

PUBLICATION

Texas Ruling Highlights the Need for Shareholder Agreements in Closely Held Corporations

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On June 20, 2014, the Texas Supreme Court issued a landmark decision that brings to light the importance of every corporation, especially closely held corporations, having a comprehensive shareholders' agreement that addresses important issues that may arise during the life of a corporation.

Ritchie v. Rupe provides a cautionary tale of what can happen when a closely held corporation does not have a shareholders' agreement. In *Ritchie v. Rupe*, Ann Rupe and her son inherited 18 percent of a closely held corporation from Rupe's husband. The corporation did not have a shareholders' agreement. The relationship between Rupe and her deceased husband's family, who owned the majority of the corporation's shares, became hostile; therefore, Rupe asked the corporation to redeem her shares. Because there was no shareholders' agreement, there was no formula in place for determining a valuation of shares. Therefore, the majority shareholders used a formula that they had "previously used" to formulate an offer to redeem Rupe's shares. This was not satisfactory to Rupe and she began to search for prospective outside purchasers. The majority shareholders, however, refused to meet with the prospective purchasers, and, again, because there was no shareholders' agreement, they were not required to. Because Rupe was unable to sell her shares, she filed suit against various members of the corporation, alleging they engaged in oppressive conduct and requesting that the court enter an order requiring the corporation to purchase her shares at fair market value. Rupe succeeded in the trial court and in front of the Dallas Court of Appeals. However, the Texas Supreme Court reversed the judgment of the court of appeals and held that the majority shareholders did not engage in oppressive conduct in violation of Texas law.

The Texas Supreme Court placed significant importance on the fact that the majority shareholders had no contractual duty to meet with prospective buyers and had no specific contractual requirements they had to meet regarding the valuation of Rupe's shares. The Court recognized that the directors' refusal to meet with prospective purchasers placed Rupe in a difficult situation that prevented her from selling her shares, but the Court stated that "shareholders of closely held corporations may address and resolve such difficulties by entering into shareholders' agreements that contain buy-sell, first refusal, or redemption provisions." The Court's ruling rested heavily on the Court's discussion of the many provisions that closely held corporations can include in shareholders' agreements so as to avoid situations such as the one that arose between Rupe and the majority shareholders. The Court recognized that "by definition, a closely held corporation is owned by a small number of shareholders whose shares are not publicly traded" and "often, these shareholders enjoy personal relationships as friends or family members in addition to their business relationship." For these reasons, the Court noted the importance of closely held corporations entering into shareholder agreements.

The Texas Supreme Court's holding in *Ritchie v. Rupe* brings to light the importance of corporations entering into a shareholders' agreement at the outset that define things such as their respective management and voting powers, the apportionment of losses and profits, the payment of dividends, and their rights to buy or sell their shares from or to each other, the corporation, or an outside party because things don't work out as planned. As the Court stated, "Shareholders die, businesses struggle, relationships change, and disputes arise." When, as in *Ritchie v. Rupe*, there is no shareholders' agreement, minority shareholders who lack both contractual rights and voting power may have no control over how those disputes are resolved. Additionally, on the other side of the coin, majority shareholders may get tied up in lengthy, expensive litigation over issues that

could have been addressed and resolved amicably based on the terms of a previously agreed upon shareholders' agreement.

For more information about shareholder agreements, please contact your Baker Donelson attorney or a member of our Mergers & Acquisitions group.