Relief for Oppressed Minority Shareholders in Texas

BY SAMUEL S. NICHOLLS

The absence of a shareholder oppression statute in Texas has relegated litigants to pursue a choice of law—the Texas receivership statute, whose language does not define "oppression," and whose legislative intent appears to have been to remedy instances of extreme mismanagement or criminal activity. Recent Texas Supreme Court rulings may invite repercussions for business valuation, dispute resolution, access to capital, and public policy in Texas insofar as the business climate is concerned.

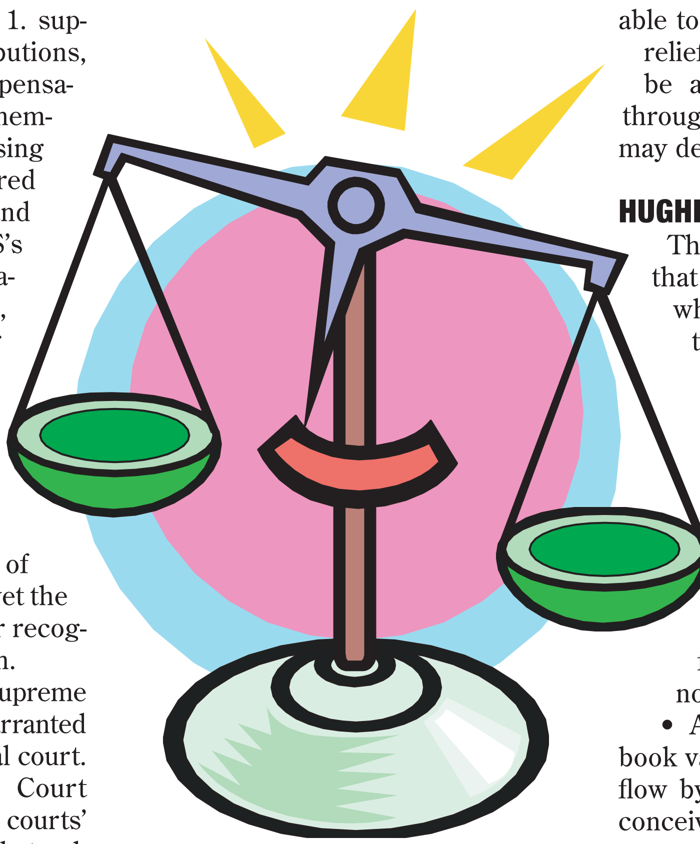
CASE BACKGROUND

In *Cardiac Perfusion Services v. Hughes* in the Dallas Court of Appeals in 2012, Randall Hughes was hired by Michael Joubran to work at his company, Cardiac Perfusion Services (CPS), in 1991, and the following year Hughes purchased a 10 percent ownership interest for $25,000. A buy/sell agreement was executed whereby Joubran would purchase Hughes's shares at book value should Hughes ever be terminated from employment. Joubran later terminated Hughes, sued Hughes for breach of fiduciary duty and tortious interference, and petitioned to enforce the buy/sell agreement. Hughes countersued claiming shareholder oppression.

Both the trial jury and Dallas Court of Appeals found that Joubran: 1. suppressed payment of profit distributions, 2. paid himself excessive compensation, 3. improperly paid family members and personal expenses using CPS funds, 4. intentionally lowered the value of Hughes's stock, and 5. denied Hughes access to CPS's books. The remedy was nullification of the buy/sell agreement, and that Joubran was to pay fair market value of $300,000 for Hughes' ownership interest.

Hughes was petitioned to the Texas Supreme Court by CPS and Joubran. Texas trial and appellate courts have rendered many decisions in favor of plaintiff minority shareholders, yet the Texas Supreme Court had never recognized oppression as a valid claim.

On June 27, 2014, the Texas Supreme Court found that grievances warranted that the case be remanded to trial court. However, the Texas Supreme Court reversed the appellate and trial courts' remedy of a buy-out at fair market value. As in its ruling on June 20, 2010, in the matter of *Ritchie v. Rupe*, the court determined that a claim for shareholder oppression is only available under §11.404 of the Texas Business Organizations Code as it relates to rehabilitative receivership,



and that a common-law claim for shareholder oppression is not valid.

The court did acknowledge that transgressions had occurred, but that the choice of law was faulty. As the court wrote in *Ritchie*, there are "other existing legal protections" that could be pursued other than a common-law cause of action, such as a derivative action for breach of fiduciary duties under §21.563(c) of the Business Corporations Code. Typically, a shareholder derivative suit is brought by a shareholder on behalf of a corporation, and the damages are awarded to the corporation. However, in Texas, a shareholder of a closely-held corporation may seek damages for oneself, pursuant to Texas Business Corporation Act, Article 5.14 (Derivative Proceedings), §L.

THE ISSUE

The Texas receivership statute includes as a condition for receivership "illegal, oppressive, or fraudulent" actions by management. The Texas legislature, by conflating the word "oppressive" with "illegal" and "fraudulent," tinged the meaning of oppression with imagery of flagrant, dastardly deeds. Did the legislature intend for the statute to apply only under dire circumstances, or was the legislature intentionally vague so as to pass the baton to common law to add the detail?

IMPACT ON CORPORATE FINANCE

What are the implications for determining the fair market value of fractional interests in Texas businesses, considering that discounts for relative lack of marketability and lack of control of minority interests in privately held entities may be more pronounced than in other states because minority shareholders in Texas are more vulnerable to shareholder oppression without relief? Majority shareholders may also be affected when requiring capital through an equity offering, as investors may demand lower valuation multiples.

HUGHES' BUY/SELL AGREEMENT

The following features of *Hughes* that may serve as words to the wise when entering into a securities transaction:

- Hughes' buy/sell agreement was priced at 1.0x book value. However, when an entity's value as a going-concern exceeds break-up value, such a metric does not avail the future seller. Furthermore, valuations based on book value are typically confined to companies in the financial or real estate sectors, not the healthcare sector.
- A buy/sell agreement based on book value invites manipulation of cash flow by controlling shareholders. It is conceivable that a company could generate nearly zero growth in book value over 10 years, while generating robust growth in revenue and free cash flow. This could be achieved simply through paying exorbitant salaries to controlling, managing shareholders. Under that scenario, if a company, hypothetically, would fetch a valuation of 1.0x revenue to a willing buyer, it could be valued at $100 million under the guideline publicly traded company method (the market approach), but could be valued at only $1 million if valued at 1.0x book value (the asset approach) if it were mismanaged.
- The buy/sell agreement gave Joubran an incentive to fire Hughes when the fair market value of CPS exceeded its book value. Essentially, the buy/sell agreement was a free stock option with no expiration date for Joubran. The more that CPS grew, the more compelling was the arbitrage opportunity for Joubran, which he could exercise simply by firing Hughes and immediately capturing the difference between book value and fair market value, multiplied by the percentage ownership of Hughes.
- The buy/sell agreement could have stipulated that an independent appraiser determine fair market value. IHT

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