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Ritchie v. Rupe and the Future of Shareholder Oppression

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In 1988, the Texas Court of Appeals held in *Davis v. Sheerin* that minority shareholders in close corporations are entitled to a buy-out of their shares if they are "oppressed" by the majority shareholders.[1] *Davis* synthesized other states' case law in order to arrive at a two-part test for shareholder oppression. Under this test, actions of majority shareholders are oppressive when they either (1) substantially defeat a minority shareholder's reasonable expectations or (2) constitute harsh or wrongful conduct that departs from the standards of fair dealing.[2] *Davis*, in short, is the type of opinion to which one does not have much to add—it carefully considered applicable precedent, the words of the relevant statute, and other jurisdictions' approaches to the problem. The *Davis* court also acknowledged that minority shareholders in close corporations are particularly vulnerable to oppression, as they cannot freely exit an enterprise in the same manner as a member of a partnership or a shareholder of a public corporation.[3] The test set out in *Davis*—which has rightly been described as "seminal"[4]—became the prevailing approach in Texas,[5] influenced case law in a number of other states,[6] and earned a prime place in black-letter corporations law.[7]

1. 754 S.W.2d 375, 381-82 (Tex. App. 1988).
2. *See id.*
3. *See id.* at 381. Texas law allows partners to withdraw from a venture and receive either a fair buy-out of their shares (if the partnership continues) or their portion of proceeds (if the partnership terminates). TEX BUS. ORGS. CODE ANN. §§ 152.501(b)(1), 152.601(1) (West 2006). Shareholders of a public corporation may sell their shares on the open market at any time.
4. Ritchie v. Rupe, No. 11-0447, 2014 WL 2788335, at *10 (Tex. June 20, 2014).
5. Respondents' Brief on the Merits at *18, Ritchie v. Rupe, No. 11-0447, 2014 WL 2788335 (Tex. June 20, 2014) (No. 11-0447), 2012 WL 6047972 (collecting cases).
6. *See, e.g.*, Baur v. Baur Farms, Inc., 780 N.W.2d 249 (Iowa Ct. App. Feb. 10, 2010); Bedore v. Familian, 125 P.3d 1168, 1172 n.20 (Nev. 2006); Lien v. Lien, 674 N.W.2d 816, 825 (S.D. 2004).
7. *See, e.g.*, ROBERT W. HAMILTON & JONATHAN R. MACEY, CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 500-07 (9th ed. 2005); *see also* John H. Matheson & R. Kevin Maler, *A Simple Statutory Solution to Minority Oppression in the Closely Held Business*, 91 MINN. L. REV. 657, 678 (2007) (discussing

No matter. In June of 2014, the Texas Supreme Court flatly overruled *Davis*. The Court's six-to-three opinion in *Ritchie v. Rupe*—labeled "astonishing" by one commentator[8]—gutted the cause of action for shareholder oppression in Texas.

This Essay argues that *Ritchie* was wrongly decided. Instead of adhering to precedent, the Texas Supreme Court adopted a cramped and formalistic reading of the shareholder oppression statute. The resulting opinion—just one in a series of anti-plaintiff rulings recently handed down by the Texas Supreme Court[9]—presents the narrowest interpretation of shareholder oppression remedies ever expressed in any judicial opinion.[10]

Other states, this Essay argues, should hesitate before following *Ritchie*. The problem is not simply that *Ritchie* is bad law. *Ritchie* is also bad policy—indeed, it may have disastrous economic effects. Although the full impact of the opinion has yet to be seen, this Essay contends that *Ritchie* is likely to disincentivize investment in close corporations, ramp up the frequency of shareholder oppression, and imperil the financial health of many small businesses.

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Ritchie v. Rupe involved a dispute between the majority shareholders of a small investment corporation and Ann Caldwell Rupe, who had inherited a minority stake in the business. When the majority shareholders became openly hostile toward her, Rupe requested that they purchase her minority stake so that she could exit the venture. The majority shareholders then offered Rupe $1 million for shares that a jury later valued at $7.3 million.[11] Rupe declined the offer and sent a note to Ritchie, a majority shareholder, asking when he would be available to meet with potential outside buyers of her shares. Ritchie informed Rupe that he would not attend such meetings. Rupe then sued Ritchie. The trial court and the Court of Appeals held that, since no reasonable purchaser would ever buy Rupe's shares without first meeting with the majority shareholders, Ritchie's conduct functionally prevented Rupe from

Davis); Barry M. Wertheimer, *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*, 47 DUKE L.J. 613, 642 n.138 (1998) (same).

8. *Shareholder Litigation*, 26 BUS. TORTS REP. 267, 267 (2014).

9. *See* Barry Barnett, *Do Plaintiffs Stand a Chance in the Texas Supreme Court—Part 3*, BLAWGLETTER (June 23, 2014, 3:50PM), http://blawgletter.typepad.com/bbarnett/2014/06/do-plaintiffs-stand-a-chance-in-the-texas-supreme-court-part-3.html [http://perma.cc/M7HL-BUTQ] (documenting recent plaintiffs' losses in the Texas Supreme Court).

10. Ritchie v. Rupe, No. 11-0447, 2014 WL 2788335, at *28 (Tex. June 20, 2014) (Guzman, J., dissenting).

11. *Ritchie*, 2014 WL 2788335, at *2-3.

alienating her shares.[12] Applying *Davis*, the Texas Court of Appeals found that Ritchie had defeated Rupe's "general reasonable expectation of being able to market her unrestricted stock."[13] The court therefore ordered Ritchie to buy out Rupe's shares at fair market value.

The Texas Supreme Court reversed, insisting that the buy-out remedy ordered by the Court of Appeals below was not available under the Texas Business Organizations Code.[14] The Court went on to hold that the standard for "oppressive" conduct set out in *Davis* was much too permissive.[15] The Court announced a new test under which the majority shareholders' conduct is considered oppressive only "when they abuse their authority over the corporation with the intent to harm the interests of one or more of the shareholders, in a manner that does not comport with the honest exercise of their business judgment, and by doing so create a serious risk of harm to the corporation."[16]

The *Ritchie* Court's restriction of remedies cannot be squared with the plain language of the Texas Business Organizations Code. Section 11.402(a) of that statute provides that a court may appoint a receiver for a domestic business entity if, "in an action by an owner or member of the domestic entity, it is established that . . . the actions of the governing persons of the entity are illegal, oppressive, or fraudulent."[17] Section 11.402(b) limits the scope of 402(a) by specifying that a "court may appoint a receiver under Subsection (a) only if . . . the court determines that *all other available legal and equitable remedies . . . are inadequate*."[18] The majority in *Ritchie* interpreted these provisions to "create[] a single cause of action with a single remedy: an action for appointment of a rehabilitative receiver."[19]

But this interpretation of Section 11.412(b) renders the statute's "all other available legal and equitable remedies" language meaningless, violating the rule against superfluities.[20] The *Ritchie* dissent rightly notes that, "[i]f no other

12. Ritchie v. Rupe, 339 S.W.3d 275, 296-97 (Tex. App. 2011), *rev'd* 2014 WL 2788335 (Tex. June 20, 2014).
13. *Ritchie*, 339 S.W.3d at 294.
14. *Ritchie*, 2014 WL 2788335, at *11 (majority opinion).
15. *Id.* at *9-10.
16. *Id.* at *9.
17. TEX. BUS. ORGS. CODE ANN. § 11.404(a) (West).
18. *Id.* § 11.404(b) (emphasis added).
19. *Ritchie*, 2014 WL 2788335, at *10. Under Texas law, "rehabilitative receivers" are occasionally appointed to control the affairs of financially imperiled corporations. The purpose of rehabilitative receivership is "to conserve the property and business of the domestic entity and avoid damage to interested parties." TEX. BUS. ORGS. CODE § 11.404(b)(1).
20. *See* Columbia Med. Ctr. of Las Colinas, Inc. v. Hogue, 271 S.W.3d 238, 256 (Tex. 2008) ("The Court must not interpret the statute in a manner that renders any part of the statute

remedies are available under the statute or common law, as the Court holds, the oppression statute would have no need to express a preference for their use."[21] For this reason, courts and commentators have agreed that the Texas statute—and similar statutes in other jurisdictions—must be read to authorize lesser remedies.[22] Tellingly, before *Ritchie* was decided, no other court had ever interpreted a shareholder oppression statute to foreclose all remedies other than receivership.[23]

Contrary to the formalist reasoning of the *Ritchie* majority, the fact that the statute does not expressly authorize a buy-out remedy does not mean that such a remedy is not available. When the legislature authorized receivership as a remedy for oppression, it was supplementing—not abrogating—previously existing equitable remedies.[24] This explains why the legislature never acted to overrule *Davis*, even though it had been law for twenty-five years. Alas, the Texas Supreme Court was not persuaded by this argument, even though it has previously recognized legislative acquiescence as an important factor in statutory interpretation.[25]

Ritchie is likely to have at least three major effects.

First, *Ritchie* will likely result in more abusive conduct toward minority shareholders. Under *Ritchie*, majority shareholders are not liable for oppression unless their conduct is irrational and harmful to the corporation. Given this framework, freeze-outs and squeeze-outs will become highly attractive to majority shareholders.

In the wake of *Ritchie*, many have advised potential minority shareholders that they can avoid freeze-outs and squeeze-outs by either (1) insisting that the venture become a statutory close corporation[26] or (2) negotiating ex ante for clear shareholder agreements that provide protections in the event of a

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meaningless or superfluous.").

21. *Ritchie*, 2014 WL 2788335, at *27 (Guzman, J., dissenting).

22. For an extensive collection of authorities supporting this proposition, *see id.* at *28 & nn. 26-30.

23. *Id.* at *28.

24. Brief of Amicus Curiae Erwin Cruz, M.D., in Support of the Respondent, Ritchie v. Rupe, No. 11-0447, 2014 WL 2788335 (Tex. June 20, 2014), No. 11-0447, 2013 WL 314975, at *6-9 (making this argument at length and collecting cases in accord).

25. Grapevine Excavation, Inc. v. Maryland Lloyds, 35 S.W.3d 1, 5 (Tex. 2000) ("It is a firmly established statutory construction rule that once appellate courts construe a statute and the Legislature re-enacts or codifies that statute without substantial change, we presume that the Legislature has adopted the judicial interpretation.").

26. Shareholders in a close corporation may elect statutory status under Texas law, in which case certain additional protections are due to minority shareholders. For example, statutory close corporations must be managed according to the terms of a shareholder agreement. TEX. BUS. ORGS. CODE ANN. § 21.715 (West 2003).

disagreement.[27] But minority shareholders in close corporations are often relatives or personal friends of the majority shareholders.[28] Others are small business owners. Many of these minority shareholders are not sophisticated actors or repeat players, and therefore they will not know that they need to negotiate for additional protections. Thus, the real effect of *Ritchie* is to shift the default from a regime in which shareholder-oppression claims are viable to a "Hobbesian state-of-nature" that "would leave the bulk of family businesses and small businesses exposed, unless they each had the foresight, funds, and tactical nous to hire lawyers to re-create the 'oppression' wheel for each new business that gets formed."[29]

Second, *Ritchie* will likely disincentivize investment in Texas close corporations. Absent the protections afforded by *Davis*, rational businesspeople may find that investing in a Texas close corporation is too risky. Investors—eager to avoid freeze-outs and squeeze-outs—will flock to large public corporations or partnerships. This, in turn, could cause major macroeconomic damage. Indeed, in the wake of *Ritchie*, "[s]hares of closely-held corporations [will] become unmarketable, . . . and innovative, small, and growing companies—the 'job creators' we hear so much about—will find capital hard to come by."[30] The economy at large will end up paying a price for the folly of *Ritchie*. And if Texas continues to follow *Ritchie* while other states protect minority shareholders, potential minority investors may well take their money outside the Lone Star State. It is only a matter of time before "[c]apital will make its way to other areas of the country in which small, risk-taking investors cannot be held hostage by a majority of shareholders."[31]

Third, Ritchie will likely damage the economic health of many close corporations. By enabling majority shareholders to prevent minority shareholders from freely alienating their shares, the *Ritchie* decision may well prevent share valuation in close corporations. Many courts—including the United States Supreme Court[32]—have recognized that "[s]hare valuation is not solely about a minority shareholder's personal gain, but rather assessing

27. *See, e.g.*, *Texas Supreme Court Rejects a General Cause of Action for Minority Shareholder Oppression*, BRACEWELL & GIULIANI LLP (July 9, 2014), http://www.bracewellgiuliani.com/news-publications/updates/texas-supreme-court-rejects-general-cause-action-minority-shareholder-oppr [http://perma.cc/9GQK-FA7Q].

28. Douglas Moll, *Majority Rule Isn't What It Used to Be: Shareholder Oppression in Texas Close Corporations,* 63 TEX. BUS. J. 434, 436 (2000); *see also Ritchie*, 2014 WL 2788335, at *13.

29. Brief of Amicus Curiae Erwin Cruz, M.D., *supra* note 24, at *12.

30. Brief of Amicus Curiae Texas Trial Lawyers Association in Support of Respondents at *5, Ritchie v. Rupe, No. 11-0447, 2014 WL 2788335 (Tex. June 20, 2014).

31. *Id.*

32. Basic Inc. v. Levinson, 485 U.S. 224, 244-45 (1988).

corporate value, a task beneficial to the corporation and to all shareholders."[33] *Ritchie* has the effect of complicating (or preventing) corporate valuation. When the company cannot be evaluated, the shares cannot be accurately priced; when shares cannot be accurately priced, they are more speculative and less valuable.[34] This lessens the value of the entire business. Moreover, *Ritchie*'s instruction that the majority shareholder need not allow inspection of the books may prevent the discovery of fraud, breach of fiduciary duty, or other business torts. For these reasons, some have gone so far as to argue that efforts to prevent share valuation and limit share liquidity may violate the business judgment rule.[35]

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In the wake of *Ritchie*, minority shareholders are already having a much tougher time in the courts. In the recent case of Cardiac Perfusion Services, Inc. v. Hughes, for example, the Texas Supreme Court cited *Ritchie* en route to holding that a buy-out remedy was not available even when a majority shareholder had refused to pay dividends while overpaying himself, intentionally reduced the value of minority shares, and denied access to books and records.[36]

As other states continue to grapple with the contours of their own shareholder-oppression law, they may be tempted to follow Texas and cut back on shareholder oppression. That temptation should be resisted. *Ritchie v. Rupe* is misguided, formalistic, and at odds with a wealth of precedent. Other states would be well advised to ignore *Ritchie* entirely and to rely instead on the sound reasoning set out so long ago in *Davis*.

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33. Brief of Trial Lawyers Association, *supra* note 32, at *7 (citing *Basic Inc.*, 485 U.S. at 244-45).

34. *See* Robert B. Thompson, *The Shareholder's Cause of Action for Oppression*, 48 BUS. LAW. 699, 702 n.23 (1993) (citing FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 230-31 (1991)).

35. Brief of Trial Lawyers Association, *supra* note 32, at *9. Under the business-judgment rule, "[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." Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

36. No. 13-0014, 2014 WL 2896002, at *1 (Tex. June 27, 2014).