SHAREHOLDER OPPRESSION IN TEXAS
CLOSE CORPORATIONS:

MAJORITY RULE ISN’T WHAT IT USED TO BE

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The doctrine of shareholder oppression protects the close corporation minority shareholder from the improper exercise of majority control. Although the Texas Supreme Court has not explicitly adopted the doctrine, appellate courts in Texas and in other jurisdictions have recognized and applied it in numerous decisions. Because the shareholder oppression doctrine potentially alters a number of fundamental legal principles, it is critically important to be familiar with the doctrine’s operation in close corporation disputes.

I. THE NATURE OF THE CLOSE CORPORATION

A close corporation is a business organization typified by a small number of stockholders, the absence of a market for the corporation’s stock, and substantial shareholder participation in

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1. See infra Part II (discussing judicial acceptance of the shareholder oppression doctrine).
the management of the corporation. In the traditional public corporation, the shareholder is normally a detached investor who neither contributes labor to the corporation nor takes part in management responsibilities. In a close corporation, however, shareholders “usually expect employment and a meaningful role in management, as well as a return on the money paid for [their] shares.” Moreover, close corporation investors are often linked by family or other personal relationships that result in a familiarity between the participants.

Conventional corporate law norms of majority rule and centralized control can lead to serious problems for the close corporation minority shareholder. Traditionally, most corporate power is centralized in the hands of the board of directors. In a close corporation, the board is ordinarily controlled by the shareholder or shareholders holding a majority of the voting power. Through this control of the board, the majority shareholder has the ability to act in ways that are harmful to the minority shareholder’s interests. Such actions are often referred to as “freeze-out” or “squeeze-out” techniques that “oppress” the close corporation minority shareholder.

Common freeze-out

2. See, e.g., Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 511 (Mass. 1975) (noting that these characteristics give close corporations a “distinctive nature”); see also TEX. BUS. CORP. ACT ANN. arts. 12.11–12.14 (Vernon 1998) (setting forth the requirements for electing statutory close corporation status in Texas).

3. See 1 F. HODGE O’NEAL & ROBERT B. THOMPSON, O’NEAL’S CLOSE CORPORATIONS § 1.08, at 31–32 (3d ed. 1996) [hereinafter CLOSE CORPORATIONS].

4. Robert B. Thompson, The Shareholder’s Cause of Action for Oppression, 48 BUS. LAW. 699, 702 (1993); see, e.g., Pedro v. Pedro, 463 N.W.2d 285, 289 (Minn. Ct. App. 1990) (“[T]he primary expectations of minority shareholders include an active voice in management of the corporation and input as an employee.”).


6. See TEX. BUS. CORP. ACT ANN. art 2.31 (Vernon 1998) (“[T]he powers of a corporation shall be exercised by or under the authority of, and the business and affairs of a corporation shall be managed under the direction of, the board of directors of the corporation.”).

7. See, e.g., 1 F. HODGE O’NEAL & ROBERT B. THOMPSON, O’NEAL’S OPPRESSION OF MINORITY SHAREHOLDERS § 1:02, at 3 (2d ed. 1985) [hereinafter OPPRESSION] (“Indeed, in most closely held corporations, majority shareholders elect themselves and their relatives to all or most of the positions on the board.”).

8. See 1 OPPRESSION, supra note 7, § 1:01, at 3 n.2 (“The term ‘freeze-out’ is often used as a synonym for ‘squeeze-out.’”). It has been noted that the term “squeeze-out” means “the use by some of the owners or participants in a business enterprise of strategic position, inside information, or powers of control, or the utilization of some legal device or technique, to eliminate from the enterprise one or more of its owners or participants.” Id. at 1; see also Davis v. Sheerin, 754 S.W.2d 375, 381 (Tex. App.—Houston [1st Dist.] 1988, writ denied) (noting that, in a close corporation, “the oppressive acts of the majority are an attempt to ‘squeeze out’ the minority, who do not have a ready market for the corporation’s shares, but are at the mercy of the majority”).
techniques include the termination of a minority shareholder’s employment, the refusal to declare dividends, the removal of a minority shareholder from a position of management, and the siphoning off of corporate earnings through high compensation to the majority shareholder.\(^9\) Quite often, these tactics are used in combination. For example, the close corporation investor typically looks to salary rather than dividends for a share of the business returns because the “[e]arnings of a close corporation often are distributed in major part in salaries, bonuses and retirement benefits.”\(^10\) When actual dividends are not paid, therefore, a minority shareholder who is discharged from employment and removed from the board of directors is effectively denied any return on his investment as well as any input into the management of the business.\(^11\)

In public corporations, minority shareholders can escape these predicaments by simply selling their shares on the market. By definition, however, there is no ready market for the stock of a close corporation.\(^12\) Thus, close corporation shareholders can be “locked-in” to the company, yet “frozen-out” from any business returns.

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10. Douglas K. Moll, Shareholder Oppression v. Employment at Will in the Close Corporation: The Investment Model Solution, 1999 U. Ill. L. Rev. 517, 523 (1999) (internal quotation omitted); see also 1 OPPRESSION, supra note 7, § 1:03, at 4–5 (“[A] close corporation, in order to avoid so-called ‘double taxation,’ usually pays out most of its earnings in the form of salaries rather than as dividends.”).

11. See, e.g., Balvik v. Sylvester, 411 N.W.2d 383, 388 (N.D. 1987) (“Balvik was ultimately fired as an employee of the corporation, thus destroying the primary mode of return on his investment. Any slim hope of gaining a return on his investment and remaining involved in the operation of the business was dashed when Sylvester removed Balvik as a director and officer of the corporation.”); 1 CLOSE CORPORATIONS, supra note 3, § 1.15, at 89 (“An investor taking a minority investment position in a close corporation, expecting to receive a return on the investment in the form of a regular salary, would face the risk that, after a falling out among the participants, the directors would terminate the minority shareholder’s employment and deprive that investor of any return on the investment in the corporation.”).

12. See, e.g., Donahue, 328 N.E.2d at 514 (“In a large public corporation, the oppressed or dissentient minority stockholder could sell his stock in order to extricate some of his invested capital. By definition, this market is not available for shares in the close corporation.”); Brenner v. Berkowitz, 634 A.2d 1019, 1027 (N.J. 1993) (“[U]nlike shareholders in larger corporations, minority shareholders in a close corporation cannot readily sell their shares when they become dissatisfied with the management of the corporation.”).

II. THE CAUSE OF ACTION FOR SHAREHOLDER OPPRESSION

Over the years, state legislatures and courts have developed two significant avenues of relief for the “oppressed” close corporation shareholder. First, many state legislatures have amended their corporate dissolution statutes to include “oppression” by the controlling shareholder as a ground for involuntary dissolution of the corporation. Moreover, when oppressive conduct has occurred, courts have authorized alternative remedies that are less drastic than dissolution (e.g., buyouts, dividend orders, receivers). Second, particularly in states without an oppression-triggered dissolution statute, some courts have imposed a fiduciary duty between close corporation shareholders and have allowed an oppressed shareholder to bring a direct cause of action for breach of this duty.

In Texas, the shareholder oppression precedents reflect both the statutory and the fiduciary duty developments. With respect to the statutory action for oppression, articles 7.05 and 7.06 of the Texas Business Corporation Act provide for the appointment of a receiver and the eventual possibility of liquidation when aggrieved shareholders can establish particular grounds, including “illegal, oppressive, or fraudulent” conduct by “directors or those in control.” In Davis v. Sheerin, the First Court of Appeals attempted to give some meaning to this “oppressive conduct” ground by citing the following two definitions:

[1][O]ppression should be deemed to arise only when the majority’s conduct substantially defeats
the expectations that objectively viewed were both reasonable under the circumstances and were central to the minority shareholder’s decision to join the venture.

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[2][Oppressive conduct refers to] burdensome, harsh and wrongful conduct, a lack of probity and fair dealing in the affairs of a company to the prejudice of some of its members, or a visible departure from the standards of fair dealing and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely. 18

In Davis, the majority shareholder refused to recognize the minority shareholder’s 45% ownership interest in the corporation. 19 The majority claimed that the minority had previously relinquished his stockholdings to the majority as a gift. 20 The jury disagreed, as it found that the majority shareholder had conspired to deprive the minority shareholder of his ownership interest in the corporation. 21 Referencing the first definition of “oppressive conduct,” the Davis court stated that the majority’s actions would “not only . . . substantially defeat any reasonable expectations [the minority shareholder] may have had . . . but would totally extinguish any such expectations.” 22 In addition, the jury found that the majority shareholder had breached his fiduciary duty by making profit-sharing contributions solely for his own benefit, and by wasting corporate funds on his own attorneys’ fees. 23 As a result of these findings, the Davis court affirmed the lower court’s conclusion that “oppressive conduct” had occurred. 24 After noting that a court “could order less harsh remedies” than liquidation under its “general equity powers,” the Davis court upheld an order requiring the majority shareholder to buy out the stockholdings of the minority shareholder at a jury-determined “fair value.” 25

18. Davis, 754 S.W.2d at 381–82.
19. See id. at 377–78.
20. See id. at 377.
21. See id. at 383.
22. Id. at 382.
23. See id.
24. Id. at 383.
25. Id. at 378, 380, 383. The Davis court also upheld various awards for damages, the appointment of a receiver, and an injunction prohibiting the majority shareholder
In *Willis v. Bydalek*, the First Court of Appeals again confronted a statutory action for shareholder oppression. In *Willis*, a minority shareholder was fired from his employment with a close corporation. The corporation paid no dividends, but the evidence indicated that the business had always been unprofitable. In conducting its shareholder oppression analysis, the *Willis* court cited the two definitions of “oppressive conduct” that were noted in *Davis*. After balancing “[the majority’s] business judgment in the face of four profitless years of operation against the [minority’s] reasonable expectations of participating in the business,” the *Willis* court concluded that no oppressive conduct had occurred. As the court stated, “we hold [that the majority] did not oppress [the minority] by firing him when (1) the jury found no wrong besides a [firing], (2) the corporation and [the majority shareholder], personally, always lost money, both before and after the [firing], and (3) the [minority shareholders] were at-will employees.”

As mentioned, Texas cases also allow shareholders to challenge oppressive conduct as a breach of fiduciary duty. In *Patton v. Nicholas*, T.W. Patton was the 60% owner of a close corporation. The other two shareholders, J.W. Nicholas and Robert R. Parks, each owned 20% of the company’s stock. The corporation continuously earned profits and the net worth of the corporation steadily increased. Patton, however, refused to declare a dividend. Nicholas and Parks eventually sued, alleging that Patton had committed fraud and abuse of his controlling position. At trial, the jury found in part that Patton “wrongfully dominated and controlled the Board of Directors so as to prevent the declaration of dividends,” and that Patton “did

from contributing to a profit-sharing plan unless a proportionate sum was paid to the minority shareholder. *See id.* at 378, 388.

26. *See Willis v. Bydalek*, 997 S.W.2d 798, 800–01 (Tex. App.—Houston [1st Dist.] 1999, writ denied). The shareholder oppression claim in *Willis* likely derived from article 7.05 of the Texas Business Corporation Act rather than from common-law fiduciary duty notions. Indeed, although the minority shareholder alleged a claim for breach of fiduciary duty, such a claim was not submitted to the jury. *See id.* at 800. Instead, the jury granted relief to the minority shareholder on a separate claim of “wrongful lock-out”—a claim that presumably stemmed from the statutory action for shareholder oppression. *See id.* at 799, 802 n.2.

27. *See id.* at 801.

28. *Id.* at 802.

29. *Id.*


31. *See id.*

32. *See id.* at 851.

33. *See id.* at 849.
this for the sole purpose of preventing Nicholas and Parks from sharing in the profits to be derived from the operation of the corporation.\textsuperscript{34} In affirming these jury findings, the \textit{Patton} court noted that “the malicious suppression of dividends is a wrong akin to breach of trust, for which the courts will afford a remedy.”\textsuperscript{35} The court crafted a mandatory injunction requiring the corporation to pay a reasonable dividend “at the earliest practical date” as well as in future years.\textsuperscript{36}

In \textit{Duncan v. Lichtenberger}, Waldron Duncan owned 60\% of a close corporation that operated a night club.\textsuperscript{37} C.F. Lichtenberger and D.M. Hogness each owned 20\% of the corporation’s shares. When the company began to experience financial difficulties, Duncan discharged Lichtenberger and Hogness from their corporate positions.\textsuperscript{38} Although Duncan continued to receive management fees and officer compensation, Lichtenberger and Hogness “never received any compensation as corporate officers and no dividends were ever distributed to shareholders.”\textsuperscript{39} In response to Duncan’s actions, Lichtenberger and Hogness asserted that Duncan had breached a fiduciary duty owed directly to them.\textsuperscript{40} The jury agreed and damages were awarded to the two minority shareholders.\textsuperscript{41} The \textit{Duncan} court upheld the jury’s findings, observing that “[t]he breach of a fiduciary duty is the type of wrong for which the courts of this State will afford a remedy.”\textsuperscript{42}

\textbf{III. IMPLICATIONS OF THE SHAREHOLDER OPPRESSION DOCTRINE}

\textbf{A. A Limitation on Employment at Will}

Because employment is often the vehicle for distributing the profits of a close corporation,\textsuperscript{43} a majority shareholder’s decision to terminate the employment of a minority shareholder may be considered oppressive, even if the minority shareholder can also

\begin{itemize}
  \item 34. \textit{Id.} at 852.
  \item 35. \textit{Id.} at 854.
  \item 36. \textit{Id.} at 857.
  \item 37. \textit{See} Duncan v. Lichtenberger, 671 S.W.2d 948, 950 (Tex. App.—Fort Worth 1984, writ ref’d n.r.e.).
  \item 38. \textit{See id.}
  \item 39. \textit{Id.} at 951.
  \item 40. \textit{See id.} at 951–52.
  \item 41. \textit{See id.} at 952 (declaring that “the jury found that a fiduciary duty had been breached, that such breach was the proximate cause of damages and that the damages could be compensated for by a set dollar amount”).
  \item 42. \textit{Id.} at 953.
  \item 43. \textit{See supra} note 10 and accompanying text.
\end{itemize}
be characterized as an at-will employee. Indeed, numerous courts, including *Duncan*, have granted oppression-based relief to minority shareholders challenging their terminations from close corporation employment.\(^{44}\) Even the First Court of Appeals noted in *Willis* that “[w]e are not holding that firing an at-will employee who is a minority shareholder can never, under any circumstances, constitute shareholder oppression; we simply hold that under these particular facts, it does not.”\(^{45}\) Although the *Willis* court referenced the employment at will doctrine in stating that “[e]xpectations of continued employment that are contrary to well settled law cannot be considered objectively reasonable,”\(^{46}\) the court seemed to suggest that oppression liability could arise when a minority shareholder is terminated from a profitable corporation, at least to the extent that the termination precludes the minority shareholder from receiving his proportionate share of the business returns.\(^{47}\)

**B. The End of Business Judgment Rule Deference**

The business judgment rule is a fundamental principle of corporate law that generally precludes courts from interfering with directors’ business decisions that have been made in good faith and with ordinary care.\(^{48}\) When the business judgment rule applies, judicial scrutiny of a board’s substantive business decision is practically non-existent. The directors are entitled to prevail when their actions are challenged so long as they can articulate any rational business purpose for their conduct.\(^{49}\) As a

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\(^{44}\) See, e.g., *Duncan*, 671 S.W.2d at 950, 953 (involving the “firing” of two minority shareholders); *Moll*, supra note 10, at 531 n.65, 559 & n.167 (citing cases); see also *W&W Equip. Co. v. Mink*, 568 N.E.2d 564, 574 (Ind. Ct. App. 1991) (acknowledging the employment at will rule but affirming a breach of fiduciary duty finding); *Pedro v. Pedro*, 463 N.W.2d 285, 289 (Minn. Ct. App. 1990) (“In a closely-held corporation the nature of the employment of a shareholder may create a reasonable expectation by the employee-owner that his employment is not terminable at will.”).


\(^{46}\) Id. at 803.

\(^{47}\) See *id.* at 802 (emphasizing that the corporation and the majority shareholder “always lost money” and distinguishing contrary authority on the grounds that they involved profitable corporations and majority shareholders who received compensation or other corporate benefits to the exclusion of the minority shareholder).

For an argument that a minority shareholder’s termination could be oppressive even if (1) the corporation is unprofitable, or (2) the discharged shareholder is still receiving his proportionate share of the business returns, see *Moll*, supra note 10, at 547–51, 568.


\(^{49}\) See, e.g., *Wheat*, 970 F.2d at 130–31 & n.13 (noting that a director or officer “shall not be held liable for honest mistake of judgment if he acted with due care, in good
result of this rule, judicial interference with board decisions involving employment, management, or dividend matters is rare.  

As mentioned, however, the shareholder oppression doctrine recognizes that decisions about such matters by a majority-controlled board can be part of a minority shareholder freeze-out.  

The oppression doctrine, therefore, is implicitly premised upon the notion that close corporation employment, management, and dividend decisions require more than a mere surface inquiry into the majority’s conduct.  Indeed, the fact that courts applying the oppression doctrine are subjecting the majority’s actions to “reasonable expectations” or “burdensome, harsh, and wrongful conduct” standards suggests that courts are requiring majority shareholders to do more than merely articulate a rational business purpose for their decisions.  In fact, some courts have explicitly acknowledged that majority shareholder decisions in close corporations call for more judicial scrutiny than conventional business judgment rule deference.

faith, and in furtherance of a rational business purpose”); see also Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (“A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose.”); Krishnan S. Chittur, Resolving Close Corporation Conflicts: A Fresh Approach, 10 HARV. J. L. & PUB. POL’Y 129, 154 (1987) (“So long as the controlling stockholder’s conduct is not outrageous—that is, a plausible business reason can be articulated—his decisions are protected by the business judgment rule.”).

50. See, e.g., Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 662 (Mass. 1976) (“[C]ourts fairly consistently have been disinclined to interfere in those facets of internal corporate operations, such as the selection and retention or dismissal of officers, directors or employees, which essentially involve management decisions subject to the principle of majority control.”); Donahue v. Rodel Electrotype Co., 328 N.E.2d 505, 513 (Mass. 1975) (“[T]he plaintiff will find difficulty in challenging dividend or employment policies. Such policies are considered to be within the judgment of the directors.” (footnote omitted)).

51. See supra notes 7–11 and accompanying text.

52. See supra text accompanying note 18.

53. See supra text accompanying note 18.

54. See, e.g., O’Donnell v. Marine Repair Servs., 530 F. Supp. 1199, 1205–08 (S.D.N.Y. 1982) (rejecting defendants’ asserted business justification as pretextual); cf. Zimmerman v. Bogoff, 524 N.E.2d 849, 854 (Mass. 1988) (same); Wilkes, 353 N.E.2d at 663–65 (concluding that the controlling shareholders’ employment and management decisions were improper because there was no evidence of a legitimate business purpose for the actions).

55. See, e.g., Smith v. Atlantic Properties, Inc., 422 N.E.2d 798, 801, 804 (Mass. App. Ct. 1981) (stating, in a close corporation dispute, that “[t]he judgment . . . necessarily disregards the general judicial reluctance to interfere with a corporation’s dividend policy ordinarily based upon the business judgment of its directors”); Fox v. 7L Bar Ranch, 645 P.2d 929, 935 (Mont. 1982) (“When it is also considered that in close corporations dividend withholding may be used by controlling shareholders to force out minority shareholders, the traditional judicial restraint in interfering with corporate dividend policy cannot be justified.” (internal quotation omitted)); Exadaktilos v. Cinnaminson Realty Co., 400 A.2d
C. Avoidance of Derivative Requirements

A majority shareholder’s fiduciary duty ordinarily runs to the corporation and not to the individual shareholders. Actions alleging breach of the majority’s fiduciary duty, therefore, are typically brought as “derivative” lawsuits on behalf of the corporation. In such lawsuits, the aggrieved shareholder “brings suit in the name of the corporation to redress the defendant’s breach of duty to the corporation and [to] the shareholders as a whole.” Derivative actions can be perilous, however, as they require the plaintiff shareholder to comply with a number of procedural requirements. For example, the derivative plaintiff must typically (1) possess an ownership interest in the corporation at the time of the alleged wrong; (2) represent fairly and adequately the interests of the corporation; and (3) make a demand “with particularity” upon the corporation’s board to take suitable action against the wrongdoers. Failure to comply with these requirements can result in the dismissal of the lawsuit.

In close corporations, however, there are precedents in Texas and in other jurisdictions involving a fiduciary duty owed by...
majority shareholders directly to minority shareholders. Because this duty runs to minority shareholders individually, courts have allowed the duty to be enforced in a direct action rather than in a derivative proceeding. As a consequence, minority shareholders in close corporations have been able to assert claims for breach of fiduciary duty (e.g., claims that controlling shareholders have misappropriated assets or have received excessive compensation) on their own behalf without needing to comply with the procedural hurdles accompanying a derivative lawsuit. Thus, the associated risk of dismissal on these procedural grounds is eliminated. Article 5.14(L) of the Texas Business Corporation Act supports this position by noting that most of the procedural requirements for derivative suits are not applicable to a “closely held corporation,” and by stating that “[i]f justice requires . . . a derivative proceeding brought by a shareholder of a closely held corporation may be treated by a court as a direct action brought by the shareholder for his own benefit . . . .”

IV. Conclusion

Although it has yet to receive the blessing of the Texas Supreme Court, the shareholder oppression doctrine has a firm toehold in Texas jurisprudence. Unfortunately, the precise contours of the doctrine are fuzzy at best. What is clear, however, is that the doctrine’s operation clashes with traditional employment at-will, business judgment rule, and derivative lawsuit principles, and it may significantly alter how those principles are applied. As a consequence, Texas lawyers need to familiarize themselves with the shareholder oppression doctrine. Simply put, when close corporation disputes are at issue, majority rule may no longer carry the day.

61. See, e.g., Hoggett, 971 S.W.2d at 488 n.13 (citing Texas cases); Alexander v. Sturkie, 909 S.W.2d 166, 170 n.2 (Tex. App.—Houston [14th Dist.] 1995, writ denied); supra note 16 and accompanying text; infra note 62.


63. See, e.g., Thompson, supra note 4, at 735–37; supra note 62.

64. TEX. BUS. CORP. ACT ANN. art. 5.14(L) (Vernon Supp. 2000).