was heavily involved in discussing an acquisition of Del Monte with potential acquirers.<sup>353</sup> After Del Monte shut down the sale of the company, Barclays continued to meet with several bidders (unbeknownst to Del Monte), eventually generating a bid late in 2010 from KKR of \$17.50 per share.<sup>354</sup> Barclays and the bidders actively concealed from Del Monte the fact that Vestar was also heavily involved in the bid by KKR.<sup>355</sup>

After some negotiations but before the parties had settled on a price, Barclays finally requested what it had secretly desired all along: to provide buy-side financing to KKR.<sup>356</sup> Del Monte agreed, thus allowing Barclays to provide financing for the deal while negotiating with KKR on price.<sup>357</sup> In November 2010, KKR made its final offer of \$19 per share.<sup>358</sup> The board approved the merger agreement.<sup>359</sup>

The terms of the merger agreement provided a 45-day post signing go-shop period and deal protection devices such as matching rights and a termination fee of \$60 million.<sup>360</sup> During this 45-day period, Barclays contacted 53 parties, and none expressed interest in purchasing Del Monte.<sup>361</sup>

The court applied the enhanced scrutiny standard of review and determined that the directors satisfied the objective prong by successfully demonstrating that they sought to

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<sup>350</sup> *In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d 813, 817 (Del. Ch. 2011).

<sup>351</sup> *Id.*

<sup>352</sup> *Id.*

<sup>353</sup> *Id.* at 820.

<sup>354</sup> *Id.* at 823.

<sup>355</sup> *Id.*

<sup>356</sup> *Id.* at 825–26.

<sup>357</sup> *Id.* at 826.

<sup>358</sup> *Id.*

<sup>359</sup> *Id.* at 827.

<sup>360</sup> *Id.* at 827–28.

<sup>361</sup> *Id.* at 828.

achieve the best transaction possible for the shareholders.<sup>362</sup> The court then turned to the subjective prong: the directors must show that “their actions were reasonable in relation to their legitimate objective.”<sup>363</sup>

Even applying the enhanced scrutiny, the court showed an inclination towards the business judgment rule, stating, “Enhanced scrutiny ‘is not a license for law-trained courts to second-guess reasonable, but debatable tactical choices that directors have made in good faith.’”<sup>364</sup> The court noted that unreasonableness can generally be found by acts that jeopardize the integrity of the process, such as self-interest, undue favoritism, or disdain towards a particular bidder.<sup>365</sup>

The court examined the directors’ reliance on expert advisors and the behavior of those advisors.<sup>366</sup> The court found the acts by Barclays, particularly the active concealment of information from the board, to be egregious.<sup>367</sup> In addition to these improper acts by Barclays, the court found that two of the board’s acts were unreasonable: (1) failing to meaningfully consider Vestar’s proposed participation; and (2) allowing Barclay to act as one of KKR’s lead banks while still negotiating price.<sup>368</sup>

After thoroughly discussing the egregious acts of Barclays and though seemingly empathizing with the board earlier in its opinion, the court then states, “Although the blame for what took place appears at this preliminary stage to lie with Barclays, the buck stops with the Board.”<sup>369</sup> When a board relies on the advice of advisors, normally its decisions, when made with the proper exercise of business judgment, will not be disrupted.<sup>370</sup> However, if the board is misled by conflicted advisors, “the protections girding the decision itself vanish.”<sup>371</sup> In this case, the court concluded that the board was deceived by Barclays and that the plaintiffs showed that the board failed to act reasonably.<sup>372</sup> The court enjoined the board from conducting the shareholder vote for twenty days.<sup>373</sup>

iv. *In re Openlane, Inc. Shareholders Litigation*, Const. C.A. No. 6849-VCN, 2011 Del. Ch. LEXIS 156 (Del. Ch. Sept. 30, 2011).

This suit stems from a proposed merger of Openlane with a wholly-owned subsidiary wherein the purchasing entities proposed paying \$210 million (approximately \$8.30 per share)

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<sup>362</sup> *Id.* at 830.

<sup>363</sup> *Id.* (citing *Mercier v. Inter-tel (Del.) Inc.*, 929 A.2d 786, 810 (Del. Ch. 2007)).

<sup>364</sup> *Id.* at 831 (citing *In re Toys “R” Us, Inc. S’holder Litig.*, 877 A.2d 975, 1000 (Del. Ch. 2005)).

<sup>365</sup> *Id.* at 831.

<sup>366</sup> *Id.* at 833.

<sup>367</sup> *Id.* at 834.

<sup>368</sup> *Id.* at 835.

<sup>369</sup> *Id.*

<sup>370</sup> *Id.* at 836. (citing *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1283–84 (Del. 1989)).

<sup>371</sup> *Id.*

<sup>372</sup> *Id.*

<sup>373</sup> *Id.* at 844.

to purchase Openlane in an all-cash transaction.<sup>374</sup> Plaintiff brought suit against defendants for breach of their fiduciary duties in failing to take an adequate process to sell Openlane and failing to disclose material information.<sup>375</sup> Plaintiff also filed a motion for a preliminary injunction to enjoin the merger.<sup>376</sup> The court, applying the enhanced scrutiny standard, held in favor of the defendants and denied the injunction.<sup>377</sup>

Openlane's primary business involved selling leased vehicles turned in by lessees.<sup>378</sup> In April 2010, the board predicted a decline in the number of vehicles coming off lease in the near future, and worked with a third company to locate strategic acquirers.<sup>379</sup> After negotiations with several potential purchasers, the board unanimously approved the merger with KAR.<sup>380</sup> It proceeded to receive consents from a majority of Openlane's preferred and common stockholders, as required by Delaware law.<sup>381</sup>

The plaintiff filed suit, claiming that the process used by the board was flawed, and in violation of *Revlon*.<sup>382</sup> Plaintiff criticized the defendants for contacting only three potential buyers, failing to perform an adequate market check, failing to receive a fairness opinion, and relying on inadequate financial information, which resulted in a transaction that failed to maximize shareholder value.<sup>383</sup> The plaintiff further contended that the defendants "breached their fiduciary duties by agreeing to improper deal protection devices," e.g., the no-solicitation clause and lockup of the shareholder vote.<sup>384</sup> Plaintiff questioned the board's motives for approving the merger.<sup>385</sup>

Because it was a change in control transaction, the court applied the enhanced scrutiny standard, recognizing that the board had "the burden of proving that they were adequately informed and acted reasonably."<sup>386</sup> In the context of a preliminary injunction, however, the defendant "must establish a reasonable likelihood that at trial the [board] would not be able to show that [it] had satisfied [its] fiduciary duties."<sup>387</sup> Examining the facts, the court determined that the board here represented one of the rare boards that "possess an impeccable knowledge of the company's business," and that the board made reasonable efforts to maximize shareholder value.<sup>388</sup> The court determined that the plaintiff failed to present a compelling

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<sup>374</sup> In re Openlane, Inc. S'holders Litig., Const. C.A. No. 6849-VCN, 2011 Del. Ch. LEXIS 156, at \*1 (Del. Ch. Sept. 30, 2011).

<sup>375</sup> *Id.* at \*8.

<sup>376</sup> *Id.*

<sup>377</sup> *Id.* at \*46.

<sup>378</sup> *Id.* at \*1-2.

<sup>379</sup> *Id.* at \*3.

<sup>380</sup> *Id.* at \*4-6.

<sup>381</sup> *Id.* at \*6.

<sup>382</sup> *Id.* at \*10.

<sup>383</sup> *Id.*

<sup>384</sup> *Id.*

<sup>385</sup> *Id.* at \*11.

<sup>386</sup> *Id.* at \*15.

<sup>387</sup> *Id.*

<sup>388</sup> *Id.* at \*17-20.

argument to support its request for injunctive relief.<sup>389</sup>

The court then applied the standard outlined in *Unocal* to examine the plaintiff's claim for breach of fiduciary duty based on the board's use of defensive devices that resulted in a lock up of the merger.<sup>390</sup> Under the first prong, the board must show that it had reasonable grounds for believing a danger to corporate policy existed.<sup>391</sup> This prong can be satisfied by "demonstrating good faith and reasonable investigation," which must lead to the finding of a threat.<sup>392</sup> The second prong required the board to show that its response was "reasonable in relation to the threat posed."<sup>393</sup> The anticipated decline in Openlane's business provided the danger and threat required under the first prong.<sup>394</sup> The court rejected the impermissible lock up claim on the grounds that the votes were not "locked up" according to a voting agreement, but instead, after the board approved the merger agreement, a majority of the holders "quickly provided consents."<sup>395</sup> As such, the court concluded that the merger agreement "neither forced a transaction on the shareholders, nor deprived them of the right to receive alternative offers."<sup>396</sup>

In balancing the equities, the court expressed concern in maximizing shareholder value when the sale lacks "an auction, a fairness opinion, a fiduciary out, or any post-agreement market check."<sup>397</sup> However, the court noted that here, no other offers came forward, and the board members were competent and had the same incentive to maximize value as all minority shareholders.<sup>398</sup> This decision suggests that Delaware courts will respect and uphold the reasonable decisions of an knowledgeable board, even if they deviate from customary practice.

*c. The Entire Fairness Standard: Delaware's Most Onerous Standard*

To avoid application of the business judgment standard, the plaintiff must produce evidence that refutes the business judgment presumption.<sup>399</sup> There are a number of ways the plaintiff can rebut the business judgment presumption, including by showing that the majority of directors who approved the action (1) had a personal interest in the subject matter of the action; (2) were not fully informed in approving the action; or (3) did not act in good faith in approving the action.<sup>400</sup> If the plaintiff rebuts the business judgment presumption, the court applies the entire fairness standard of review to the challenged action and places the burden on the directors to prove that the action was entirely fair.<sup>401</sup>

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<sup>389</sup> *Id.* at 20.

<sup>390</sup> *Id.* at \*21–22.

<sup>391</sup> *Id.* at \*22.

<sup>392</sup> *Id.* (citing *Paramount Commc'ns, Inc. v. Time Inc.*, 571 A.2d 1140, 1152 (Del. 1989)).

<sup>393</sup> *Id.* (citing *Unocal Corp v. Mesa Petroleum*, 493 A.2d 946, 955 (Del. 1985)).

<sup>394</sup> *Id.* at \*23–24.

<sup>395</sup> *Id.* at \*25.

<sup>396</sup> *Id.* at \*26.

<sup>397</sup> *Id.* at \*45.

<sup>398</sup> *Id.* at \*45–46.

<sup>399</sup> *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162 (Del. 1995).

<sup>400</sup> *Ebay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 36 (Del Ch. 2010).

<sup>401</sup> *Id.*

The concept of fairness has two basic elements: fair dealing and fair price.<sup>402</sup> Fair dealing examines issues such as: “when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained.”<sup>403</sup> The element of fair price examines the economic and financial considerations of the transaction, including relevant factors such as: “assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company’s stock.”<sup>404</sup> All aspects of the two elements must be considered as a whole to determine entire fairness.<sup>405</sup>

Notably, if the director or controlling stockholder implements two protective components, then the transaction can evade the entire fairness review.<sup>406</sup> The two components are: (1) the controlling shareholder must permit “the board to form a duly empowered and properly functioning special committee”; and (2) the transaction must be conditioned on approval by a “majority-of-the-minority vote.”<sup>407</sup> If the controlling shareholder employs both of these components to protect the minority shareholder, “then the burden could shift to the plaintiff to prove that the transaction was unfair,” essentially avoiding the entire fairness review and invoking the business judgment rule.<sup>408</sup>

v. *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

In *Weinberger v. UOP, Inc.*, the Delaware Supreme Court applied the standard of entire fairness in the context of a freeze-out merger.<sup>409</sup> There, the Signal Companies (“Signal”) owned 50.5% of subsidiary UOP and sought to acquire the remaining shares in a cash-out merger.<sup>410</sup> Signal’s initial offer of \$20 a share was raised to \$21 after UOP formed an independent committee to negotiate.<sup>411</sup> Signal also provided a fairness opinion from an investment bank claiming that \$21 was a fair price.<sup>412</sup> The merger, which required the votes of a majority of UOP’s minority shareholders, was eventually approved.<sup>413</sup> However, the shareholders were not told of a feasibility study written by two UOP executives and given directly to Signal that said that a fair price would be \$21-\$24 a share.<sup>414</sup>

Plaintiff minority shareholders filed suit alleging that the cash-out merger was illegal in that: (1) its sole purpose was to eliminate the minority shareholders; and (2) the price per share

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<sup>402</sup> *Weinberger v. Uop*, 457 A.2d 701, 711 (Del. 1983).

<sup>403</sup> *Id.*

<sup>404</sup> *Id.*

<sup>405</sup> *Id.*

<sup>406</sup> *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 460 (Del. Ch. 2011).

<sup>407</sup> *Id.* (citing *In re Cox Commc’ns, Inc. S’holders Litig.*, 879 A.2d 604, 644 (Del. Ch. 2005)).

<sup>408</sup> *Id.*

<sup>409</sup> *See Weinberger v. UOP Inc.*, 457 A.2d 701 (Del. 1983).

<sup>410</sup> *Id.* at 704–05.

<sup>411</sup> *Id.* at 705–06.

<sup>412</sup> *Id.* at 706–07.

<sup>413</sup> *Id.* at 708.

<sup>414</sup> *Id.* at 708–09.

to be paid by minority shareholders was grossly inadequate.<sup>415</sup> Weinberger sought to set merger aside or, in the alternative, an award of monetary damages against the subsidiary, the majority shareholder of corporation, and the investment-banking firm that provided the fairness opinion prior to merger.<sup>416</sup> The Court of Chancery entered judgment for defendants, and plaintiffs appealed.<sup>417</sup>

The Delaware Supreme Court abandoned the business purpose test as a requirement for mergers and returned to the appraisal procedure as the primary remedy for shareholders who can prove a violation of fairness.<sup>418</sup> The court held that the present transaction did not satisfy any reasonable concept of fairness.<sup>419</sup> In so ruling, the court stated that the test of entire fairness has two aspects: *fair dealing* and *fair price*.<sup>420</sup> The fair dealing element focuses upon the conduct of the corporate fiduciaries in effecting a freeze-out merger.<sup>421</sup> The fair price element relates to the economic and financial considerations relied upon when valuing the proposed purchase including assets, including assets, market values, cash flow, and earnings.<sup>422</sup>

The court found that there was not fair dealing because the disclosure to the defendant's directors was wholly flawed by conflicts of interest raised in the feasibility study, and the minority shareholders were denied critical information; therefore, the vote of the minority shareholders was not an informed one.<sup>423</sup> In addition, the price was not fair because the accounting methods that were used to value UOP's stock did not meet section 262(h).<sup>424</sup>

- vi. *In re LNR Property Corp. Shareholders Litigation*, 896 A.2d 169 (Del. Ch. 2005).

[T]he business judgment rule does not protect the board's decision to approve a merger (even where a majority of the directors are independent and disinterested) where a controlling shareholder has a conflicting self-interest. Instead, Delaware law imposes an entire fairness burden when the fiduciary charged with protecting the minority in a sale of the company does not have an undivided interest to extract the highest value for the shareholders.<sup>425</sup>

In that case, former shareholders filed fiduciary class action in connection with a cash-out

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<sup>415</sup> *Id.* at 703.

<sup>416</sup> *Id.* at 703–04.

<sup>417</sup> *Id.* at 703.

<sup>418</sup> *Id.* at 715.

<sup>419</sup> *Id.* at 712.

<sup>420</sup> *Id.* at 711.

<sup>421</sup> *Id.* at 711–12.

<sup>422</sup> *Id.* at 713–14.

<sup>423</sup> *Id.* at 711–12.

<sup>424</sup> *Id.* at 713–14.

<sup>425</sup> *In re LNR Prop. Corp. S'holders Litig.*, 896 A.2d 169, 177 (Del. Ch. 2005) (footnote omitted).

merger, naming LNR Property Corporation and its former directors as defendants.<sup>426</sup> They further alleged that LNR's board of directors breached its fiduciary duties by allowing the controlling stockholder and the chief executive officer ("CEO"), who had "obvious and disabling conflicts of interest, to negotiate the . . . deal."<sup>427</sup> Although the board formed a special independent committee to consider the deal, plaintiffs alleged that the committee was a "sham" because it was "dominated and controlled" by the controlling shareholder and the CEO, and the committee was not permitted to negotiate with the buyer or seek other deals.<sup>428</sup> Additionally, the shareholders claimed that the committee failed to get an independent evaluation of the deal, but relied on a financial advisor who worked with the controlling shareholder and the CEO to negotiate the deal, and stood to gain an \$11 million commission when the transaction was completed.<sup>429</sup> Defendants moved to dismiss for failure to state a claim.<sup>430</sup>

The Court of Chancery held that plaintiffs' allegations were sufficient to warrant application of the entire fairness standard of review and wrote: "when a controlling shareholder stands on both sides of a transaction, he or she is required to 'demonstrate [his or her] utmost good faith and most scrupulous inherent fairness of the bargain.'"<sup>431</sup> The court concluded that the complaint could be read to allege that the board improperly allowed the controlling shareholder to control the negotiations with the acquirer, as well as the outcome of the vote, resulting in an unfair and inadequate price for the stock in the cash-out.<sup>432</sup> The court found that due to the seriousness of the allegations, the business judgment rule would not apply to the transaction.<sup>433</sup> The court also rejected defendants' argument that plaintiffs' claims were barred based on the corporation's exculpatory charter provision because the alleged misconduct implicated defendants' duties of loyalty and good faith.<sup>434</sup>

vii. *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442 (Del. Ch. 2011).

A recent Delaware case, *Reis v. Hazelett Strip-Casting Corp.*, outlined the three standards discussed above, ultimately relying on the entire fairness standard.<sup>435</sup> This case involved a reverse stock split by the corporation that prevented beneficiaries from receiving shares they otherwise would have received.<sup>436</sup> The corporation was a family business, with two brothers as the only stockholders.<sup>437</sup> One brother, Bill held almost seventy percent of the equity in the corporation, while the second brother, Dick, held thirty percent of the equity.<sup>438</sup> Dick, the

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<sup>426</sup> *Id.* at 171.

<sup>427</sup> *Id.* at 174.

<sup>428</sup> *Id.* at 176–77.

<sup>429</sup> *Id.* at 174.

<sup>430</sup> *In re LNR Prop. Corp.*, 896 A.2d at 174–75.

<sup>431</sup> *Id.* at 176 (quoting *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983)).

<sup>432</sup> *Id.*

<sup>433</sup> *Id.* at 177.

<sup>434</sup> *Id.* at 178–79.

<sup>435</sup> *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442 (Del. Ch. 2011).

<sup>436</sup> *Id.* at 449.

<sup>437</sup> *Id.*

<sup>438</sup> *Id.* at 450.

minority shareholder, died in 2002, leaving his 350 shares to 169 different individuals.<sup>439</sup> Bill and his son, David, objected to the bequest of Dick's shares to 169 people.<sup>440</sup> Specifically, they worried that such a bequest could jeopardize the business and interfere with the management of the corporation.<sup>441</sup> After an unsuccessful attempt to purchase the estate's shares, the directors approved a reverse stock split and presented the plan at a special meeting of stockholders.<sup>442</sup> The only stockholder present at the meeting to approve the reverse stock split was a limited partnership that was both formed by Bill and held Bill's shares.<sup>443</sup> When the executors refused to accept the payment associated with the reverse split, the corporation and the estate's lawyer asked the probate court to remove the executors, which the court did.<sup>444</sup> One of the recently removed executors continued to oppose the reverse split, bringing suit on behalf of the beneficiaries.<sup>445</sup>

After a brief discussion of the three standards available to the court, it determined that the entire fairness test was the appropriate standard by which to evaluate the reverse split transaction.<sup>446</sup> Applying the two prongs of the entire fairness test (fair dealing and fair price), the court concluded that the reverse split was not entirely fair, and awarded damages.<sup>447</sup>

viii. *In re Southern Peru Copper Corp. Shareholder Derivative Litigation*, 52 A.3d 761 (Del. Ch. 2011).

In a post-trial opinion, Chancellor Strine from the Delaware Court of Chancery—applying the entire fairness standard—concluded that the defendants breached their fiduciary duty of loyalty resulting in a “manifestly unfair transaction.”<sup>448</sup> This suit stems from Southern Peru Copper Corporation's (“Southern Peru”) acquisition of Minera México (“Minera”), a Mexican mining company, from Grupo México, Southern Peru's controlling shareholder.<sup>449</sup> The court ultimately determined that Southern Peru significantly overpaid to obtain Minera.<sup>450</sup>

Grupo México approached Southern Peru, proposing that Southern Peru acquire Grupo México's interest in Minera.<sup>451</sup> The intended result of the merger would cause Minera to become a wholly-owned subsidiary of Southern Peru.<sup>452</sup> Southern Peru formed a Special Committee and hired Goldman Sachs to evaluate the proposal.<sup>453</sup> However, important to the

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<sup>439</sup> *Id.* at 451.

<sup>440</sup> *Id.*

<sup>441</sup> *Id.*

<sup>442</sup> *Id.* at 453.

<sup>443</sup> *Id.*

<sup>444</sup> *Id.* at 454.

<sup>445</sup> *Id.*

<sup>446</sup> *Id.* at 461.

<sup>447</sup> *Id.* at 479.

<sup>448</sup> *In re S. Peru Copper Corp. S'holder Derivative Litig.*, 52 A.3d 761, 763, 765 (Del. Ch. 2011).

<sup>449</sup> *Id.* at 765–67.

<sup>450</sup> *Id.* at 813.

<sup>451</sup> *Id.* at 769.

<sup>452</sup> *Id.*

<sup>453</sup> *Id.* at 769–70.

court's analysis, the Special Committee had no express power to negotiate or explore other strategic alternatives.<sup>454</sup> Goldman Sachs initially determined that the value of what Southern Peru would receive in the transaction was significantly less than the value of stock Grupo México would receive, and made a counterproposal.<sup>455</sup> After some negotiation, a deal was made; however, at that time, the stockholder vote that would be required to approve the merger was still unresolved.<sup>456</sup> Eventually, after accepting a value far below the proposed amount of Southern Peru stock, the Special Committee conceded its majority of the minority provision, and agreed to require only the approval of two-thirds of the outstanding common stock of Southern Peru.<sup>457</sup> Following the transaction, a derivative suit was filed.<sup>458</sup>

Both parties agreed that, because a controlling stockholder stood on both sides of the transaction, the appropriate standard of review was the entire fairness test.<sup>459</sup> Thus, the transaction must meet standards for fair price and fair dealing.<sup>460</sup> The defendants argued that the burden of persuasion shifted to the plaintiff because of their use of an independent Special Committee.<sup>461</sup> The court acknowledged that the burden of persuasion can shift from the defendants if (1) the transaction was approved by an independent board majority; or (2) the transaction was approved by an informed vote of the majority of the minority shareholders.<sup>462</sup> However, the court ultimately determined that the Special Committee did not truly exercise "real bargaining power 'at an arms-length'" and was not "well functioning," and therefore the burden remained with the defendants.<sup>463</sup> The court clarified that factors that trigger the burden shift include the "independence of the committee and the adequacy of its mandates (i.e., was it given blocking and negotiating power)."<sup>464</sup> After an extensive analysis of whether the burden of persuasion should shift to the plaintiff, the court stated:

As a trial judge, I take very seriously the standard of review as a prism through which to determine a case. When a standard of review does not function as such, it is not clear what utility it has, and it adds costs and complication to the already expensive and difficult process of complex civil litigation. . . . If we take seriously the notion, as I do, that a standard of review is meant to serve as the framework through which the court evaluates the parties' evidence and trial testimony in reaching a decision, and, as important, the framework through which the litigants determine how best to prepare their cases for trial, it is problematic to adopt an analytical approach whereby the burden allocation can only be determined in a post-trial opinion, after all the

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<sup>454</sup> *Id.* at 769.

<sup>455</sup> *Id.* at 771–75.

<sup>456</sup> *Id.* at 777–78.

<sup>457</sup> *Id.* at 778.

<sup>458</sup> *Id.* at 785.

<sup>459</sup> *Id.* at 787.

<sup>460</sup> *Id.*

<sup>461</sup> *Id.* at 788.

<sup>462</sup> *Id.*

<sup>463</sup> *Id.* at 789 (quoting *Kahn v. Tremont Corp.*, 694 A.2d 422, 428–29 (Del. 1997)).

<sup>464</sup> *Id.* at 791.

evidence and all the arguments have been presented to the court.<sup>465</sup>

Nonetheless, the court noted that it was required to take “a factual look at the actual effectiveness of the special committee before awarding a burden shift.”<sup>466</sup> It further stated that “[r]egardless of who bears the burden, I conclude that the Merger was unfair to Southern Peru and its stockholders.”<sup>467</sup> The defendants then argued that the burden of persuasion shifted because they “ultimately received super-majority support of the stockholders.”<sup>468</sup> The court quickly disregarded this argument, stating that “any burden-shifting should not depend on the after-the-fact vote result but should instead require that the transaction has been conditioned up-front on the approval of a majority of the disinterested stockholders.”<sup>469</sup> The court further concluded that the vote was not “fully informed.”<sup>470</sup> The court reiterated that “even if the vote shifted the burden of persuasion, it would not change the outcome.”<sup>471</sup>

After wading through the burden-shifting analysis, the court finally reviewed the transaction under the entire fairness standard.<sup>472</sup> The court concluded that “from inception, the Special Committee fell victim to a controlled mindset and allowed Grupo México to dictate the terms and structure of the Merger.”<sup>473</sup> Such an arrangement “took off the table other options that would have generated a real market check and also deprived the Special Committee of negotiating leverage to extract better terms.”<sup>474</sup> This narrowed lens caused the Special Committee to try and make the merger make sense without evaluating whether “the Merger was a good idea in the first place.”<sup>475</sup> Finding that “Goldman and the Special Committee went to strenuous lengths to equalize the values of Southern Peru and Minera,”<sup>476</sup> the court ultimately concluded that the deal was unfair and that the defendants breached their fiduciary duty of loyalty.<sup>477</sup>

## **2. True Shareholder Oppression Claims: *Little v. Waters*, No. 12155, 1992 WL 25758, (Del. Ch. Feb. 11, 1992).**

As evidenced by the previous discussion, most cases in Delaware involving oppression suffered by the minority shareholders at the hands of directors and controlling shareholders are presented as claims of breach of fiduciary duty. The Delaware Court of Chancery tackled the issue of oppression head-on in *Little v. Waters*.<sup>478</sup> While other cases have suggested the

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<sup>465</sup> *Id.* at 792–93 (citation omitted).

<sup>466</sup> *Id.* at 793.

<sup>467</sup> *Id.*

<sup>468</sup> *Id.*

<sup>469</sup> *Id.*

<sup>470</sup> *Id.* at 794.

<sup>471</sup> *Id.* at 797.

<sup>472</sup> *See id.*

<sup>473</sup> *Id.* at 798.

<sup>474</sup> *Id.*

<sup>475</sup> *Id.* at 801.

<sup>476</sup> *Id.*

<sup>477</sup> *Id.* at 813.

<sup>478</sup> *Little v. Waters*, No. 12155, 1992 WL 25758, (Del. Ch. Feb. 11, 1992).

possibility of a minority shareholder claim in Delaware, *Little* has been cited as the “only Delaware case that has squarely addressed the issue of oppression.”<sup>479</sup>

In *Little*, the plaintiff and the defendant jointly formed two subchapter S corporations.<sup>480</sup> Subsequently, the defendant fired plaintiff and merged the two companies while retaining the subchapter S status.<sup>481</sup> Although the new corporation reported earnings, the board did not declare dividends.<sup>482</sup> Therefore, the plaintiff was forced to pay taxes from personal funds and could not use any cash distributions of the corporation.<sup>483</sup>

The plaintiff filed suit against the defendant alleging that the failure to issue dividends constituted a breach of fiduciary duties and “gross and oppressive abuse of discretion.”<sup>484</sup> The defendant argued that “the declaration and payment of a dividend rests in the discretion of the corporation’s board of directors in the exercise of its business judgment.”<sup>485</sup>

In determining the plaintiff’s claim of fiduciary breach, the court held that the entire fairness standard applied because of the defendant’s self-interest in the challenged transactions.<sup>486</sup> The court noted that the defendant served his own personal financial interests in making the decision not to declare dividends because he was then able to receive a greater share of cash available for corporate distributions via loan repayments.<sup>487</sup> The defendant was also able to pressure the minority shareholder to sell his shares back to the defendant at a steep discount, since the shares became only a liability to the plaintiff who received no corporate distributions yet owed taxes on the company’s income.<sup>488</sup>

Noting that no Delaware case has defined the legal standard for “oppression,” the court looked elsewhere for guidance to determine whether the defendant’s withholding of dividends was an oppressive abuse of discretion.<sup>489</sup> The court relied in particular on the New York case of *Gimpel v. Bolstein*,<sup>490</sup> which recognized the principal standard for oppression as violation of “reasonable expectations.”<sup>491</sup> Applying the reasonable expectation test, the court held that the defendant’s scheme represented a “classic squeeze[-]out situation,” noting that the failure to

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<sup>479</sup> Orloff v. Shulman, No. 852-N, 2005 Del. Ch. LEXIS 184, at \*29 n.52 (Del. Ch. Nov. 23, 2005); *see also* Gagliardi v. Trifoods Int’l, Inc., 683 A.2d 1049, 1051 (Del. Ch. 1996) (stating that the court “need not address the general question whether Delaware fiduciary duty law recognizes a cause of action for oppression of minority shareholders; [and] . . . assum[ing] for purposes of this motion, without deciding, that under some circumstances it may.”).

<sup>480</sup> *Little*, 1992 WL 25758, at \*1.

<sup>481</sup> *Id.*

<sup>482</sup> *Id.* at \*2.

<sup>483</sup> *Id.*

<sup>484</sup> *Id.* at \*6.

<sup>485</sup> *Id.* at \*3.

<sup>486</sup> *Id.* at \*5.

<sup>487</sup> *Id.* at \*4.

<sup>488</sup> *Id.* (Though the minority’s shares were never sold).

<sup>489</sup> *Id.* at \*7.

<sup>490</sup> *Gimpel v. Bolstein*, 477 N.Y.S.2d 1014 (N.Y. Sup. Ct. 1984).

<sup>491</sup> *Little*, 1992 WL 25758, at \*7–8.

pay dividends can be especially devastating in a subchapter S corporation.<sup>492</sup> The defendant's refusal to declare dividends when it was in a position to do so "was a visible departure from the standards of fair dealing and fair play."<sup>493</sup> As such, the court determined it could potentially provide relief for the oppression claims, and denied the defendant's motion to dismiss those claims.<sup>494</sup> Despite the fact that the court determined it *could* possibly grant relief under the circumstances, the court also noted "that '[f]ew, if any, cases have involved a set of facts egregious enough to meet [the fraudulent, oppressive or gross abuse of discretion] standard.'"<sup>495</sup> Given that no other Delaware case has "squarely addressed" or recognized a separate claim for shareholder oppression,<sup>496</sup> the *Little* court's limiting statement that "few, if any, cases" are egregious enough to mount the high burden for such a claim remains true today in Delaware.<sup>497</sup>

### 3. *Benefits of the Developed Standards*

The three standards discussed above provide some predictability in how the Delaware courts will handle claims for oppression or breach of fiduciary duty. These standards protect not only the minority from any potential oppression, but also the controlling shareholders or directors in structuring their management in accordance with the standards. A prime example of the protection available to directors and controlling shareholders involves the directors' ability to enjoy review under the business judgment standard and avoid review under the entire fairness standard if the directors implement the two protective elements discussed previously (if done properly).<sup>498</sup> The developed standards of Delaware in this area of law, unlike the amorphous body of law in Texas, provide protection for both minority and controlling shareholders.

However, while the standards provide some guidance, if not applied consistently, such standards are useless. A recent decision from the Delaware Court of Chancery has encountered some criticism after applying the *Revlon* standard of review to analyze a merger involving consideration consisting of approximately 50% cash and 50% stock.<sup>499</sup>

*In Re Smurfit-Stone Container Corp. Litigation* involved a proposed merger of a publicly held corporation, Smurfit-Stone Container Corp. ("Smurfit"), with a wholly-owned subsidiary of another publicly held corporation, Rock-Tenn Co. ("Rock-Tenn").<sup>500</sup> The proposal provided that the Smurfit shareholders would receive \$35 per share, with half of the consideration in

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<sup>492</sup> *Id.* at \*8.

<sup>493</sup> *Id.*

<sup>494</sup> *Id.* at \*9.

<sup>495</sup> *Id.* (quoting *Blackwell v. Nixon*, No. 9041, 1991 WL 194725 (Del. Ch. Sept. 26, 1991), *rev'd*, 626 A.2d 1366 (Del. 1993)).

<sup>496</sup> *Orloff v. Shulman*, No. 852-N, 2005 Del. Ch. LEXIS 184, at \*29 n.52 (Del. Ch. Nov. 23, 2005).

<sup>497</sup> *Little*, 1992 WL 25758, at \*9.

<sup>498</sup> *See In re S. Peru Copper Corp. S'holder Derivative Litig.*, 52 A.3d 761 (Del. Ch. 2011).

<sup>499</sup> *See In re Smurfit-Stone Container Corp. S'holder Litig.*, No. 6164-VCP, 2011 WL 2028076, at \*11 (Del. Ch. May 24, 2011) (applying the standard of review established in *Revlon, Inc. v. MacAndrews & Forbes Holding, Inc.*, 506 A.2d 173 (Del. 1986)).

<sup>500</sup> *Id.* at \*1.

cash, and the other half in Rock-Tenn's stock.<sup>501</sup> The plaintiffs challenged the merger, claiming that the price per share was unreasonable.<sup>502</sup> The plaintiffs further claimed that the merger warranted heightened scrutiny under the *Revlon* standard because of the resulting "change in control," forcing the court to consider at what point a mixed stock and cash merger constitutes a change of control and requires application of the *Revlon* standard.<sup>503</sup>

Because the merger would liquidate half of each investor's investment—despite the fact that control of Rock-Tenn would remain with unaffiliated stockholders following the merger—the court determined that the facts triggered the *Revlon* standard, but noted that its conclusion was "not free from doubt."<sup>504</sup> Applying the *Revlon* standard, the court concluded that the board of directors satisfied its fiduciary duties and denied injunctive relief.<sup>505</sup>

Critics have attacked the court's application of the *Revlon* standard under these circumstances, contending that there was "no change in control." Both companies were publicly held with no controlling shareholder and would remain the same post-merger; thus, the control essentially remained unchanged.<sup>506</sup> According to this view, because the *Revlon* standard was not triggered, the court should have applied the more lenient business judgment rule. While the application would not have changed the outcome in the current case (i.e., the defendants prevailed even under the more stringent *Revlon* standard),<sup>507</sup> it does have the potential to affect future outcomes.

#### **4. Taking the "Minority" Position: Protecting the Majority in Shareholder Oppression Claims**

Delaware courts have demonstrated a historical preference that the parties should be left to the bargain made, whether it be for a majority or minority shareholder position. In accordance with this preference, several Delaware cases go to some lengths to protect the rights of *majority* shareholders against incursion by the board or minority shareholders.

a. *Nixon v. Blackwell*, 626 A.2d 1366, 1380 (Del. 1993).

Delaware courts have alluded to the minority shareholder's ability to contract for a better position before acquiring an interest in the corporation. In *Nixon*, the Delaware Supreme Court stated:

The tools of good corporate practice are designed to give a purchasing minority stockholder the opportunity to bargain for protection before parting with consideration. It would do violence to normal corporate practice and our corporation law to fashion an ad hoc ruling which would result in a court-imposed stockholder

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<sup>501</sup> *Id.*

<sup>502</sup> *Id.*

<sup>503</sup> *Id.* at \*10.

<sup>504</sup> *Id.* at \*11.

<sup>505</sup> *Id.* at \*26.

<sup>506</sup> *See id.* at \*11.

<sup>507</sup> *Id.*

buy-out for which the parties had not contracted.<sup>508</sup>

There, the founder of E.C. Barton & Co., a closely held corporation, created two classes of stock, with voting Class A shares going to either current or past employees of the company, and non-voting Class B shares allocated to family members of the founder.<sup>509</sup> There was no public market for either class of stock.<sup>510</sup> The company retained most of its earnings and paid only modest dividends.<sup>511</sup> Recognizing its shareholders' needs for liquidity, the company offered to purchase the Barton family stock.<sup>512</sup> Several family members sold over the years, although they were not always satisfied with price offered.<sup>513</sup> Employee stockholders were also given the option to sell their shares to the company at various times.<sup>514</sup> Those who acquired their interest in Barton stock through an Employee Stock Ownership Plan ("ESOP") were able to take cash instead of stock at the time of retirement.<sup>515</sup> The family members brought suit against the directors of the company, complaining that defendants had maintained a discriminatory policy that unfairly favored employee shareholders over plaintiffs.<sup>516</sup> Specifically, the defendants are charged with having breached their fiduciary duties by distributing the company's profits through the ESOP rather than dividends, thereby excluding plaintiffs.<sup>517</sup>

The Delaware Supreme Court, applying the entire fairness standard, held that the vice chancellor erred as a matter of law in concluding that substantially equal treatment was required as to plaintiffs, because it was well-established that stockholders need not always be treated equally for all purposes.<sup>518</sup> There was evidence that ESOP was established to benefit the corporation.<sup>519</sup> The court held that the defendants had met their burden of establishing entire fairness of dealings with the plaintiffs, because the record was sufficient to conclude that the plaintiffs' claim that defendant directors had maintained a discriminatory policy of favoring Class A employee stockholders over Class B non-employee stockholders was without merit.<sup>520</sup>

The court held that there should not be any "special, judicially-created rules to 'protect' minority stockholders of closely held Delaware corporations."<sup>521</sup> The court noted that Delaware has passed legislation enabling shareholders in closely held corporations to modify their relationships by contract: "A stockholder who bargains for stock in a closely held

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<sup>508</sup> *Nixon v. Blackwell*, 626 A.2d 1366, 1380 (Del. 1993).

<sup>509</sup> *Id.* at 1370–71.

<sup>510</sup> *Id.* at 1371.

<sup>511</sup> *Id.* at 1373.

<sup>512</sup> *Id.* at 1371.

<sup>513</sup> *Id.*

<sup>514</sup> *Id.*

<sup>515</sup> *Id.*

<sup>516</sup> *Id.* at 1373.

<sup>517</sup> *Id.*

<sup>518</sup> *Id.* at 1377.

<sup>519</sup> *Id.*

<sup>520</sup> *Id.* at 1379.

<sup>521</sup> *Id.* at 1380–81.

corporation and who pays for those shares . . . can make a business judgment whether to buy into such a minority position, and if so on what terms.”<sup>522</sup> Moreover, a stockholder intending to buy into a minority position in a Delaware corporation may enter into definitive stockholder agreements, and such agreements may provide for elaborate earnings tests, buyout provisions, voting trusts, or other voting agreements.<sup>523</sup> Consequently, the court believed that shareholders should protect themselves in this fashion rather than expecting courts to provide protection.<sup>524</sup>

*b. Canada Southern Oils, Ltd. v. Manabi Exploration Co., 96 A.2d 810 (Del. Ch. 1953).*

In this case, the Delaware Court of Chancery notably stated that “majority voting control is a right which a court of equity will protect under . . . [appropriate] circumstances.”<sup>525</sup> Plaintiff, Canada Southern Oils, Ltd. (“Canada Southern”), controlled by the Buckleys, was the majority shareholder of Manabi Exploration Co. (“Manabi”), holding 50.4% of Manabi’s outstanding stock.<sup>526</sup> The Buckleys and Cecil Hagan, the president of both Canada Southern and Manabi, had a mild disagreement about the management of Manabi.<sup>527</sup> Soon thereafter, a resolution authorizing Manabi’s board to issue more shares at its sole discretion was adopted at a shareholder vote in which the plaintiff’s shares were voted by a director and lawyer of Manabi by proxy.<sup>528</sup> The Buckley-Hagan rift grew deeper and Hagan resigned from his position at Canada Southern but not from Manabi.<sup>529</sup>

Hagan then engineered a board meeting of Manabi, and notified the company’s directors by telegram of the board meeting to be held in Texas four days later.<sup>530</sup> The two directors representing the Buckleys, on receiving the notice in New York, objected to the meeting due to its short notice and suggested postponement, but the request was denied.<sup>531</sup> The other directors attended the meeting and authorized the sale of the unissued shares to a third company.<sup>532</sup> Thereafter, plaintiff filed an application for a preliminary injunction to prevent the issuance, transfer, or voting of those shares of Manabi’s stock.<sup>533</sup> Plaintiff contended that Manabi sold the shares for an improper purpose, namely, to deprive plaintiff of clear voting control and to give it instead to the directors.<sup>534</sup>

The Court of Chancery dismissed Manabi’s claim that the issuance was driven by a need for financing, and granted plaintiff’s preliminary injunction blocking the issuance and transfer

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<sup>522</sup> *Id.*

<sup>523</sup> *Id.*

<sup>524</sup> *Id.*

<sup>525</sup> Canada S. Oils, Ltd. v. Manabi Exploration Co., 96 A.2d 810, 814 (Del. Ch. 1953).

<sup>526</sup> *Id.* at 810–11.

<sup>527</sup> *Id.* at 811–12.

<sup>528</sup> *Id.* at 811.

<sup>529</sup> *Id.* at 812.

<sup>530</sup> *Id.*

<sup>531</sup> *Id.*

<sup>532</sup> *Id.*

<sup>533</sup> *Id.*

<sup>534</sup> *Id.*

of the new shares, stating:

When the undisputed facts are viewed cumulatively I find it reasonable to infer that the primary purpose behind the sale of these shares was to deprive plaintiff of the majority voting control. Hagan and his associates did too much too soon with too little disclosure to justify a contrary conclusion.<sup>535</sup>

The court assumed and the defense conceded that, if the issuance was motivated by a desire to deprive plaintiff of control, it was an improper interference with shareholder voting.<sup>536</sup> The decision could be read to stand for the proposition that share issuances undertaken for the primary purpose of diluting the voting rights of majority stockholders were per se invalid.

## V. ALTERNATIVE TO DELAWARE FOR INCORPORATION

Delaware has enjoyed the reputation of a management-friendly state, thus attracting companies to incorporate under its laws. Nevada provides a promising alternative for businesses to consider for incorporation.

### A. Dearth of Case Law

Unfortunately, Nevada has only a limited amount of case law addressing shareholder oppression, so a complete assessment of how Nevada courts will treat various claims of oppression is not possible. While the majority of states allow dissolution as a remedy for oppression of minority shareholders by controlling shareholders, Nevada does not list oppression as a ground for dissolution.<sup>537</sup> However, “[t]he dissolution statutes do not provide the exclusive remedies for oppressed shareholders; courts have equitable powers to fashion appropriate remedies where the majority shareholders have breached their fiduciary duty to the minority by engaging in oppressive conduct.”<sup>538</sup>

### B. *Hollis v. Hill*, 232 F.3d 460 (5th Cir. 2000).

One significant Fifth Circuit case (applying Nevada law) suggests that Nevada courts may treat shareholder oppression claims as fiduciary duty claims, and hold the controlling shareholder liable.<sup>539</sup> In *Hollis*, the plaintiff and defendant jointly founded a Nevada corporation, and were each 50% shareholders, officers, and employees in the corporation.<sup>540</sup> The defendant took a more active role in the management of the corporation, and due to his vast control, he was treated by both the trial court and the Fifth Circuit as the “majority” shareholder.<sup>541</sup> Tension developed between the two shareholders, and the defendant implemented changes to the plaintiff’s detriment, such as reducing and eventually terminating

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<sup>535</sup> *Id.* at 813.

<sup>536</sup> *Id.* at 812–13.

<sup>537</sup> See NEV. REV. STAT. §78.650.

<sup>538</sup> *Hollis v. Hill*, 232 F.3d 460, 468 (5th Cir. 2000) (applying Nevada law).

<sup>539</sup> *Id.* at 470.

<sup>540</sup> *Id.* at 463.

<sup>541</sup> *Id.* at 466 n.16.

the plaintiff's salary, withholding financial information from the plaintiff, and closing one of the company's offices.<sup>542</sup> The plaintiff responded by filing suit, alleging shareholder oppression.<sup>543</sup>

Applying the internal affairs doctrine, the Texas courts determined that Nevada corporate law should determine the existence and scope of duties between the plaintiff and defendant.<sup>544</sup> Finding that dispositive decisions from the Nevada courts were "non-existent," the court was forced to consider analogous decisions, scholarly works, and other reliable data to determine what the highest court in Nevada would decide.<sup>545</sup> The court acknowledged that Nevada lacks a statute addressing shareholder oppression claims, but found that the defendant's actions constituted a breach of fiduciary duty, thus entitling the plaintiff to equitable relief.<sup>546</sup> Examining close corporation and partnership jurisprudence, the court concluded that the Nevada Supreme Court would likely "find fiduciary obligations between shareholders in a corporation such as . . . [the one at hand] operated by shareholder-directors."<sup>547</sup> The court determined that the absence of oppression as a ground for statutory dissolution in Nevada does not preclude the existence of a fiduciary duty.<sup>548</sup> Finding that a fiduciary duty was owed and breached by the defendant's oppressive conduct, the court ordered a buyout of the plaintiff's shares.<sup>549</sup>

The dissenting opinion disagrees with the majority's conclusion recognizing a cause of action for minority shareholder oppression under Nevada law.<sup>550</sup> Circuit Judge, E. Grady Jolly, states that "whether framed as a breach of fiduciary duty or statutory right," the majority had no basis under which to conclude that Nevada would accept such a claim.<sup>551</sup> Instead, Jolly states that "all indications are that Nevada attempts to pattern its corporate law after the management-friendly approach of Delaware, a state that clearly prohibits a cause of action for oppression of minority shareholders."<sup>552</sup>

Interestingly, the Respondent in *Rupe* cited *Hollis v. Hill* to argue that certain closely held companies approach a partnership situation, and urged that in those instances, fiduciary duties should be enforced.

## VI. CONCLUSION

The assertion of a shareholder oppression claim is a relatively new concept in all U.S. jurisdictions. Some states, however, have developed a more cohesive body of law in this area

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<sup>542</sup> *Id.* at 464.

<sup>543</sup> *Id.*

<sup>544</sup> *Id.* at 465.

<sup>545</sup> *Id.*

<sup>546</sup> *Id.* at 465–66.

<sup>547</sup> *Id.* at 468.

<sup>548</sup> *Id.*

<sup>549</sup> *Id.* at 471–72.

<sup>550</sup> *Id.* at 472 (Jolly, J., dissenting).

<sup>551</sup> *Id.*

<sup>552</sup> *Id.* at 473.

than others. Delaware in particular, though not flawless, provides standards that make the outcome of bringing and defending shareholder oppression claims more predictable. Without any decisions from the Texas Supreme Court, Texas is in the unenviable position of deciding cases without a controlling interpretation from its highest court. As such, it remains an amorphous, broadly defined, and inconsistently applied cause of action.

However, the Texas Supreme Court is now tackling this issue in *Rupe*.<sup>553</sup> Hopefully the court's ruling will provide much-needed guidance for Texas appellate courts to ensure predictability and uniformity in evaluating shareholder oppression claims. Texas would greatly benefit by modeling its development of this uncharted area of law after Delaware and implementing set standards by which to review alleged oppressive conduct. Established standards will prove advantageous to all parties by protecting minority shareholders from oppression, and advising controlling shareholders and directors of the paradigm by which their conduct will be measured. Until Texas outlines its position on oppression claims, businesses will likely continue to routinely select Delaware for incorporation, and perhaps Nevada, as well.

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<sup>553</sup> Ritchie v. Rupe, 339 S.W.3d 275 (Tex. App.—Dallas, *pet. granted*).