

## Derivative Shareholder Litigation Involving Closely Held Corporations

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The Texas Supreme Court's recent decision in *Sneed v. Webre* strengthened the rights of shareholders of closely held corporations to challenge irresponsible or self-serving corporate management. *Sneed v. Webre*, No. 12-0045, 2015 WL 3451653 (Tex. May 29, 2015). Many small businesses in Texas operate as closely held corporations, i.e., the company has less than thirty-five shareholders and is not publicly traded. Tex. Bus. Orgs. Code § 21.563 (2015). The Court's opinion reinforced the legislature's prerogative to provide shareholders of closely held corporations easier access to judicial relief in derivative actions. It ultimately held (1) shareholders of closely held corporations could bypass the board of directors in pursuing derivative claims against the company, and (2) in the closely held corporation context, a shareholder of a parent corporation may bring a "double derivative" suit on behalf of a subsidiary entity. See *Sneed*, at \*10, \*15.

- **Factual and Procedural Background**

Lloyd Webre owned 24% of Texas United, a closely held corporation with multiple subsidiaries, including United Salt. Webre filed a derivative suit on behalf of United Salt and alleged that the defendants misrepresented the terms of a transaction to United Salt's board of directors, which caused United Salt to enter into an unprofitable acquisition.

The trial court found that Webre lacked standing to bring his derivative claims, and dismissed his lawsuit. The Court of Appeals reversed and held that the shareholder had double-derivative standing to sue, and that the business judgment rule did not impose a jurisdictional barrier that the shareholder had to overcome to bring a derivative lawsuit on behalf of a closely held corporation. The defendants appealed to the Texas Supreme Court and argued that Webre was required to plead and prove facts to overcome the board of directors' business judgment not to pursue the closely held corporation's cause of action and that his double-derivative suit was barred.

- **The Board of Directors of a Closely Held Corporation May Not Interfere with a Shareholder's Derivative Suit.**

The Court first addressed the defendants' argument that the business judgment rule "vests responsibility for decision-making in the corporation's board of directors and precludes shareholders from disrupting the board's decisions through derivative actions when the board has determined a particular action is or is not in the corporation's best interest." The court was not convinced, and stressed that article 5.14(L) of the Business Corporations Act<sup>[1]</sup> expressly permits a shareholder in a closely held corporation to file a derivative suit without serving a written demand on the corporation explaining the concerns regarding the corporation's potential cause of action and requesting the corporation to take suitable action.

The Supreme Court explained, "[B]y removing the demand requirement, the Legislature gave shareholders of closely held corporations the right to pursue corporate causes of action derivatively without interference from the board of directors." The court further rejected the defendants' contention that even if demand is not required, the shareholder must prove that the board acted wrongfully in failing to pursue the action, and reasoned that by virtue of the statute, "closely held

corporations do not have the same deference to their boards of directors' decision?making with respect to pursuing corporate causes of action.”

- **Shareholders of a Parent Corporation Have Standing to Pursue a Derivative Claim on Behalf of a Subsidiary Corporation.**

Next, the Court clarified whether a shareholder of a parent company could maintain a derivative action on behalf of a subsidiary by virtue of his ownership in the parent corporation. The Supreme Court underscored that a shareholder of a parent corporation, as the beneficial owner of the corporation’s assets, has equitable ownership of a subsidiary corporation as well. “Thus, in the closely held corporation context, the derivative plaintiff is not required to be a shareholder of the corporation he is bringing suit on behalf of, and the definition of a shareholder does not exclude those with a beneficial or equitable interest in a subsidiary.”

The Court believed that this was a necessary result, “otherwise, the directors of a closely held holding corporation could create a wholly owned subsidiary to circumvent the Legislature’s intent to make it easier for shareholders to assert derivative proceedings on behalf of closely held corporations.” It rejected any interpretation of the statute<sup>[2]</sup> that deprived the corporation of any remedy for wrongdoing by the majority shareholders, and concluded that “double-derivative” suits were permissible under Texas law.

- **Conclusion**

Arriving less than a year after the court abolished the shareholder oppression cause of action, the *Sneed* opinion should be viewed as a victory for minority shareholders—and a warning for majority owners—in closely held corporations. Not only does it transfer control of shareholder-derivative litigation from the board of directors to the shareholders, but it also prevents majority owners from shielding their actions from derivative lawsuits by operating via a wholly owned subsidiary.

[1] Now codified as Tex. Bus. Orgs. Code § 21.653(b) (2015).

[2] Tex. Bus. Orgs. Code § 21.653(b) (2015).

## **Related Practices**

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