Derivative Actions Under the Business Organizations Code

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DERIVATIVE ACTIONS UNDER THE TEXAS BUSINESS ORGANIZATIONS CODE

By

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CHAPTER 1. INTRODUCTION

The Texas Legislature enacted the Texas Business Organizations Code (the "***TBOC***") to codify the Texas statutes relating to business entities, together with the Texas statutes governing the formation and operation of other for-profit and non-profit private sector entities.[1] The TBOC is applicable to entities formed or converting to another entity form under Texas law after January 1, 2006. Entities in existence on January 1, 2006 could continue to be governed by the Texas source statutes until January 1, 2010, after which time they must conform to the TBOC.

Like Texas, Delaware has a body of statutory and case law relating to corporations as well as alternative entities, including partnerships (general and limited) and LLCs. Those statutes include the Delaware General Corporation Law (as amended, the "***DGCL***"), the Delaware Revised Uniform Partnership Act ("***DRPA***"), the Delaware Revised Limited Partnership Act ("***DRLPA***") and the Delaware Limited Liability Company Act (the "***DLLCA***").

The fiduciary duties of directors or other governing persons of an entity and its officers are generally owed to the corporation, limited liability company ("***LLC***") or limited partnership ("***LP***") entity

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1 The TBOC is principally a codification of the existing Texas statutes governing for-profit and non-profit private-sector entities, rather than substantive modifications to existing law. These statutes, which are now repealed and replaced by the TBOC, consisted of the following: the Texas Business Corporation Act (the "***TBCA***"), the Texas Non-Profit Corporation Act (the "***TNPCA***"), the Texas Miscellaneous Corporation Laws Act (the "***TMCLA***"), the Texas Limited Liability Company Act (the "***LLC Act***"), the Texas Revised Partnership Act (the "***TRPA***"), the Texas Revised Limited Partnership Act (the "***TRLPA***"), The Texas Real Estate Investment Trust Act (the "***TREITA***"), the Texas Uniform Unincorporated Nonprofit Associations Act ("***TUUNA***"), the Texas Professional Corporation Act (the "***TPCA***"), the Texas Professional Associations Act (the "***TPAA***"), the Texas Cooperative Associations Act (the "***TCAA***").

they serve and not to any individual owners.[2] Thus, a cause of action against a director or other governing persons of an entity and its officers for breach of fiduciary duty would be vested in, and brought by or in the right of, the entity.[3] Since the cause of action belongs to the entity and the power to manage the business and affairs of an entity generally resides in its board of directors or other governing body ("***Board***"),[4] a disinterested Board would have the power to determine whether to bring or dismiss a breach of fiduciary duty claim for the entity.[5]

Statutes in both Texas[6] and Delaware[7] authorize an action brought in the right of the entity by a stakeholder against its Board for breach of fiduciary duty.[8] Such an action is called a "***derivative action***." Texas and Delaware also recognize situations where a derivative claim may be brought directly (rather than in a derivative action) by an injured stakeholder.[9]

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2 *Somers v. Crane*, 295 S.W.3d 5, 11-12 (Tex. App.—Houston [1st Dist.] 2009, pet. denied); *R2 Enterprises v. Whipple*, No. 2-07-257-CV, 2008 WL 2553444, 2008 Tex. App. LEXIS 4780 (Tex. App.—Fort Worth 2008) ("An individual stakeholder in a legal entity does not have a right to recover personally for harms done to the legal entity. *Wingate v. Hajdik*, 795 S.W.2d 717, 719 (Tex. 1990), *superseded by statute as stated in Sneed v. Webre*, 465 S.W.3d 169, 188 (Tex. 2015); *Nauslar v. Coors Brewing Co.*, 170 S.W.3d 242, 250 (Tex. App.—Dallas 2005, no pet.) (applying rule to partnerships). A stakeholder does not have standing to seek damages on a cause of action belonging to an entity alone, such as when the damages are based on diminution of the entity's worth or the entity's loss of profits."). *See* EGAN ON ENTITIES at notes 578, 630-739, 766-768.

3 *Redmon v. Griffith*, 202 S.W.3d 225, 233-234 (Tex. App.—Tyler 2006, pet. denied), *disapproved of by Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014); *Somers v. Crane*, 295 S.W.3d 5, 11-12 (Tex. App.—Houston [1st Dist.] 2009, pet. denied) ("[B]ecause of the abundant authority stating that a director's or officer's fiduciary duty runs only to the corporation, not to individual shareholders, we decline to recognize the existence of a fiduciary relationship owed directly by a director to a shareholder in the context of a cash-out merger. Accordingly, we hold that the Class cannot bring a cause of action directly against appellees for breach of fiduciary duty."); *A. Copeland Enters., Inc. v. Guste*, 706 F. Supp. 1283, 1288 (W.D. Tex. 1989) ("Claims concerning breach of a corporate director's fiduciary duties can only be brought by a shareholder in a derivative suit because a director's duties run to the corporation, not to the shareholder in his own right.").

4 DGCL § 141(a); *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244, 253-54 (Del. 2000). The TBOC provisions governing derivative proceedings for LLCs are in TBOC § 101.451 – 463 and for LPs are in TBOC § 153.401 – 153.405.

5 *See Wingate v. Hajdik*, 795 S.W.2d 717, 719 (Tex. 1990), *superseded by statute as stated in Sneed v. Webre*, 465 S.W.3d 169, 188 (Tex. 2015) ("Ordinarily, the cause of action for injury to the property of a corporation, or the impairment or destruction of its business, is vested in the corporation, as distinguished from its stockholders . . . ."); *Pace v. Jordan*, 999 S.W.2d 615, 622 (Tex. App.—Houston [1st Dist.] 1999, pet. Denied) (noting that "[a] corporation's directors, not its shareholders, have the right to control litigation of corporate causes of action").

6 The TBOC provides that the TBOC provisions applicable to corporations (TBOC Titles 1 and 2) may be officially and collectively known as "Texas Corporation Law," however, because until 2010 some Texas for-profit corporations were governed by the TBCA and others by the TBOC, and because the substantive principles under both statutes are generally the same, the term "Tex. Corp. Stats." is used herein to refer to the TBOC and the TBCA (as supplemented by the TMCLA) collectively. The TBOC provisions relating to corporate derivative actions are in §§ 21.551-21.563; TBCA art. 5.14.

7 Del. Ct. of Chancery R. 23.1.

8 *See Wingate v. Hajdik*, 795 S.W.2d 717, 719 (Tex. 1990), *superseded by statute as stated in Sneed v. Webre*, 465 S.W.3d 169, 188 (Tex. 2015) ("Ordinarily, the cause of action for injury to the property of a corporation, or the impairment or destruction of its business, is vested in the corporation, as distinguished from its stockholders . . . ."); *Pace v. Jordan*, 999 S.W.2d 615, 622 (Tex. App.—Houston [1st Dist.] 1999, pet. Denied) (noting that "[a] corporation's directors, not its shareholders, have the right to control litigation of corporate causes of action").

9 *See infra* note 50-57 and related text (TBOC § 21.563 permitting a claim by a shareholder of a closely held corporation to be treated as a direct claim if justice requires); *Moroney v. Moroney*, 286 S.W. 167, 170 (Tex. Com. App. 1926) (applying Texas law and allowing the shareholder to pursue a direct claim for payment of dividends, reasoning that the claim "is not so much an action by the wards to recover damages to their stock, as it is to recover a loss of specific profits they would have

The TBCA is continually being updated and improved through the efforts of the Texas Business Law Foundation and the Business Law Section of the State Bar of Texas in an effort to make Texas a more attractive jurisdiction for the organization of entities.[10] This updating process continued in the 86th Texas Legislature, Regular Session (the "***2019 Legislative Session***"), which convened on January 11, 2019 and adjourned on May 27, 2019. The TBOC was amended in the 2019 Legislative Session to make consistent derivative proceedings provisions governing for profit corporations with those governing LLCs and LPs by House Bill No. 3603, which became effective on September 1, 2019 and is attached as **ANNEX A** (H.B. 3603).

CHAPTER 2. DIRECT VERSUS DERIVATIVE ACTIONS.

2.1. Delaware Law on Direct Versus Derivative Actions.

In *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, the Delaware Supreme Court set forth the analytical framework for ascertaining whether a cause of action is direct or derivative in Delaware and held that this determination can be made by answering two questions: "[W]ho suffered the alleged harm . . . and who would receive the benefit of any recovery or other remedy . . . ?"[11] The Delaware Supreme Court elaborated on this analysis in *Feldman v. Cutaia*:

> If the corporation alone, rather than the individual stockholder, suffered the alleged harm, the corporation alone is entitled to recover, and the claim in question is derivative. Conversely, if the stockholder suffered harm independent of any injury to the corporation that would entitle him to an individualized recovery, the cause of action is direct.[12]

The Delaware Supreme recently confirmed that the *Tooley* analysis applies to companies governed by contract (LLCs and LPs), rejecting the notion that any claim sounding in contract is direct by default.[13] In *El Paso Pipeline GP Co., L.L.C. v. Brinckerhoff*, a limited partner alleged that the general partner breached the limited partnership agreement's conflicts of interest provision. The "core theory" of plaintiff's complaint "was that 'the Partnership was injured' when the defendants caused [the Partnership] to pay too much" in a conflicted transaction.[14]

The *El Paso* court reversed the lower court's holding, which held that in the limited partnership context, limited partners can sue directly to enforce contractual constraints in the limited partnership agreement, holding instead that a plaintiff's status as a party to the contract does not alone enable him to

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earned"); *see infra* notes 11-23 and related text (highlighting Delaware case law allowing a derivative claim to be brought directly).

10 See *EGAN ON ENTITIES* 5-8.

11 845 A.2d 1031, 1033 (Del. 2004).

12 951 A.2d 727, 732 (Del. 2008). *Compare In re Primedia, Inc. Shareholders Litigation (Primedia II)*, 67 A.3d 455, 478 (Del. Ch. May 10, 2013) (plaintiffs whose standing to pursue derivative insider trading claims had been extinguished by merger had standing in a class action to challenge directly the entire fairness of that merger based on a claim that the target Board failed to obtain sufficient value in the merger for the pending derivative claims) *with Binks v. DSL.net, Inc.*, C.A. No. 2823-VCN, 2010 WL 1713629, at *12-*13, 2010 Del. Ch. LEXIS 98, at *47 (Del. Ch. April 29, 2010) (claims that Board breached its fiduciary duties by authorizing the sale of convertible notes so cheaply that waste of corporate assets resulted are derivative).

13 *El Paso Pipeline GP Co., L.L.C. v. Brinckerhoff*, 152 A.3d 1248, 1260 (Del. 2016).

14 152 A.3d 1248, 1260 (Del. 2016).

litigate every claim arising from the agreement.[15] Instead, the Delaware Supreme Court found that "it is plain under the limited partnership agreement that the limited partnership itself was entitled in the first instance to sue and obtain recovery against the general partner and its co-defendants for any claim that the transaction was economically unfair to the limited partnership. That individual limited partners might press the limited partnership's rights as derivative plaintiffs does not make the claims ones belonging to them individually."[16]

Accordingly, plaintiff's status as a limited partner and party to the limited partnership agreement did not enable the plaintiff to litigate directly every claim arising from the limited partnership agreement. "Such a rule would essentially abrogate *Tooley* with respect to alternative entities merely because they are creatures of contract."[17] Hence, when a claim stems from breach of a contractual duty owed to the company, the court must still employ the *Tooley* test to determine whether the claim to enforce the company's rights must be asserted derivatively or whether it is dual in nature such that it can proceed directly, just as a court would do in a breach of fiduciary duty claim.

Subject to the exceptions set forth by the *Gentile v. Rosette* case below, claims of overpayment are generally treated as causing harm solely to a corporation and, thus, are regarded as derivative.[18] This rule extends to a plaintiff seeking to recover for an alleged disclosure violation—a plaintiff in a disclosure case must allege damages distinct to those which the corporation would be entitled to recover on a derivative claim arising out of the same facts.[19] The Delaware Supreme Court affirmed dismissal of a class action alleging a breach of the duty of disclosure in connection with J.P. Morgan's acquisition of Bank One Corporation.[20] In that case, the plaintiffs argued that J.P. Morgan overpaid for Bank One and that the "issuance of $7 billion worth of [J.P. Morgan] shares" to consummate the transaction "resulted in a dilution of the proportionate economic value and voting power" of the plaintiffs' shares.[21] The Court held that, even assuming that improper disclosures caused the alleged $7 billion in damages and dilution the plaintiffs claimed, the harm was to J.P. Morgan, not directly to the shareholders.[22] Accordingly, the Court held that the could not be maintained directly by the plaintiffs because claimed damages flowing from the alleged disclosure violation were identical to those allegedly suffered by J.P. Morgan.

In *Gentile v. Rossette*,[23] the Delaware Supreme Court established that certain equity dilution claims may be pled both derivatively and directly against a controlling shareholder and directors who authorized

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15 152 A.3d 1248, 1255 (Del. 2016).

16 152 A.3d 1248, 1259 (Del. 2016).

17 152 A.3d 1248, 1259-1260 (Del. 2016).

18 *Gentile v. Rossette*, 906 A.2d 766, 772 (Del. 2006).

19 *See J.P. Morgan I*, 906 A.2d at 825 (observing that, when "the damages flowing from the disclosure violation are exactly the same as those suffered by [the corporation] in the underlying claim[,] . . . the injury alleged in the complaint is properly regarded as injury to the corporation, not to the class," and therefore, "the claim for actual damages, if there is one, belongs to the corporation and can only be pursued by the corporation, directly or derivatively").

20 *In re J.P. Morgan Chase & Co. Shareholder Litig. (J.P. Morgan II)*, 906 A.2d 766, 768 (Del. 2006).

21 906 A.2d 766, 772 (Del. 2006).

22 906 A.2d 766, 774-75 (Del. 2006) (quoting *In re Paxson Commc'n Corp. S'holder Litig.*, 2001 Del. Ch. LEXIS 95, 2001 WL 812028, at *5 (Del. Ch. July 12, 2001) ("[D]ilution claims are individual in nature only where a significant stockholder's interest is increased at the sole expense of the minority" and not "where the entity benefiting from the allegedly diluting transaction . . . is a third party rather than an existing significant or controlling stockholder.").

23 906 A.2d 91, 103 (Del. 2006). *See* EGAN ON ENTITIES at notes 527-534 and related text.

an unfair self-dealing transaction with the controlling shareholder. In *Gentile*, the plaintiffs were former minority shareholders suing for breach of fiduciary duty against the corporation's former directors and its CEO/controlling stockholder arising from a self-dealing transaction in which the CEO/controlling stockholder forgave the corporation's debt to him in exchange for being issued stock whose value allegedly exceeded the value of the forgiven debt. The transaction wrongfully reduced the cash-value and the voting power of the public stockholders' minority interest, and increased correspondingly the value and voting power of the controller's majority interest. After the debt conversion, the corporation was later acquired by another company in a merger and shortly after the merger, the acquirer filed for bankruptcy and was liquidated. The plaintiffs then sued in the Court of Chancery to recover the value of which they claimed to have been wrongfully deprived in the debt conversion. The Supreme Court held that the former minority stockholders could bring a direct claim against the fiduciaries responsible for the debt conversion transaction complained of. In so holding Justice Jacobs explained:

> To analyze the character of the claim at issue, it is critical to recognize that it has two aspects. The first aspect is that the corporation . . . was caused to overpay for an asset or other benefit that it received in exchange (here, a forgiveness of debt). The second aspect is that the minority stockholders lost a significant portion of the cash value and the voting power of their minority stock interest. Those separate harms resulted from the same transaction, yet they are independent of each other.
>
> Normally, claims of corporate overpayment are treated as causing harm solely to the corporation and, thus, are regarded as derivative. The reason (expressed in *Tooley* terms) is that the corporation is both the party that suffers the injury (a reduction in its assets or their value) as well as the party to whom the remedy (a restoration of the improperly reduced value) would flow. In the typical corporate overpayment case, a claim against the corporation's fiduciaries for redress is regarded as exclusively derivative, irrespective of whether the currency or form of overpayment is cash or the corporation's stock. Such claims are not normally regarded as direct, because any dilution in value of the corporation's stock is merely the unavoidable result (from an accounting standpoint) of the reduction in the value of the entire corporate entity, of which each share of equity represents an equal fraction. In the eyes of the law, such equal "injury" to the shares resulting from a corporate overpayment is not viewed as, or equated with, harm to specific shareholders individually.
>
> There is, however, at least one transactional paradigm—a species of corporate overpayment claim—that Delaware case law recognizes as being both derivative and direct in character. A breach of fiduciary duty claim having this dual character arises where: (1) a stockholder having majority or effective control causes the corporation to issue "excessive" shares of its stock in exchange for assets of the controlling stockholder that have a lesser value; and (2) the exchange causes an increase in the percentage of the outstanding shares owned by the controlling stockholder, and a corresponding decrease in the share percentage owned by the public (minority) shareholders. Because the means used to achieve that result is an overpayment (or "over-issuance") of shares to the controlling stockholder, the corporation is harmed and has a claim to compel the restoration of the value of the overpayment. That claim, by definition, is derivative.

But, the public (or minority) stockholders also have a separate, and direct, claim arising out of that same transaction. Because the shares representing the "overpayment" embody both economic value and voting power, the end result of this type of transaction is an improper transfer—or expropriation—of economic value and voting power from the public shareholders to the majority or controlling stockholder. For that reason, the harm resulting from the overpayment is not confined to an equal dilution of the economic value and voting power of each of the corporation's outstanding shares. A separate harm also results: an extraction from the public shareholders, and a redistribution to the controlling shareholder, of a portion of the economic value and voting power embodied in the minority interest. As a consequence, the public shareholders are harmed, uniquely and individually, to the same extent that the controlling shareholder is (correspondingly) benefited. In such circumstances, the public shareholders are entitled to recover the value represented by that overpayment—an entitlement that may be claimed by the public shareholders directly and without regard to any claim the corporation may have.[24]

In deference to the power of the Board, a shareholder would ordinarily be expected to demand that the Board commence the action before commencing a derivative action on behalf of the corporation.[25] An independent and disinterested Board could then decide whether commencing the action would be in the best interest of the corporation and, if it concludes that the action would not be in the best interest of the corporation, could decide to have the action dismissed.[26] Texas and Delaware differ in cases in which

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[24] *Id.* at 99-100.

[25] DEL. CT. OF CHANCERY R. 23.1; TBOC § 21.553; TBCA art. 5.14(C).

[26] TBOC § 21.558, as amended by H.B. 3603, provides:

> Section 21.558. Dismissal of Derivative Proceeding. (a) A court, sitting in equity as the finder of fact, shall dismiss a derivative proceeding on a motion by the corporation if the person or group of persons described by Section 21.554 determines in good faith, after conducting a reasonable inquiry and based on factors the person or group considers appropriate under the circumstances, that continuation of the derivative proceeding is not in the best interests of the corporation.
>
> (b) In determining whether the requirements of Subsection (a) have been met, the burden of proof shall be on:
>
> (1) the plaintiff shareholder if:
>
> (A) the majority of the board of directors consists of independent and disinterested directors at the time the determination is made;
>
> (B) the determination is made by a panel of one or more independent and disinterested persons appointed under Section 21.554(a)(3); or
>
> (C) the corporation presents prima facie evidence that demonstrates that the applicable person or persons making the determination under Section 21.554(a) are independent and disinterested; or
>
> (2) the corporation in any other circumstance.

The terms "Disinterested Person" and "Independent Person" are defined in TBOC §§ 1.003 and 1.004 as follows:

> Sec. 1.003. Disinterested Person.
>
> (a) For purposes of this code, a person is disinterested with respect to the approval of a contract, transaction, or other matter, or to the consideration of the disposition of a claim or challenge relating to a contract, transaction, or particular conduct, if the person or the person's associate:
>
> (1) is not a party to the contract or transaction or materially involved in the conduct that is the subject of the claim or challenge; and

(2) does not have a material financial interest in the outcome of the contract or transaction or the disposition of the claim or challenge.

(b) For purposes of Subsection (a), a person is not materially involved in a contract or transaction that is the subject of a claim or challenge and does not have a material financial interest in the outcome of a contract or transaction or the disposition of a claim or challenge solely because:

(1) the person was nominated or elected as a governing person by a person who is:

(A) interested in the contract or transaction; or

(B) alleged to have engaged in the conduct that is the subject of the claim or challenge;

(2) the person receives normal fees or customary compensation, reimbursement for expenses, or benefits as a governing person of the entity.

(3) the person has a direct or indirect equity interest in the entity;

(4) the entity has, or its subsidiaries have, an interest in the contract or transaction or was affected by the alleged conduct;

(5) the person or an associate of the person receives ordinary and reasonable compensation for reviewing, making recommendations regarding or deciding on the disposition of the claim or challenge; or

(6) in the case of a review by the person of the alleged conduct that is the subject of the claim or challenge:

(A) the person is named as a defendant in the derivative proceeding regarding the matter or as a person who engaged in the alleged conduct; or

(B) the person, acting as a governing person, approved, voted for, or acquiesced in the act being challenged if the act did not result in a material personal or financial benefit to the person and the governing person would be held liable t the entity or its owners or members as a result of the conduct.

Sec. 1.004. Independent Person.

(a) For purposes of this code, a person is independent with respect to considering the disposition of a claim or challenge regarding a contract or transaction, or particular or alleged conduct, if the person:

(1) is disinterested;

(2) either:

(A) is not an associate, or member of the immediate family, of a party to the contract or transaction of a person who is alleged to have engaged in the conduct that is the subject of the claim or challenge; or

(B) is an associate to a party or person described by Paragraph (A) that is an entity if the person is an associate solely because the person is a governing person of the entity or of the entity's subsidiaries or associates;

(3) does not have a business, financial, or familial relationship with a party to the contract or transaction, or with another person who is alleged to have engaged in the conduct, that is the subject of the claim or challenge that could reasonably be expected to materially and adversely affect the judgment of the person in favor of the party or other person with respect to the consideration of the matter; and

(4) is not shown, by a preponderance of the evidence, to be under the controlling influence of a party to the contract or transaction that is the subject of the claim or challenge or of a person who is alleged to have engaged in the conduct that is the subject of the claim or challenge.

(b) For purposes of Subsection (a), a person does not have a relationship that could reasonably be expected to materially and adversely affect the judgment of the person regarding the disposition of a matter that is the subject of a claim or challenge and is not otherwise under the controlling influence of a party to a contract or transaction that is the subject of a claim or challenge or that is alleged to have engaged in the conduct that is the subject of a claim or challenge solely because:

(1) the person has been nominated or elected as a governing person by a person who is interested in the contract or transaction or alleged to be engaged in the conduct that is the subject of the claim or challenge;

(2) the person receives normal fees or similar customary compensation, reimbursement for expenses, or benefits as a governing person of the entity;

(3) the person has a direct or indirect equity interest in the entity;

(4) the entity has, or its subsidiaries have, an interest in the contract or transaction or was affected by the alleged conduct;

(5) the person or an associate of the person receives ordinary and reasonable compensation for reviewing, making recommendations regarding, or deciding on the disposition of the claim or challenge; or

(6) the person, an associate of the person, other than the entity or its associates, or an immediate family member has a continuing business relationship with the entity that is not material to the person, associate, or family member.

TBOC § 21.554 provides an alternative for dismissal of derivative action upon determination by an independent and disinterested person appointed by the court, which can be helpful in the event that the requisite independent and disinterested directors are not available, as follows:

Section 21.554. Determination by Directors or Independent Persons. (a) A determination of how to proceed on allegations made in a demand or petition relating to a derivative proceeding must be made by an affirmative vote of the majority of:

(1) the independent and disinterested directors of the corporation present at a meeting of the board of directors of the corporation at which interested directors are not present at the time of the vote if the independent and disinterested directors constitute a quorum of the board of directors;

(2) a committee consisting of two or more independent and disinterested directors appointed by an affirmative vote of the majority of one or more independent and disinterested directors present at a meeting of the board of directors, regardless of whether the independent and disinterested directors constitute a quorum of the board of directors; or

(3) a panel of one or more independent and disinterested persons appointed by the court on a motion by the corporation listing the names of the persons to be appointed and stating that, to the best of the corporation's knowledge, the persons to be appointed are disinterested and qualified to make the determinations contemplated by Section 21.558.

(b) The court shall appoint a panel under Subsection (a)(3) if the court finds that the persons recommended by the corporation are independent and disinterested and are otherwise qualified with respect to expertise, experience, independent judgment, and other factors considered appropriate by the court under the circumstances to make the determinations. A person appointed by the court to a panel under this section may not be held liable to the corporation or the corporation's shareholders for an action taken or omission made by the person in that capacity, except for an act or omission constituting fraud or willful misconduct.

The proceedings and discovery are stayed under the TBOC while the decision is being made whether to pursue or dismiss the action. TBOC § 21.555, as amended by H.B. 3603, provides:

Section 21.555. Stay of Proceeding. (a) If the corporation that is the subject of a derivative proceeding commences an inquiry into the allegations made in a demand or petition and the person or group of persons described by Section 21.554 is conducting an active review of the allegations in good faith, the court shall stay a derivative proceeding for not more than 60 days until the review is completed and a determination is made by the person or group regarding what further action, if any, should be taken.

(b) To obtain a stay, the corporation must provide the court with a written statement agreeing to advise the court and the shareholder making the demand of the determination promptly on the completion of the review of the matter. A stay, on application, may be reviewed every 60 days for the continued necessity of the stay.

(c) A stay, on motion, may be reviewed every 60 days for continuation of the stay if the corporation provides the court and the shareholder with a written statement of the status of the review and the reasons why an extension for a period not to exceed 60 additional days is appropriate. An extension

making such a demand upon the Board is likely to have little or no effect, generally because a majority of the Board lacks independence or is otherwise interested in the actions being disputed.

2.2. Texas Law on Direct Versus Derivative Actions.

Texas jurisprudence closely mirrors Delaware's distinctions between direct and derivative cases. In Texas, corporate stockholders cannot recover personally for a wrong done only to the corporation.[27] That is true even if the stockholder may be injured by the wrong.

The outcome is different in those cases in which the plaintiff alleges that the wrongdoer owed individual duties to him and that those duties were breached and caused distinct damages to the individual. The Texas Supreme Court's opinion in *Linegar v. DLA Piper LLP*[28] demonstrates this principle. In that case, an aggrieved shareholder argued that he "has standing to bring a malpractice claim against a professional who gives bad advice directly to the shareholder on which he relies and causes the corporation to act." *Id.* In that case, the firm believed it represented only the corporate entity, but the plaintiff contended that the law firm provided advice to him in his individual capacity, and failed to timely perfect a security interest to ensure payment on a note to a third party. In response, the firm contended that the shareholder lacked standing to assert his claims because any wrong was to the corporate entity, not to the shareholder individually. However, the shareholder was seeking redress for wrongs done to him individually causing damages he individually suffered. To have standing to bring such claims, he was required to allege and prove that the firm owed him a duty individually and that he was personally and concretely aggrieved by the firm's breach of that duty. The Texas Supreme Court concluded that he met that burden.[29]

CHAPTER 3. TEXAS DERIVATIVE ACTIONS

3.1. Corporations

(a) Standing; Demand. In Texas, a shareholder[30] may not institute or maintain a derivative proceeding unless he (i) was a shareholder at the time of the act or omission complained of (or became a

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shall be granted for a period not to exceed 60 days if the court determines that the continuation is appropriate in the interests of the corporation.

In the event that a decision is made to seek dismissal of the proceeding, discovery is limited by the Tex. Corp. Stats. to whether (i) the person making the decision to dismiss was independent and disinterested; (ii) the good faith of the inquiry and review, and (ii) the reasonableness of the procedures. TBOC § 21.556; TBCA art.5.14.

See EGAN ON ENTITIES at 734-739 (discussing the meaning of "independent" and "disinterested" in the context of director action to dismiss a shareholder derivative action). *See Johnson v. Jackson Walker, L.L.P.*, 247 S.W.3d 765, 769 (Tex. App.—Dallas 2008, pet. denied).

27 *Linegar v. DLA Piper LLP (US)*, 495 S.W.3d 276, 279 (Tex. 2016).

28 *Linegar*, 495 S.W.3d at 278.

29 Following *Linegar*, subsequent Texas Courts of Appeals have explored and followed this direct versus derivative distinction. *See Stephens v. Three Finger Black Shale P'ship,* 580 S.W.3d 687 (Tex. App.—Eastland 2019, no pet.).

30 "Shareholder" is defined in TBOC §§ 1.002 and 21.551(2) to include the record owner and a beneficial owner whose shares are held by a voting trust or nominee to the extent of rights granted by a nominee statement on file with the corporation. Thus, a shareholder of a parent company may bring a derivative action for fiduciary duty breaches by an officer of a

shareholder by operation of law from such a shareholder) and (ii) fairly and adequately represents the interests of the corporation in enforcing the right of the corporation.[31] Further, the plaintiff must remain a qualified shareholder throughout the derivative proceedings.[32]

An individual shareholder generally has "no separate and independent right of action for injuries suffered by the corporation which merely result in the depreciation of the value of their stock."[33] As a result, a suit for injury to the company must be brought by the corporation, not individual shareholders.[34] In a shareholder derivative suit, "the individual shareholder steps into the shoes of the corporation and usurps the board of directors' authority to decide whether to pursue the corporation's claims."[35]

A shareholder bringing a derivative suit on behalf of a Texas corporation *must* file a written demand in order to maintain the suit, and no showing of futility can excuse this requirement.[36] Moreover, a 90-

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subsidiary as a shareholder of the parent is a beneficial owner of shares of the subsidiary. *See Sneed v. Webre*, 465 S.W.3d 169, 169, 189-92 (Tex. 2015).

31 TBOC § 21.552 provides:

> Sec. 21.552. STANDING TO BRING PROCEEDING. (a) Subject to Subsection (b), a shareholder may not institute or maintain a derivative proceeding unless:
>
> (1) the shareholder:
>
> (A) was a shareholder of the corporation at the time of the act or omission complained of; or
>
> (B) became a shareholder by operation of law originating from a person that was a shareholder at the time of the act or omission complained of; and
>
> (2) the shareholder fairly and adequately represents the interests of the corporation in enforcing the right of the corporation.
>
> (b) If a corporation is the surviving form of an entity in a conversion, a shareholder of that corporation may not institute or maintain a derivative proceeding based on an act or omission that occurred with respect to the converting entity before the date of the conversion unless:
>
> (1) the shareholder was an equity owner of the converting entity at the time of the act or omission; and
>
> (2) the shareholder fairly and adequately represents the interests of the corporation in enforcing the right of the corporation.

TBOC § 21.563(b) provides that TBOC § 21.552 does not apply to a closely held corporation (defined as one with fewer than 35 shareholders and no public trading market for its shares.) *See infra* note 50 and related text.

32 *Somers v. Crane*, 295 S.W.3d 5, 14 (Tex. App.—Houston [1st Dist.] 2009, pet. denied); *Zauber v. Murray Sav. Ass'n*, 591 S.W.2d 932, 935 (Tex. Civ. App.—Dallas 1979), writ ref'd per curiam, 601 S.W.2d 940 (Tex. 1980), *superseded by statute as stated in Sneed v. Webre*, 465 S.W.3d 169 (Tex. 2015). *See infra* notes 125-129 and related text.

33 *Perry v. Cohen*, 285 S.W.3d 137, 144 (Tex. App.—Austin 2009, pet. denied) (quoting *Wingate v. Hajdik*, 795 S.W.2d 717, 719 (Tex. 1990)).

34 *Webre v. Sneed*, 358 S.W.3d 322, 329-30 (Tex. App.—Houston [1st Dist.] 2011) *aff'd*, 465 S.W.3d 169 (Tex. 2015); *see also Grinnell v. Munson*, 137 S.W.3d 706, 718 (Tex. App.—San Antonio 2004, no pet.) ("[T]he right to proceed against an officer or former officer of a corporation for breaching a fiduciary duty owed to the corporation belongs to the corporation itself.").

35 *Webre*, 358 S.W.3d at 330 (quoting *In re Crown Castle Int'l Corp.*, 247 S.W.3d 349, 355 (Tex. App.—Houston [14th Dist.] 2008, orig. proceeding)).

36 TBOC § 21.553(a); TBCA art. 514(C)(1). The Tex. Corp. Stats. apply to corporations formed under the laws of a jurisdiction other than Texas (a "foreign corporation") transacting business in Texas. TBOC §§ 21.001(2), (7); TBCA art. 1.02(A)(14). In a derivative proceeding brought in Texas in the right of a foreign corporation, the requirement that the shareholder make written demand is governed by the laws of the jurisdiction where the foreign corporation is incorporated. TBOC § 21.562(a); TBCA art. 5.14(K). Even though the substantive law of the jurisdiction where the foreign corporation is incorporated applies, Texas procedural law governs matters of remedy and procedure. *Connolly v. Gasmire*, 257 S.W.3d 831, 839 (Tex. App.—Dallas 2008, no pet.).

day waiting period is required from the delivery of the demand notice until the commencement of a suit.[37] This waiting period can only be avoided if the shareholder is earlier notified that the Board has rejected his demand, or if irreparable injury to the corporation is being suffered or would result by waiting for the expiration of the 90-day period.[38]

The written demand must meet a stringent set of requirements in order to satisfy the Tex. Corp. Stats.[39] Though much of the analysis done by the courts to evaluate potential "irreparable harm" may be

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Under Texas procedural law, a party is generally required to file a special exception to challenge a defective pleading. *See* TEX. R. CIV. P. 90, 91 (providing the means for a party to specifically except to an adverse party's pleadings, and providing that a special exception shall point out the pleading excepted to and, with particularity, the defect or insufficiency in the allegations of the pleading). The purpose of special exceptions is to furnish a party with a medium by which to force clarification of an adverse party's pleadings when they are not clear or sufficiently specific. *Id.*

When a trial court sustains a party's special exceptions, the trial court must give the pleader an opportunity to amend his pleadings before dismissing the case. When a petition fails to satisfy the requirements for demand futility under the laws of a foreign jurisdiction, the proper remedy under Texas procedural law is to sustain the special exceptions and allow the plaintiff an opportunity to amend the petition, even if dismissal is the proper remedy under the laws of the foreign jurisdiction. *Id.*

[37] TBOC § 21.553; TBCA art. 5.14(C)(2). TBOC § 21.553 provides:

> Section 21.553. Demand. (a) A shareholder may not institute a derivative proceeding until the 91st day after the date a written demand is filed with the corporation stating with particularity the act, omission, or other matter that is the subject of the claim or challenge and requesting that the corporation take suitable action.
>
> (b The waiting period required by Subsection (a) before a derivative proceeding may be instituted is not required or, if applicable, shall terminate if:
>
> (1) the shareholder has been previously notified that the demand has been rejected by the corporation;
>
> (2) the corporation is suffering irreparable injury; or
>
> (3) irreparable injury to the corporation would result by waiting for the expiration of the 90-day period.

[38] TBOC § 21.553(b); TBCA art. 5.14(C)(2).

[39] In *In re Schmitz*, 285 S.W.3d 451, 455 (Tex. 2009), the Texas Supreme Court rejected a shareholder challenge to a merger and held that merely alleging (a) the availability of a superior offer price and (b) the Board's duty to "'fully and fairly consider all potential offers' and 'disclose to shareholders all of [their] analysis,'" without further analysis of the proposed transactions and explanation of the Board's failure to fulfill their duties, is not sufficient to meet article 5.14's particularity requirement. In so holding, the Texas Supreme Court wrote:

> The contours of the demand requirement in Texas law have always been somewhat unclear, in part because shareholder derivative suits have been relatively rare.
>
> * * *
>
> In 1997, the Legislature extensively revised the Texas Business Corporation Act "to provide Texas with modern and flexible business laws which should make Texas a more attractive jurisdiction in which to incorporate." Included were changes to article 5.14 to conform Texas derivative actions to the Model Business Corporation Act. Article 5.14(C) now provides that "[n]o shareholder may commence a derivative proceeding until . . . a written demand is filed with the corporation setting forth with particularity the act, omission, or other matter that is the subject of the claim or challenge and requesting that the corporation take suitable action." Unlike Texas law for a century before, the new provision requires presuit demand in all cases; a shareholder can no longer avoid a demand by proving it would have been futile.
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> * * *

Article 5.14 does not expressly state that a presuit demand must list the name of a shareholder. But because parts of the article and most of its purposes would be defeated otherwise, we hold that a demand cannot be made anonymously.

The statute here provides that "[n]o shareholder may commence a derivative proceeding until … a written demand is filed." It expressly limits standing to shareholders who owned stock "at the time of the act or omission complained of." It requires that the demand state "the subject of the claim or challenge" that forms the basis of the suit. And it tolls limitations for 90 days after a written demand is filed. Given the interrelation between the demand and the subsequent suit, it is hard to see how or why the demand could be made by anyone other than the shareholder who will file the suit.

Of course, requiring the demand to come from the putative plaintiff is not the same as requiring that it state the plaintiff's name. But for several reasons we believe it must.

First, article 5.14 presumes that a corporation knows the identity of the shareholder making the demand. The article prohibits filing suit until 90 days after the demand "unless the shareholder has earlier been notified that the demand has been rejected." The tolling provision suspends limitations for the shorter of 90 days or "30 days after the corporation advises the shareholder that the demand has been rejected." For a corporation to "notify" or "advise" the shareholder of rejection, it must know who the shareholder is.

Second, the identity of the shareholder may play an important role in how the corporation responds to a demand. "The identity of the complaining shareholder may shed light on the veracity or significance of the facts alleged in the demand letter, and the Board might properly take a different course of action depending on the shareholder's identity." In other words, a demand from Warren Buffett may have different implications than one from Jimmy Buffett.

Third, a corporation cannot be expected to incur the time and expense involved in fully investigating a demand without verifying that it comes from a valid source. Article 5.14 sets out a procedure for independent and disinterested directors to conduct an investigation and decide whether the derivative claim is in the best interests of the corporation. If they determine in good faith that it is not, the court must dismiss the suit over the plaintiff's objection. It would be hard to imagine requiring these procedures, especially in cases like this one involving an imminent corporation merger, at the instance of someone who could in no event file suit.

Finally, we are concerned with the potential for abuse if demands can be sent without identifying any shareholder. The letter here was on the letterhead of a California law firm whose principal prosecuted hundreds of stockholder derivative actions, and later pleaded guilty to paying kickbacks to shareholders recruited for that purpose.

* * *

The only complaint and demand for action listed in this letter was that the Board stop the Hoshizaki merger "in light of a superior offer … at $23 per share." The demand gives no reason why the Hoshizaki offer was inferior other than what one can imply from the $1 difference in price. All other things being equal, shareholders should of course prefer $1 more rather than $1 less. But in comparing competing offers for a merger, all other things are rarely equal.

A large number of variables may affect the inherent value of competing offers for corporate stock. A cash offer may prove more or less valuable than an offer of stock currently valued at the same amount. Competing bidders may be more or less capable of funding the offers they tender, or completing the transaction without anti-trust or other obstacles. Competitors may attach conditions that make an offer more or less attractive in the short or long run.

In a merger like this involving several hundred million dollars, one cannot say whether the $23 offer was superior to the $22 offer without knowing a lot more. A rule requiring that a corporation always accept nominally higher offers, in addition to sometimes harming shareholders, would replace the business judgment that Texas law requires a board of directors to exercise. As a result, a board cannot analyze a shareholder's complaint about a higher competing offer without knowing the basis of that

similar to the analysis required for demand futility claims in Delaware, the fact that the Tex. Corp. Stats. focus on the harm to the corporation, rather than the apparent futility of demand, presents a slightly different set of issues than are normally addressed in cases involving Delaware corporations.

(b) Texas Fiduciary Duties.

Unless otherwise restricted by a corporation's governing documents, corporate officers and directors owe three distinct duties to the Texas corporations they serve: obedience, loyalty, and due care.[40] The duty of obedience requires a director to avoid acting beyond the scope of their powers granted in the governing documents (ultra vires acts). The duty of loyalty requires that that a director act in good faith and not allow his or her personal interests to prevail over the interests of the corporation (self-dealing). the duty of care requires a director to be diligent and prudent in managing the corporation's affairs.

The duty of care, often limited by a corporation's certificate of formation, is subject to the business judgment rule. The business judgment rule in Texas generally protects corporate officers and directors, who owe fiduciary duties to the corporation, from liability for acts that are within the honest exercise of their business judgment and discretion.[41] The rule protects corporate officers and directors from being held liable to the corporation based on actions that are "negligent, unwise, inexpedient, or imprudent if the actions were within the exercise of their discretion and judgment in the development or prosecution of the enterprise in which their interests are involved."[42] While the business judgment rule provides a measure of protection against fiduciary duty claims, there remains some question as to the burden of proof in the trial courts. A recent Texas case, following Delaware's example, concluded that it was part of the plaintiff's case to disprove the business judgment rule, an important distinction that protects corporate directors and officers further.[43]

Although fiduciary duties to the company are presumed, fiduciary duties among shareholders or members are not created lightly. In a closely held corporation, passing references to shareholders as "partners" in the course of their transactions do not establish a fiduciary relationship when other requisites

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> complaint. As this demand said nothing about that, it was not stated "with particularity" as required by article 5.14.
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> The second sentence of the demand here added that the Board should "fully and fairly consider all potential offers" and "disclose to shareholders all of your analysis" for recommending the Hoshizaki sale. This bland statement of a corporate board's duties could be sent to any board at any time on any issue. The demand did not suggest how the board had failed to consider other offers, or what information it might be withholding. Thus, it gives no direction about what Lancer's board should have done here.
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> * * *
>
> Whether a demand is specific enough will depend on the circumstances of the corporation, the board, and the transaction involved in the complaint. But given the size of this corporation and the nature of this transaction, this demand was clearly inadequate.

40 *See Ritchie v. Rupe*, 443 S.W.3d 856, 868 (Tex. 2014); citing *Gearhart Indus., Inc. v. Smith Intern.*, Inc., 741 F.2d 707, 723-24 (5th Cir. 1984). *See* EGAN ON ENTITIES 100-116.

41 *Sneed v. Webre*, 465 S.W.3d 169, 173 (Tex. 2015).

42 *Id.* at 178 (internal quotations omitted).

43 *In re Estate of Poe*, No. 08-18-00015-CV, 2019 Tex. App. LEXIS 7842, at *62 (Tex. App.—El Paso, Aug. 28, 2019)

are missing.[44] In one recent example, the parties created a corporation, with each of the investors participating as a one-third shareholder. This circumstance does not give rise to a formal fiduciary duty because "a co-shareholder in a closely held corporation does not as a matter of law owe a fiduciary duty to his co-shareholder."[45] The corporation's sole director owed fiduciary duties to the corporation but not to individual shareholders.

However, the absence of direct fiduciary duties among shareholders in a closely held corporation or company does not foreclose fiduciary claims entirely. In those instances, as discussed *infra*, such claims may be pursued derivatively on behalf of the corporation and may be treated as direct claims. This distinction is illustrated by *Cardwell v. Gurley* a recent case from the Dallas Court of Appeals, in which the defendant argued that because the company was a two member limited liability company whose certificate of formation provided that it would not have managers, neither member owed the other a fiduciary duty—that they "they were simply businessmen interacting as equals."[46] The other member, however, brought his claims individually and derivatively on behalf of the company, which fell within the definition of a closely-held limited liability company. Of course, the defendant member testified at trial that he did not engage in self-dealing, and the governing documents gave him broad authority as manager member. Ultimately, however, as a fiduciary to the company, he owed a strict duty of good faith and candor and was prohibited from using the relationship to benefit his personal interests without the other principal's full knowledge and consent.

Texas law requires a corporate director and officer to exercise a "extreme measure of honesty, unselfishness, and good faith" in self-dealing transactions.[47] Nevertheless, self-dealing transactions are not automatically void, and might be permitted by the savings rules codified by Section 21.418 of the Texas Business Organizations Code which states that an otherwise valid and enforceable transaction "is not void or voidable," if one of several conditions are met:

> (1) the material facts as to the relationship or interest . . . and as to the contract or transaction are disclosed to or known by:
>
> (A) the corporation's board of directors or a committee of the board of directors, and the board of directors or committee in good faith authorizes the contract or transaction by the approval of the majority of the disinterested directors or committee members, regardless of whether the disinterested directors or committee members constitute a quorum; or
>
> (B) the shareholders entitled to vote on the authorization of the contract or transaction, and the contract or transaction is specifically approved in good faith by a vote of the shareholders; or

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44 *Cho v. Kim,* 572 S.W.3d 783, 794 (Tex. App.—Houston [14th Dist.] 2019, no pet.)

45 *Id.*

46 *Cardwell v. Gurley*, No. 05-09-01068-CV, 2018 Tex. App. LEXIS 5460, at *18 (Tex. App.—Dallas 2018, pet. denied).

47 *General Dynamics v. Torres*, 915 S.W.2d 45, 49 (Tex.App.--El Paso 1995, writ denied), citing *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 576 (Tex. 1963).

(2) the contract or transaction is fair to the corporation when the contract or transaction is authorized, approved, or ratified by the board of directors, a committee of the board of directors, or the shareholders.

The Fort Worth Court of Appeals recently applied TBOC §21.418 the self-dealing analysis to a three shareholder corporation when two of the three shareholders removed the third shareholder.[48] In that case, the defendant shareholders claimed that they could not be liable for taking money from the corporation because they were officers and directors of the corporation acting with the effective consent of the company. The Fort Worth Court of Appeals rejected this argument, citing TBOC §21.418, principally because the third shareholder "could not consent to transactions he knew nothing about."[49] Without the third shareholder's disinterested consent, the actions of the other two shareholders could not be saved by TBOC §21.418.

(c) Texas Distinguishes Between Public and Private Entities. While Delaware does not distinguish between public and private entities in respect of derivative claims, the Tex. Corp. Stats. provide that their demand and dismissal provisions are not applicable to "closely held corporations" (defined as those with less than 35 shareholders and no public market).[50] TBOC § 21.563, as amended by H.B. 3603, provides:

> Section 21.563. Closely Held Corporation. (a) In this section, "closely held corporation" means a corporation that has:
>
> (1) fewer than 35 shareholders; and
>
> (2) no shares listed on a national securities exchange or regularly quoted in an over-the-counter market by one or more members of a national securities association.
>
> (b) Sections 21.552-21.560 do not apply to a claim or a derivative proceeding by a shareholder of a closely held corporation against a director, officer, or shareholder of the corporation. In the event the claim or derivative proceeding is also made against a person who is not that director, officer, or shareholder, this subsection applies only to the claim or derivative proceeding against the director, officer, or shareholder.
>
> (c) If Sections 21.552-21.560 do not apply because of the Subsection (b) and if justice requires:
>
> (1) 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 the shareholder's own benefit; and

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48 *Corley v. Hendricks*, No. 02-16-00293-CV, 2017 Tex. App. LEXIS 3846, at *8 (Tex. App.—Fort Worth, Apr. 27, 2017)

49 *Id.* at 8.

50 *See Sneed v. Webre*, 465 S.W.3d 169, 169, 178-186 (Tex. 2015).

(2) a recovery in a direct or derivative proceeding by a shareholder may be paid directly to the plaintiff or to the corporation if necessary to protect the interests of creditors or other shareholders of the corporation.[51]

(d) Other provisions of state law govern whether a shareholder has a direct cause of action or right to sue a director, officer, or shareholder, and this section may not be construed to create that direct cause of action or right to sue.

Even though the demand and related dismissal provisions of the Tex. Corp. Stats. are not by their terms applicable to closely held corporations (as defined in TBOC § 21.563), a corporation could nevertheless argue that a similar result could be obtained by virtue of the inherent power of an independent and disinterested Board to determine whether a corporation should pursue any litigation.[52]

TBOC § 21.563, however, provides that the TBOC's derivative action demand and dismissal provisions, which are intended to give a corporation's Board the opportunity to delay and perhaps dismiss derivative proceedings, are not applicable to closely held corporations.[53] Just as the TBOC's demand and mandatory dismissal requirements do not apply to shareholder derivative lawsuits brought on behalf of closely held corporations, Texas law does "not require shareholders of a closely held corporation to establish derivative standing by pleading or proving that the directors failed to exercise their honest business judgment in not pursuing the corporate cause of action."[54] A shareholder of a closely held corporation is not required to plead and prove that the Board acted outside of the protections of the business judgment rule in deciding not to pursue the corporation's cause of action.[55]

TBOC § 21.563 further provides that if justice requires: (1) 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 the shareholder's own benefit; and (2) a recovery in a direct or derivative proceeding by a shareholder of a closely held corporation may be paid directly to the plaintiff or to the corporation if necessary to protect the interests of creditors or other shareholders of the corporation.

In *Ritchie v. Rupe*, the Supreme Court explained:

Even when a closely held corporation does not elect to operate as a "close corporation,"[56] the Legislature has enacted special rules to allow its shareholders to more

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51 TBOC § 21.563 is substantively identical to TBCA art. 5.14.

52 *See* EGAN ON ENTITIES notes 338, 632-633 and related text.

53 TBOC § 21.563(a) defines "closely held corporation" to mean a corporation with less than 35 shareholders and no public market.

54 *Sneed v. Webre*, 465 S.W.3d 169, 183 (Tex. 2015).

55 *Id.* at 193.

56 *See* TBOC §§ 21.701-21.763 regarding "close corporations." A Texas corporation elects "close corporation" status by including a provision to such effect in its certificate of formation, and may provide in such document or in a shareholder agreement, which can be similar to a partnership agreement, that management will be by a board of directors or by the shareholders. TBOC §§ 3.008, 21.703, 21.713. Under TBOC § 21.101, any Texas corporation (except a corporation whose shares are publicly traded) may modify how the corporation is to be managed and operated, in much the same way as a close corporation, by an agreement set forth in (1) the certificate of formation or the bylaws approved by all of the

> easily bring a derivative suit on behalf of the corporation. Shareholders in a closely held corporation, for example, can bring a derivative action without having to prove that they "fairly and adequately represents the interests of" the corporation …, without having to make a "demand" upon the corporation, as in other derivative actions, and without fear of a stay or dismissal based on actions of other corporate actors in response to a demand. And when justice requires, the court may treat a derivative action on behalf of a closely held corporation "as a direct action brought by the shareholder for the shareholder's own benefit," and award any recovery directly to that shareholder.[57]

Thus, the concept that fiduciary duty claims are derivative should not prevent shareholder plaintiffs from recovering directly on a fiduciary duty claim, just as they could on a shareholder oppression action.

(d) Limitations on Fiduciary Suits in Closely Held Corporations. While Section 21.563 permits a plaintiff to recover directly for harm to the corporation with court approval, those actions do not lose their inherently derivative nature. Shareholder plaintiffs often attempt to wholesale recharacterize derivative claims as individual claims, but Texas courts have repeatedly rejected such efforts.

First, as the Texas Supreme Court explained when discussing the predecessor to section 21.563: "[T]here is not an absolute right for a shareholder [of a closely held corporation] to recover directly for claims based on corporate injuries. Rather, if justice requires, a court may treat a derivative proceeding like a direct action and allow the shareholder to recover directly."[58] Instead, the default position remains that the company alone is entitled to recover any damages awarded in a suit. As a corollary, even if recovery by the company would benefit the alleged bad actors, there is "no case in which section 21.563(c) has been applied in such a situation to require the recovery to be paid to the only innocent one."[59]

TBOC §21.563 does not turn a derivative claim into an individual claim.[60] In other words, as recently clarified by the Dallas Court of Appeals IN *Cooke v. Karlseng* there is not an identity between individual claims and any derivative claims, simply because the latter may be treated as "direct" actions:[61]

> Rather than transforming the nature of the plaintiff's claim, the statute permits the trial court to award damages in a derivative proceeding directly to the shareholder 'if necessary to protect the interests of creditors or other shareholders of the corporation.' Bus. Orgs. § 21.563(c)(2). Accordingly, '[a] trial court's decision to treat an action as a direct action under Section 21.563(c) so as to allow recovery to be paid directly to a shareholder plaintiff, as opposed to the corporation, does not mean that the action is no longer a derivative proceeding.[62]

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shareholders or (2) a written agreement signed by all of the shareholders. Under TBOC § 21.101(b), the agreement is not required to be filed with the Secretary of State unless it is part of the certificate of formation.

57 *Ritchie v. Rupe*, 443 S.W.3d at 880-81.

58 *Sneed v. Webre*, 465 S.W.3d 169, 188 (Tex. 2015).

59 Guajardo v. Hitt, 562 S.W.3d 768, 781 (Tex. App.—Houston [14th Dist.] 2018, pet. denied).

60 *Cooke v. Karlseng*, No. 05-18-00206-CV, 2019 Tex. App. LEXIS 7137, at *10 (Tex. App.—Dallas, Aug. 14, 2019).

61 *Id.* at *11.

62 *Id.*

Similarly, a court's decision to allow the shareholder to treat a derivative claim as direct does not eliminate the requirement that a claimant presently possess an ownership interest to assert derivative claims on behalf the closely held company.[63] In a recent derivative suit, a former member of an company advanced the theory that Section 101.463's provision allowing trial courts to treat "a derivative proceeding brought by a member of a closely held limited liability company . . . as a direct action brought by the member for the member's own benefit" has the effect of making a plaintiff's standing to assert derivative claims contingent on its standing to assert direct claims, in essence collapsing the two requirements into one. The Austin Court of Appeals disagreed:

> Not so. As the Texas Supreme Court has explained regarding parallel statutory language governing closely held corporations, "the proceeding still must be derivative." And as relators urge, a "fundamental" and "definitional" attribute of a "derivative action," as long known to Texas law (and more generally), is that the claimant possesses a present ownership interest in the entity on whose behalf it purports to sue, such that it has a stake in the outcome of those claims. We are to presume that the Legislature codified its statutory versions of "derivative action[s]" with awareness of and reference to that background law, and without intending to stretch statutory standing so far as to potentially implicate justiciability concerns…And the Texas Supreme Court has never held otherwise. On the contrary, its recent decisions addressing derivative claims brought on behalf of closely held corporations have uniformly presumed a plaintiff who is presently a shareholder…Under a correct construction of Subchapter J, the district court abused its discretion in holding that [plaintiff] possessed standing as a former member to prosecute derivative claims on [the company's] behalf.[64]

Consequently, while TBOC §21.563 removes some of the initial hurdles to filing suit, this statute does not change the inherently derivative nature of corporate fiduciary actions, or the standing requirements provided by the TBOC.

(e) Texas Double Derivative Actions. A shareholder of a closely held Texas parent corporation may assert a derivative lawsuit on behalf of the parent corporation's wholly owned subsidiary against the subsidiary's directors and officers for breach of fiduciary duties (a "Double Derivative Action").[65] The Houston Court of Appeals recently observed that "it is a fundamental requirement of a double-derivative suit that the injury to the subsidiary must also cause injury to the parent."[66] The Houston Court of Appeals applied this analysis to determine that shareholders who purchased shares in a Swiss corporation after it had undergone a re-domestication process, in which it acquired the shares of a Bermuda corporation as a

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63 *In re LoneStar Logo & Signs, LLC*, 552 S.W.3d 342, 350-51 (Tex. App.—Austin 2018, orig. proceeding).

64 *Id.*

65 *Sneed v. Webre*, 465 S.W.3d 169 (Tex. 2015).

66 *Neff ex rel. Weatherford Int'l, Ltd. v. Brady*, No. 01-15-00544-CV, 2017 Tex. App. LEXIS 5975, at *22 (Tex. App.—Houston [1st Dist.] June 29, 2017). In *Neff*, plaintiffs attempted to sidestep the double derivative analysis by contending that they had standing under the TBOC to pursue their derivative claims. The Houston Court of Appeals rejected this argument, holding instead that "in a derivative proceeding brought in the right of a foreign corporation, matters of standing are governed by the laws of the jurisdiction of incorporation of the foreign corporation…Further, the 'internal affairs doctrine' provides that, with respect to foreign entities, the laws of the entity's jurisdiction of formation govern its internal affairs."

subsidiary, did not have standing to bring double derivative claims against the directors for acts committed as directors of the Bermuda corporation.[67]

3.2. Limited Liability Companies

H.B. 3603 amended the TBOC provisions applicable to LLCs so that they are substantially equivalent to those applicable to corporations after H.B. 3603.[68] With some exceptions are that beyond the scope of this paper, derivative actions involving limited liability companies are nearly identical to those involving corporations. Accordingly, case analysis of limited liability company derivative proceedings in included in the foregoing section on corporations.

3.3. Limited Partnerships

H.B. 3603 amended the TBOC provisions applicable to LPs so that they are substantially equivalent to those applicable to corporations after H.B. 3603.[69]

CHAPTER 4. DELAWARE DERIVATIVE ACTIONS.

4.1. Corporations

(a) Demand; Futility. "Because the shareholders' ability to institute an action on behalf of the corporation inherently impinges upon the directors' power to manage the affairs of the corporation the law imposes certain prerequisites on a stockholder's right to sue derivatively."[70] The most important of these perquisites (and the most commonly litigated issue) is the requirement, codified in Chancery Court Rule 23.1, that the plaintiff "first exhaust intracorporate remedies by making a demand on the directors to obtain the action desired."[71] Delaware Court of Chancery Rule 23.1 requires a plaintiff to "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort."

In Delaware, "in order to cause the corporation to pursue [derivative] litigation, a shareholder must either (1) make a pre-suit demand by presenting the allegations to the corporation's directors, requesting that they bring suit, and showing that they wrongfully refused to do so, or (2) plead facts showing that demand upon the board would have been futile."[72] If the "plaintiff does not make a pre-suit demand on the board of directors, the complaint must plead with particularity facts showing that a demand on the

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67 *Id.* at *28.

68 See Sections 13-24 of H.B. 3603 attached as ANNEX I

69 See Sections 25-30 of H.B. 3603 attached as ANNEX I

70 *Teamsters Union 25 Health Servs. & Ins. Plan v. Baiera*, 119 A.3d 44, 56 (Del. Ch. 2015) (quoting *Kaplan v. Peat, Marwick, Mitchell & Co.*, 540 A.2d 726, 730 (Del. 1988)).

71 *Kaplan*, 540 A.2d at 730.

72 *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 120 (Del. Ch. 2009).

board would have been futile."[73] This "demand requirement is not to insulate defendants from liability; rather, the demand requirement and the strict requirements of factual particularity under Rule 23.1 'exist[] to preserve the primacy of board decision making regarding legal claims belonging to the corporation.'"[74]

Under the test articulated by the Delaware Supreme Court in *Aronson v. Lewis*, "to show demand futility, plaintiffs must provide particularized factual allegations that raise a reasonable doubt that '(1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.'"[75]

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73 *Id.*

74 *Id.*

75 *Del. Cty. Emps. Ret. Fund v. Sanchez*, 124 A.3d 1017, 1020 (Del. 2015); 473 A.2d 805, 814 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000). *See In re Tyson Foods, Inc. Consolidated Shareholder Litigation*, 919 A.2d 563, 581-82 (Del. Ch. 2007):

> The first hurdle facing any derivative complaint is [Delaware Chancery] Rule 23.1, which requires that the complaint "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors . . . and the reasons for the plaintiff's failure to obtain the action or for not making the effort." Rule 23.1 stands for the proposition in Delaware corporate law that the business and affairs of a corporation, absent exceptional circumstances, are to be managed by its board of directors. To this end, Rule 23.1 requires that a plaintiff who asserts that demand would be futile must "comply with stringent requirements of factual particularity that differ substantially from the permissive notice pleadings" normally governed by Rule 8(a). Vague or conclusory allegations do not suffice to upset the presumption of a director's capacity to consider demand. As famously explained in *Aronson v. Lewis*, plaintiffs may establish that demand was futile by showing that there is a reason to doubt either (a) the disinterestedness and independence of a majority of the board upon whom demand would be made, or (b) the possibility that the transaction could have been an exercise of business judgment.
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> There are two ways that a plaintiff can show that a director is unable to act objectively with respect to a pre-suit demand. Most obviously, a plaintiff can assert facts that demonstrate that a given director is personally interested in the outcome of litigation, in that the director will personally benefit or suffer as a result of the lawsuit in a manner that differs from shareholders generally. A plaintiff may also challenge a director's independence by alleging facts illustrating that a given director is dominated through a "close personal or familial relationship or through force of will," or is so beholden to an interested director that his or her "discretion would be sterilized." Plaintiffs must show that the beholden director receives a benefit "upon which the director is so dependent or is of such subjective material importance that its threatened loss might create a reason to question whether the director is able to consider the corporate merits of the challenged transaction objectively."

See also Ryan v. Gifford, 918 A.2d 341, 351-53 (Del. Ch. 2007), for further elaboration on demand futility as follows:

> Defendants state that plaintiff has failed to make demand or prove demand futility. That is, defendants contend that the complaint lacks particularized facts that either establish that a majority of directors face a "substantial likelihood" of personal liability for the wrongdoing alleged in the complaint or render a majority of the board incapable of acting in an independent and disinterested fashion regarding demand.
>
> When a shareholder seeks to maintain a derivative action on behalf of a corporation, Delaware law requires that shareholder to first make demand on that corporation's board of directors, giving the board the opportunity to examine the alleged grievance and related facts and to determine whether pursuing the action is in the best interest of the corporation. This demand requirement works "to curb a myriad of individual shareholders from bringing potentially frivolous lawsuits on behalf of the corporation,

As "directors are entitled to a presumption that they were faithful to their fiduciary duties," a derivative plaintiff must allege "particularized facts creating a reasonable doubt" of a director's disinterestedness or independence "to rebut the presumption at the pleading stage."[76] Only if the plaintiff makes this showing with respect to at least half of the board will demand be excused under the first *Aronson* prong.[77] "A director is considered interested where he or she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders," or "where a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders."[78] Merely contending that the directors approved a challenged transaction, and thus would be required to sue themselves on behalf of the corporation, will not establish that they are interested for purposes of demand excusal; such an approach "would effectively abrogate Rule 23.1 and weaken the managerial power of directors."[79] Moreover, this standard becomes more exacting where the directors are shielded by an exculpatory charter provision pursuant to 8 DGCL § 102(b)(7).[80]

"Allegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence."[81] Instead, Delaware law makes clear that evidence of "bare social relationships," such as "allegations that [the directors] move in the same business and social circles, or a characterization that they are close friends," will not "negate

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> which may tie up the corporation's governors in constant litigation and diminish the board's authority to govern the affairs of the corporation."
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> This Court has recognized, however, that in some cases demand would prove futile. Where the board's actions cause the shareholders' complaint, "a question is rightfully raised over whether the board will pursue these claims with 100% allegiance to the corporation, since doing so may require that the board sue *itself* on behalf of the corporation." Thus, in an effort to balance the interest of preventing "strike suits motivated by the hope of creating settlement leverage through the prospect of expensive and time-consuming litigation discovery [with the interest of encouraging] suits reflecting a reasonable apprehension of actionable director malfeasance that the sitting board cannot be expected to objectively pursue on the corporation's behalf," Delaware law recognizes two instances where a plaintiff is excused from making demand. Failure to make demand may be excused if a plaintiff can raise a reason to doubt that: (1) a majority of the board is disinterested or independent or (2) the challenged acts were the product of the board's valid exercise of business judgment.
>
> The analysis differs, however, where the challenged decision is not a decision of the board in place at the time the complaint is filed. * * * Accordingly, where the challenged transaction was not a decision of the board upon which plaintiff must seek demand, plaintiff must "create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."
>
> * * * Where at least one half or more of the board in place at the time the complaint was filed approved the underlying challenged transactions, which approval may be imputed to the entire board for purposes of proving demand futility, [demand may be excused].

76 *Beam v. Stewart*, 845 A.2d 1040, 1048–49 (Del. 2004).

77 *See id.* at 1046 n.8.

78 *Rales*, 634 A.2d at 936.

79 *Aronson*, 473 A.2d at 818.

80 Under those circumstances, the plaintiff must "plead[] a non-exculpated claim against the directors based on particularized facts," *Guttman v. Huang,* 823 A.2d 492, 501 (Del.Ch. 2003), such as a cause of action premised on scienter, bad faith, or a breach of the duty of loyalty, e.g., *In re Goldman Sachs Grp., Inc. S'holder Litig.*, C.A. No. 5215-VCG, 2011 WL 4826104, at *12, *14 (Del. Ch. Oct. 12, 2011).

81 845 A.2d 1040, 1050 (Del. 2004).

independence for demand excusal purposes."[82] To the contrary, "friendship must be accompanied by substantially more in the nature of serious allegations that would lead to a reasonable doubt as to a director's independence."[83] The Delaware Supreme Court has explained that the sorts of personal relationships that cast doubt on a director's independence tend to be long-standing and accompanied by other evidence of influence.[84] For that reason, common membership on other corporate boards and on the boards of charitable and civic organizations does not demonstrate director interest absent evidence of actual influence by the defendant company or purportedly dominant director.[85]

In *Marchand v. Barnhill*, the Delaware Supreme Court held that a corporation's former CFO who owed his career at the corporation to the current CEO's father had the kind of long-standing relationship that creates an inference of director interest. [86]

Shareholder plaintiffs also assert entrenchment claims as a method to demonstrate that directors are not disinterested to avoid Rule 23.1's demand requirements, but a pair of recent opinions from Vice Chancellor Glasscock confirm that "a conclusory allegation of entrenchment…will not suffice to excuse demand."[87] Consequently, a plaintiff must allege particularized facts suggesting that the Board was motivated to entrench itself.[88] Although well-pleaded *Unocal* claims will subject directors to enhanced scrutiny[89], the mere existence of a potential *Unocal* claim does not automatically excuse demand. While Delaware authority is somewhat unsettled on the issue, Vice Chancellor Glasscock has examined demand futility in the *Unocal* context and concluded that "the presence of a narrowly pled *Unocal* claim here does not operate to excuse demand *per se*…To the extent the *Gaylord* line of cases holds that a pleading sufficient to invoke *Unocal* at the pre-closing stage is also sufficient to excuse demand under Rule 23.1, I decline to follow those cases."[90] Thus, even with the heightened scrutiny attached to entrenchment claims, demand

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82 *Id.* at 1051–52.

83 *Id.* at 1051–52.

84 *See e.g., Sanchez*, 124 A.3d at 1021 (holding that a lack of independence was pleaded adequately based on allegations that a director was the company chairman's "close friend of *a half century*, derive[d] his primary employment from a company over which [the chairman] ha[d] substantial control, ha[d] a brother in the same position, and . . . the coincidence of these personal and business ties" was "no coincidence".

85 *See, e.g.*, *S. Muoio & Co. LLC v. Hallmark Entm't Invs. Co.*, C.A. No. 4729-CC, 2011 WL 863007, at *10 (Del. Ch. Mar. 9, 2011) (finding no reasonable doubt as to the independence of a director who "served on the boards of numerous nonprofit organizations," absent evidence that the director solicited from Hallmark or the Hall family or received compensation for his service on UK-affiliated boards); *In re J.P. Morgan Chase & Co. S'holder Litig.* (*J.P. Morgan I*), 906 A.2d 808, 822–23 (Del. Ch. 2005) ("None of the outside directors stood on both sides of the transaction nor are they alleged to have received any personal financial benefit from it other than one that devolved on all JPMC stockholders alike. Thus, there is no issue regarding these directors' interest in the deal. Rather, the thrust of the plaintiffs' allegations is that the directors were so positioned, as a result of various business, charitable, or family relationships, that they were disabled from exercising independent judgment." Finding no reasonable doubt as to the independence of directors who served on the boards of a museum and a nonprofit that each received significant contributions from the defendant company because the complaint lacked any explanation of how these contributions could affect the directors' independence).

86 212 A.3d 805 (Del. 2019).

87 *Kandell v. Niv*, No. 11812-VCG, 2017 Del. Ch. LEXIS 640, at *40-41 (Del. Ch. Sep. 29, 2017).

88 *Id.*

89 *See* EGAN ON ENTITIES at note 696.

90 *Ryan v. Armstrong*, No. 12717-VCG, 2017 Del. Ch. LEXIS 80, at *35 (Del. Ch. May 15, 2017).

excusal still requires a plaintiff to plead "specific facts sufficient to conclude that the directors' exercise of business judgment is disabled."[91]

In *Sandys v. Pincus*,[92] a demand excused derivative case, Chief Justice Leo Strine explained that a director may not be independent if the circumstances of the director's relationship with the defendant controller indicate that the director would be unable to authorize a lawsuit against the controller. In *Pincus* the Court held that one director's co-ownership of a private airplane with the controller, which was a substantial and ongoing relationship that required cooperation, raised sufficient doubt about the director's ability to be impartial.[93] Co-ownership of the plane was an "unusual fact" that "signaled an extremely close, personal bond between" the two directors "and between their families."[94] Two other directors were found to lack the requisite independence because they were co-owners of a venture capital firm which owned 9.2% of the corporation's equity as a result of being an early stage investor and had interlocking relationships with the controller.[95]

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91 *Id.*

92 152 A.3d 124 (Del. 2016).

93 The Chief Justice explained:

> Co-ownership of a private plane involves a partnership in a personal asset that is not only very expensive, but that also requires close cooperation in use, which is suggestive of detailed planning indicative of a continuing, close personal friendship. In fact, it is suggestive of the type of very close personal relationship that, like family ties, one would expect to heavily influence a human's ability to exercise impartial judgment. As we noted recently, although a plaintiff has a pleading stage burden that is elevated in the demand excusal context, that standard does not require a plaintiff to plead a detailed calendar of social interaction to prove that directors have a very substantial personal relationship rendering them unable to act independently of each other. A plaintiff is only required to plead facts supporting an inference—or in the words of *Rales*, "create a reasonable doubt"—that a director cannot act impartially. Here, the facts support an inference that Siminoff would not be able to act impartially when deciding whether to move forward with a suit implicating a very close friend with whom she and her husband co-own a private plane. *Id.* at 130.

94 *Sandys*, 152 A.3d at 130.

95 Chief Justice Strine explained:

> Although it is true that entrepreneurs like the controller need access to venture capital, it is also true that venture capitalists compete to fund the best entrepreneurs and that these relationships can generate ongoing economic opportunities. There is nothing wrong with that, as that is how commerce often proceeds, but these relationships can give rise to human motivations compromising the participants' ability to act impartially toward each other on a matter of material importance. Perhaps for that reason, the Zynga board itself determined that these two directors did not qualify as independent under the NASDAQ rules, which have a bottom line standard that a director is not independent if she has "a relationship which, in the opinion of the Company's board of directors, would interfere with the exercise of independent judgment . . . ." ***
>
> These relationships, suggest the plaintiff, indicate that [directors] Gordon and Doerr have a mutually beneficial network of ongoing business relations with Pincus and Hoffman that they are not likely to risk by causing Zynga to sue them. Amplifying this argument, says the plaintiff, is the voice of Gordon's and Doerr's fellow Zynga directors who did not consider them to be independent directors. According to its own public disclosures, the Zynga board determined that Gordon and Doerr do not qualify as independent directors under the NASDAQ Listing Rules. ***
>
> We agree with the Court of Chancery that the Delaware independence standard is context specific and does not perfectly marry with the standards of the stock exchange in all cases, but the criteria NASDAQ

To properly plead demand futility under the second *Aronson* prong—that the challenged transaction was not the exercise of valid business judgment—the plaintiff must show that the situation is one of the "rare cases [in which] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability exists."[96] The second *Aronson* prong applies when the particularized facts are such that it is "difficult to conceive" that a director could have satisfied his or her fiduciary duties.[97]

Where plaintiffs do not challenge a specific decision of the Board and instead complain of Board inaction, there is no challenged action, and the traditional *Aronson v. Lewis* analysis does not apply.[98] In an inaction case, "to show demand futility where the subject of the derivative suit is not a business decision of the Board, the plaintiff must allege particularized facts that 'create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.'"[99]

Demand futility is not shown solely because all of the directors are defendants in the derivative action and the directors would be deciding to sue themselves.[100] "Rather, demand will be excused based on a possibility of personal director liability only in the rare case when a plaintiff is able to show director conduct that is 'so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists.'"[101] In a derivative action in a Texas court involving a Delaware corporation, under the internal affairs doctrine Delaware law governs standing and whether demand is excused because it would be futile.[102]

(b) <u>*Caremark* Claims After *Marchand v. Barnhill* (Blue Bell).</u> In a surprising update to Delaware jurisprudence implicating a Brenham, Texas-based Delaware subchapter S corporation, the Delaware

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has articulated as bearing on independence are relevant under Delaware law and likely influenced by our law. *Id.* at 126-31.

96 473 A.2d 805, 815 (Del. 1984).

97 *Chester Cty. Emples. Ret. Fund v. New Residential Inv. Corp*., 2016 Del. Ch. LEXIS 153, at *28 (Del. Ch. Oct. 7, 2016) (quoting *Ryan v. Gifford*, 918 A.2d 341, 355 (Del. Ch. 2007)).

98 *Rales v. Blasband*, 634 A.2d 927, 933-34 (Del. 1993); *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 120 (Del. Ch. 2009).

99 *Citigroup*, 964 A.2d at 120; *see also In re The Goldman Sachs Group, Inc. Shareholder Litigation*, C.A. No. 5215-VCG, 2011 Del. Ch. LEXIS 151, at *21 (Del. Ch. Oct. 12, 2011).

100 *In re Affiliated Computer Servs., Inc. S'holders Litig.*, C.A. No. 2821-VCL, 2009 WL 296078, at *7, 2009 Del. Ch. LEXIS 35, at *24-*28 (Del. Ch. Feb. 6, 2009); *Citigroup*, 964 A.2d at 120.

101 *Citigroup*, 964 A.2d at 121 (quoting *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244, 253-54 (Del. 2000)).

102 *In re Brick*, 351 S.W.3d 601, 603 (Tex. App.—Dallas 2011, no pet.) (the Dallas Court of Appeals granted a writ of mandamus holding that the trial court erred in denying the directors' "special exceptions" (that is, its challenges as to whether the shareholders' allegations "stated a cause of action under applicable law") because the shareholders failed to demonstrate that each individual director acted in a way not protected by the business judgment rule as required under Delaware law, which was applicable because Texas follows the internal affairs doctrine); *In re Crown Castle Int'l Corp*., 247 S.W.3d 349, 354-55 (Tex. App. 2008, orig. proceeding) ("Delaware courts hold the heightened pleading requirement for derivative suits is substantive, not simply a technical rule of pleading…In light of well-settled Delaware law, the shareholders may not seek discovery from Crown Castle for the purpose of satisfying Delaware's heightened pleading requirement in derivative proceedings."). *See* EGAN ON ENTITIES notes 345-353 regarding the internal affairs doctrine.

Supreme Court unanimously overturned the Chancery Court's dismissal of shareholder derivative lawsuit premised on a lack of oversight by the Board of Directors, known in Delaware as a *Caremark* claim.[103]

The shareholder plaintiff alleged that despite management's food safety programs and awareness of "the growing problem" of listeria, "this information never made its way to the board, and the board continued to be uninformed about (and thus unaware of) the problem." The complaint pleaded that the Blue Bell board itself had made no effort at all to implement a board-level system of mandatory reporting of any kind.

The Delaware Supreme Court reiterated that "*Caremark* claims are difficult to plead and ultimately to prove out," but emphasized that "*Caremark* does have a bottom-line requirement that is important: the board must make a good faith effort—i.e., try—to put in place a reasonable board-level system of monitoring and reporting." In this case, using information obtained through a books and records inspection, the complaint alleged that before the listeria outbreak engulfed the company:

- no board committee that addressed food safety existed;

- no regular process or protocols that required management to keep the board apprised of food safety compliance practices, risks, or reports existed;

- no schedule for the board to consider on a regular basis, such as quarterly or biannually, any key food safety risks existed;

- during a key period leading up to the deaths of three customers, management received reports that contained what could be considered red, or at least yellow, flags, and the board minutes of the relevant period revealed no evidence that these were disclosed to the board;

- the board was given certain favorable information about food safety by management, but was not given important reports that presented a much different picture; and

- the board meetings are devoid of any suggestion that there was any regular discussion of food safety issues.

As a result, the Delaware Supreme Court found that the plaintiff's complaint supported an inference that no system of board-level compliance monitoring and reporting existed at Blue Bell. For a company where "food safety was essential and mission critical," the shareholder plaintiff pleaded sufficient facts to survive the motion to dismiss.

Evidence of management's regular reporting to the board on "operational issues" was insufficient to demonstrate that the board had made a good faith effort to put in place a reasonable system of monitoring. The Delaware Supreme Court also did not believe "the fact that Blue Bell nominally complied with FDA regulations" to be determinative, because "the mundane reality that Blue Bell is in a highly regulated industry and complied with some of the applicable regulations does not foreclose any pleading-stage inference that the directors' lack of attentiveness rose to the level of bad faith indifference required

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103 *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019). Regarding duty of loyalty over sight claims under *In re Canemark International Inc.* Derivative Litigation, 698 EGAN ON ENTITIES 122-132.

to state a Caremark claim." In short, these defenses failed to show that "the board implemented a system to monitor food safety at the board level." In light of these facts, the Delaware Supreme Court held that the plaintiff met his "onerous pleading burden" and was entitled to pursue his *Caremark* claim. As the Delaware Supreme Court explained, "[w]hen a plaintiff can plead an inference that a board has undertaken no efforts to make sure it is informed of a critical compliance issue intrinsically critical to the company's business operation, then that supports an inference that the board has not made the good faith effort that Caremark requires."

(c) Delaware Double Derivative Actions. In contrast to a standard derivative action in which a shareholder brings a lawsuit asserting a claim belonging to a corporate entity in which the shareholder owns shares, a Double Derivative Action involves two entities: the corporation whose claim is being asserted ("corporation A"), and the corporation which owns or controls corporation A.[104] In *Lambrecht v. O'Neal*,[105] the essence of a Double Derivative Action in Delaware was summarized by the Delaware Supreme Court as follows:

* * *

> Thus, by its nature a double derivative suit is one brought by a shareholder of a parent corporation to enforce a claim belonging to a subsidiary that is either wholly owned or majority controlled. Normally, such a claim is one that only the parent corporation, acting through its board of directors, is empowered to enforce. Cases may arise, however, where the parent corporation's board is shown to be incapable of making an impartial business judgment regarding whether to assert the subsidiary's claim. In those cases a shareholder of the parent will be permitted to enforce that claim on the parent corporation's behalf, that is, double derivatively.
>
> Double derivative actions generally fall into two distinct categories. The first are lawsuits that are brought originally as double-derivative actions on behalf of a parent corporation that has a pre-existing, wholly owned subsidiary at the time of the alleged wrongful conduct at the subsidiary level. In this category, no intervening merger takes place. The second category involves cases, such as this, where the action is brought originally as a standard derivative action on behalf of a corporation that thereafter is acquired by another corporation in an intervening stock-for-stock merger. We distinguish these two categories because they create different standing (and pre-suit demand) issues.
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> In the first category—cases where the wholly-owned subsidiary pre-existed the alleged wrongdoing and where no intervening merger took place—corporation A is already a subsidiary of corporation B at the time of the alleged wrongdoing at corporation A. In those cases, only the parent corporation owns the subsidiary's stock at the time of the alleged wrongdoing, and the plaintiff owns stock only in the parent. Therefore, a Rule 23.1 demand could only be made—and a derivative action could only be brought—at the parent, not the subsidiary, level.

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104 *See supra* note 65 regarding Double Derivative Actions under Texas law.

105 3 A.3d 277, 281 (Del. 2010).

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The second category involves actions brought derivatively on behalf of a corporation that was originally a stand-alone entity but where, as a result of being acquired in a later stock-for-stock merger, (1) the acquired corporation became a wholly-owned subsidiary of the acquiring corporation and (2) the shareholders of the (pre-merger) entity became shareholders of the acquiring corporation. * * * What materially differentiates the second category from the first is that in this second category, as a matter of law the merger operates to divest the original shareholder plaintiff of standing to maintain the standard derivative action brought originally on behalf of the acquired corporation. That result, in turn, creates issues relating to whether—and, if so, in what circumstances—the original stockholder plaintiff, as a newly incarnated shareholder of the acquirer-parent corporation can have standing to assert the (now wholly-owned) subsidiary's claim double-derivatively. That brings us to the second subject of this preliminary sketch of the current legal roadmap: standing.[106]

(2) Standing To Sue Double Derivatively[107]

The standing issue is a consequence of the doctrine articulated in *Lewis v. Anderson*.[108] There, a standard derivative action was brought in the Court of Chancery on behalf of Conoco Inc. (Old Conoco) charging its directors with breaches of fiduciary duty. Thereafter, and while that action was pending, E.I. duPont de Nemours, Inc. (DuPont) acquired Old Conoco in a stock-for-stock merger. As a result, Old Conoco disappeared and the surviving corporation—a wholly owned subsidiary of DuPont—was renamed Conoco, Inc. (New Conoco). After the merger, the defendants moved to dismiss the derivative action, arguing that the plaintiff had lost his standing to maintain it because as a matter of law the derivative claim became the property of New Conoco, which post-merger was the only party with standing to assert the claim. The Court of Chancery dismissed the action, and this Court affirmed. The reasoning which supports that outcome is critical to understanding how the standing issue arises in the double derivative context.

The *Anderson* court, citing earlier Delaware decisions, held that for a shareholder to have standing to maintain a derivative action, the plaintiff "must not only be a stockholder at the time of the alleged wrong and at the time of commencement of suit but…must also maintain shareholder status throughout the litigation." These two imperatives are referred to, respectively, as the "contemporaneous ownership" and the "continuous ownership" requirements. The contemporaneous ownership requirement is imposed by statute; while the continuous ownership requirement is a creature of common law. *Lewis v. Anderson* holds that where the corporation on whose behalf a derivative action is pending is later acquired in a merger that deprives the derivative plaintiff of his shares, the derivative claim—originally belonging to the acquired corporation—is transferred to and becomes an asset of the acquiring corporation as a matter of statutory law. Because as a consequence

106 *Id.* at 282-83.

107 *Id.* at 284.

108 477 A.2d 1040, 1041 (Del. 1984).

> the original derivative shareholder plaintiff can no longer satisfy the continuous ownership requirement, the plaintiff loses standing to maintain the derivative action. And, because the claim is now (post merger) the property of the acquiring corporation, that corporation is now the only party with standing to enforce the claim, either by substituting itself as the plaintiff or by authorizing the original plaintiff to continue prosecuting the suit on the acquiring company's behalf.
>
> That rationale generates the question presented here, which may be stated thusly: where a shareholder has lost standing to maintain a standard derivative action by reason of an acquisition of the corporation in a stock-for-stock merger, may that shareholder, in his new capacity as a shareholder of the acquiring corporation, assert the claim double derivatively and, if so, what requirements must the plaintiff satisfy?
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> * * *
>
> In *Rales v. Blasband* we held that the traditional *Aronson v. Lewis* demand excusal test would not be employed in considering whether a demand on the parent board was required in a double derivative action. Rather, a different test (the "*Rales* test") would apply, which is whether the particularized factual allegations of the complaint create a reasonable doubt that the parent's board of directors could properly have exercised its independent and disinterested business judgment in responding to a demand. This Court further held that in a double derivative action the *Rales* test would apply as of the time the complaint was filed, as distinguished from the time of the alleged wrongdoing.[109]

The underlying actions in *Lambrecht* began as standard derivative lawsuits, filed on behalf of Merrill Lynch & Co., Inc., to recover for purported breaches of fiduciary duties by Merrill Lynch officers and directors prior to its acquisition by Bank of America Corporation's in a stock-for-stock merger. Following the merger, BofA and Merrill Lynch moved to dismiss the two pending derivative actions on the ground that the plaintiffs, who were no longer stockholders of Merrill Lynch by virtue of the merger, had lost their standing to assert derivative claims on behalf of Merrill Lynch. The Southern District Court of New York granted the motions but, in dismissing the actions without prejudice, allowed the plaintiffs to replead their claims as "double derivative" actions (i.e., actions to enforce a claim of Merrill Lynch through BofA). The defendants again moved to dismiss plaintiffs' claims for lack of standing, arguing that in order to have standing to sue double derivatively, the plaintiffs had to be able to demonstrate that: (i) they were (and remain) stockholders of BofA *both* after the merger and also at the time of the alleged fiduciary misconduct prior to the merger; and (ii) BofA itself was a stockholder of Merrill Lynch at the time of the alleged fiduciary misconduct prior to the merger. Following oral argument, the Southern District certified the following question to the Delaware Supreme Court:

> Whether plaintiffs in a double derivative action under Delaware law, who were pre-merger shareholders in the acquired company and who are current shareholders, by virtue of a stock-for-stock merger, in the post-merger parent company, must also demonstrate that, at the time of the alleged wrongdoing at the acquired company, (a) they owned stock in the

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[109] 3 A.3d at 284-86.

acquiring company, and (b) the acquiring company owned stock in the acquired company.[110]

The Delaware Supreme Court ultimately concluded that the certified question must be answered in the negative.[111] The Supreme Court concluded that a "post-merger double derivative action is not a *de facto* continuation of the pre-merger derivative action" but instead "a new, distinct action in which standing to sue double derivatively rests on a different temporal and factual basis—namely, the failure of the BofA board, post-merger, to enforce the pre-merger claim of its wholly-owned subsidiary."

CHAPTER 5. FEDERAL RULES OF CIVIL PROCEDURE.

Federal Rule of Civil Procedure 23.1 also provides that a plaintiff may bring a shareholder derivative suit if the requirements for Federal Court jurisdiction are satisfied and the following additional two requirements are met: (1) the plaintiff must have owned shares in the corporation at the time of the disputed transaction; and (2) the plaintiff must allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors.[112] Case law further requires that the plaintiff remain a shareholder throughout the course of the derivative action.[113] This demand requirement may be excused if the facts show that demand would have been futile.[114]

CHAPTER 6. EFFECT OF MERGER ON DERIVATIVE CLAIMS.

Questions arise with respect to the effect of a merger in which the corporation is not the acquiring entity on a derivative action. Under Delaware law, in the absence of fraud, "the effect of a merger . . . is normally to deprive a shareholder of the merged corporation of standing to maintain a derivative action."[115] Allegations that a Board Chairman foiled a potential superior bid by demanding a position for

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110 *Id.* at 280.

111 In so ruling, the Supreme Court overruled the Court of Chancery's decision in *Saito v. McCall*, No. 17132-NC, 2004 WL 3029876, 2004 Del. Ch. LEXIS 205 (Del. Ch. Dec. 20, 2004), to the extent it is inconsistent with the Supreme Court's reasoning and conclusions set forth in its opinion in *Lambrecht v. O'Neal*.

112 FED. R. CIV. P. 23.1.

113 *See infra* note 124 and related text.

114 *Potter v. Hughes*, 546 F.3d 1051, 1056 (9th Cir. 2008).

115 *Arkansas Teacher Retirement System v. Countrywide Financial Corporation*, 75 A.3d 888, 894 (Del. 2013) (in a derivative action, the plaintiff must be a stockholder at the time of the alleged wrong (the "*contemporaneous ownership*" requirement, which is imposed by DGCL § 327) and must maintain that stockholder status throughout the litigation (the "*continuous ownership*" requirement, which is a matter of common law; an exception exists where the merger was being perpetrated merely to deprive stockholders of standing to bring a derivative action); *Feldman v. Cutaia*, 951 A.2d 727, 728 (Del. 2008) (claim by shareholder that invalid grant of options resulted in dilution, which resulted in shareholder getting less value in merger, was derivative and did not survive merger); *Lewis v. Ward*, 852 A.2d 896, 897 (Del. 2004); *Lewis v. Anderson*, 477 A.2d 1040, 1047–49 (Del. 1984); *In re Merrill Lynch & Co., Inc. Sec., Derivative and ERISA Litig.*, 597 F. Supp. 2d 427 (S.D.N.Y. 2009); *Binks v. DSL.net, Inc.*, C.A. No. 2823-VCN, 2010 WL 1713629, at *1 n.3, 2010 Del. Ch. LEXIS 98, at *2 n.3 (Del. Ch. April 29, 2010) (mem. op.); *Schreiber v. Carney*, 447 A.2d 17, 21 (Del. Ch. 1982) ("[A] merger which eliminates a complaining stockholder's ownership of stock in a corporation also ordinarily eliminates his status to bring or maintain a derivative suit on behalf of the corporation, whether the merger takes place before or after the suit is brought, on the theory that upon the merger the derivative rights pass to the surviving corporation which then has the sole right or standing to prosecute the action."); *see Elloway v. Pate*, 238 S.W.3d 882, 900 (Tex. App.—Houston [14th Dist.] 2007, no pet.), in which a Texas court applying Delaware law held that a merger eliminated standing to bring a derivative action, but not a direct action, and explained: "A derivative claim is brought by a stockholder, on behalf of the corporation, to recover harm done to the

himself with the superior bidder (an entrenchment claim) were derivative in nature and did not survive a merger with another bidder.[116] A narrow exception to Delaware's general non-survival rule exists: a "stockholder who directly attacks the fairness or validity of a merger alleges an injury to the stockholders, not the corporation, and may pursue such a claim even after the merger at issue has been consummated."[117] As the extinguishment of a derivative claim can have value to those who would benefit therefrom, the Board should consider (i) the value (if any) of the extinguishment as it seeks to maximize the value of the corporation in the merger, (ii) whether any of the directors has a conflict of interest relative to the derivative claims, and (iii) whether its financial adviser should address such value (if any) in its fairness opinion and related analyses.[118]

The Delaware Supreme Court has reiterated its holding in *Lewis v. Anderson* that "a plaintiff who ceases to be a shareholder, whether by reason of a merger or for any other reason, loses standing to continue a derivative suit. This rule flows from the fact that, following a merger, the derivative claim—originally belonging to the acquired corporation—is transferred to and becomes an asset of the acquiring corporation as a matter of statutory law."[119] In *El Paso*, the Delaware Supreme Court determined that the

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corporation. *Tooley v. Donaldson, Lufkin & Jenrette*, 845 A.2d 1031, 1036 (Del. 2004). A stockholder's direct claim must be independent of any alleged injury to the corporation. *Id.* at 1039. If the stockholder's claim is derivative, the stockholder loses standing to pursue his claim upon accomplishment of the merger. *Parnes v. Bally Entm't Corp.*, 722 A.2d 1243, 1244-45 (Del. 1999). A stockholder who directly attacks the fairness or validity of a merger alleges an injury to the stockholders, not the corporation, and may pursue such claim even after the merger at issue has been consummated. *Id.* at 1245. To state a direct claim with respect to a merger, a stockholder must challenge the validity of the merger itself, usually by charging the directors with breaches of fiduciary duty in unfair dealing and/or unfair price. *Id.* at 1245." *Cf. Pate v. Elloway*, No. 01-03-00187-CV, 2003 WL 22682422, at *1, 2003 Tex. App. LEXIS 9681, at *3-*6 (Tex. App.—Houston [1st Dist.] Nov. 13, 2003, pet. denied); *Grosset v. Wenaas*, 175 P.3d 1184, 1197 (Cal. 2008) (in holding that a derivative lawsuit for breaches of fiduciary duty and insider trading in connection with a secondary offering by the corporation did not survive a reverse triangular merger in which it was the surviving corporation, the California Supreme Court wrote: "[W]e hold that California law, like Delaware law, generally requires a plaintiff in a shareholder's derivative suit to maintain continuous stock ownership throughout the pendency of the litigation. Under this rule, a derivative plaintiff who ceases to be a stockholder by reason of a merger ordinarily loses standing to continue the litigation. Although equitable considerations may warrant an exception to the continuous ownership requirement if the merger itself is used to wrongfully deprive the plaintiff of standing, or if the merger is merely a reorganization that does not affect the plaintiff's ownership interest, we need not address such matters definitively in this case, where no such circumstances appear.").

116 *In re NYMEX Shareholder Litigation*, C.A. No. 3621-VCN, 2009 WL 3206051, at *9, 2009 Del. Ch. LEXIS 176, at *35 (Del. Ch. Sept. 30, 2009).

117 *Parnes v. Bally Entm't Corp.*, 722 A.2d 1243, 1245 (Del. 1999).

118 *See In re Primedia, Inc. S'holders Litig. (Primedia III)*, Consolidated C.A. No. 6511-VCL, 2013 WL 679114, at *1, 2013 Del. Ch. LEXIS 306, at *3 (Del. Ch. Dec. 20, 2013) (motion to dismiss denied as to claims for breach of fiduciary duty on the ground that the merger was not entirely fair in light of *Brophy* insider trading claims involving directors and a controlling stockholder who would benefit from extinguishment of derivative claims in the merger); *Gerber v. Enter. Prods. Hldgs., LLC*, 67 A.3d 400 (Del. 2013) *overruled in part on other grounds by Winshal v. Vicom Int'l*, 76 A.3d 808 (Del. 2013) (duty of good faith and fair dealing required that the fairness opinion "address the value of derivative claims where (as here) terminating those claims was a principal purpose of a merger"); and *In re Massey Energy Derivative and Class Action Litigation*, C.A. No. 5430-VCS, 2011 WL 2176479, 2011 Del. Ch. LEXIS 83 (Del. Ch. May 31, 2011) (merger not enjoined as Court found that, while it was regrettable that the independent directors did not all understand that control of derivative claims against the directors would pass to the buyer in the merger, the independent directors ran a fair process to maximize the value of the corporation and did not approve the merger to escape personal liability; further, the Court thought it unlikely that the buyer ascribed any material value to the derivative claims, and concluded that the merger proxy statement disclosures regarding the passing of control of the derivative claims to buyer was adequate and the stockholders (largely institutions) could decide whether they were better off approving the merger or continuing to hold their stock with the attendant derivative claims).

119 152 A.3d 1248, 1265 (Del. 2016)(citing *Lewis v. Anderson*, 477 A.2d 1040 (Del.1984).

claims were required to be pursued derivatively.[120] As the company had properly executed a merger transaction, plaintiff's derivative claims passed by operation of law to the parent as a result of the Merger. The merger therefore extinguished the limited partner's standing to assert the derivative claims. Ultimately, the Delaware Supreme Court concluded that plaintiff's "remedy was to challenge the Merger, but he elected not to do so;" thus, the plaintiff was left without a remedy in "this troubling case."[121]

In Delaware, a derivative plaintiff must have been a stockholder continuously from the time of the transaction in question through the completion of the lawsuit.[122] Stockholders who obtained their shares in a merger lack derivative standing to challenge pre-merger actions.[123]

The effect of a merger in which the corporation is not the acquiring entity on a derivative action was not as clear under Texas law until 2011. Like Delaware's rules, the Federal Rules of Civil Procedure[124] and Texas' prior derivative action provisions in the TBCA[125] have been interpreted to require that the

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120 *See* discussion of the Delaware Supreme Court's direct versus derivative analysis, *supra* at notes 11-25.

121 152 A.3d 1248, 1265 (Del. 2016).

122 *Ryan v. Gifford*, 918 A.2d 341, 359 (Del. Ch. 2007); DGCL § 327.

123 *Cf. La. Mun. Police Employees' Ret. Sys. v. Crawford*, 918 A.2d 1172, 1185 (Del. Ch. 2007) and *Express Scripts, Inc. v. Crawford*, Civ. Action No. 2663-N, 2007 WL 417193, at *1-*2, 2007 Del. Ch. LEXIS 18, at *3-*5 (Del. Ch. Jan. 25, 2007) (delaying a stockholders meeting to vote on the proposed Caremark Rx/CVS merger from February 20, 2007 to March 9, 2007 to allow disclosures that (i) Caremark had three times discussed a possible transaction with Express Scripts even though after its agreement with CVS, Caremark was arguing that antitrust concerns even precluded talking to this higher bidder, and (ii) any merger of Caremark could cause other plaintiffs to lose standing to sue Caremark Rx directors for breach of fiduciary duty in respect of alleged options backdating; *but cf. In re CheckFree Corp.*, Consol. C.A. No. 3193-CC, 2007 WL 3262188, at *4, 2007 Del. Ch. LEXIS 148, at *12-*13 (Del. Ch. Nov. 1, 2007) (denying a claim that management failed to disclose the effect of a merger on a pending derivative action and that the merger would likely extinguish the claim and free one of the directors from liability, holding that "directors need not [give legal advice and] tell shareholders that a merger will extinguish pending derivative claims"). Though such information may be helpful in an abstract sense, the Court found it unlikely the disclosure would "alter the total mix of information available." *Id.*

124 FED. R. CIV. P. 23.1; *Schilling v. Belcher*, 582 F.2d 995, 999 (5th Cir. 1978) (noting "the [stock] ownership requirement continues throughout the life of the suit"); *Romero v. US Unwired, Inc.*, No. 04-2312, 2006 WL 2366342, at *5, 2006 U.S. Dist. LEXIS 60589, at *21 (E.D. La. Aug. 11, 2006) (slip op.), *aff'd in part, rev'd in part*, 565 F.3d 228 (5th Cir. 2009) (holding that merger divested shareholder plaintiff of standing to pursue derivative claim under Fed. R. Civ. P. 23.1 and dismissing suit); *Quinn v. Anvil Corporation*, 620 F.3d 1005, 1012 (9th Cir. 2010) (holding that because of the extraordinary nature of a shareholder derivative suit, FRCP 23.1 establishes two stringent conditions for bringing such a suit: First, plaintiffs must comply with Rule 23.1's pleading requirements, including that the plaintiff "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors;" Second, under Rule 23.1 (a) a derivative action "may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of shareholders or members who are similarly situated in enforcing the right of the corporation or association," from which courts have inferred a requirement not only "that a derivative plaintiff be a shareholder at the time of the alleged wrongful acts" but also "that the plaintiff retain ownership of the stock for the duration of the lawsuit" (the so-called "continuous ownership requirement") so that "if a shareholder is divested of his or her shares during the pendency of litigation, that shareholder loses standing" and as a result plaintiff's derivative action was foreclosed by operation of the reverse stock split in which plaintiff's shares were cancelled and plaintiff thereafter held no stock; plaintiff's derivative claims are an "intangible asset" belonging to the corporation, not to plaintiff and plaintiff as a nonshareholder cannot benefit from any recovery the company obtains; equitable exceptions to the continuous ownership requirement were not applicable because (i) there were other shareholders who could have brought the claim and the challenged transaction did not result in a dissolution of the corporation leaving no continuing shareholders as in the case of some mergers and (ii) there was a valid business purpose (consolidating stock ownership in employees for benefit of the corporation for the transaction) and no evidence beyond plaintiff's self serving statements that the reverse split was undertaken to cut off plaintiff's derivative claims).

125 *Zauber v. Murray Sav. Ass'n*, 591 S.W.2d 932, 937-38 (Tex. Civ. App.—Dallas 1979), writ ref'd per curiam, 601 S.W.2d 940 (Tex. 1980), *superseded by statute as stated in Sneed v. Webre*, 465 S.W.3d 169 (Tex. 2015) ("The requirement in article [TBCA]

claimant in a derivative case remain a shareholder throughout the course of the derivative claim, which requirement would not be satisfied where a derivative plaintiff's shares in the corporation are converted in the merger into cash or securities of another entity. Only one Texas court has ruled on the merger survival issue under the derivative provisions in the pre-2011 Tex. Corp. Stats., holding that, at least in a cash-out merger, the right of a shareholder to bring a derivative action on behalf of the non-surviving corporation does not survive the merger.[126] In the 2011 Texas Legislature Session, the TBOC was amended to clarify that a plaintiff in a corporate shareholder derivative suit must have been a shareholder at the time of filing suit through completion of the proceedings, and thus would not have standing to be a derivative plaintiff if his shares were converted to cash in a merger.[127] Although Delaware law explicitly

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5.14(B) [as it existed in 1979] that in order to bring a derivative suit a plaintiff must have been a shareholder at the time of the wrongful transaction, is only a minimum requirement. The federal rule governing derivative suits, which contains similar requirements to article 5.14(B), has been construed to include a further requirement that shareholder status be maintained throughout the suit. [citations omitted] The reasoning behind allowing a shareholder to maintain a suit in the name of the corporation when those in control wrongfully refuse to maintain it is that a shareholder has a proprietary interest in the corporation. Therefore, when a shareholder sues, he is protecting his own interests a well as those of the corporation. If a shareholder voluntarily disposes of his shares after instituting a derivative action, he necessarily destroys the technical foundation of his right to maintain the action. [citation omitted] If, on the other hand, a shareholder's status is involuntarily destroyed, a court of equity must determine whether the status was destroyed without a valid business purpose; for example, was the action taken merely to defeat the plaintiff's standing to maintain the suit? * * * If no valid business purpose exists, a court of equity will consider the destruction of a stockholder's status a nullity and allow him to proceed with the suit in the name of the corporation. Therefore, on remand of this suit, a finding that appellant has failed to maintain his status as shareholder is dependent upon findings that the disposition of the stock was voluntary or, though involuntary, that the corporation's termination proceeding was instituted to accomplish a valid business purpose, rather than to dispose of the derivative suit by a reverse stock split.").

126 *Somers v. Crane*, 295 S.W.3d 5, 15 (Tex. App.—Houston [1st Dist.] 2009, pet. denied). TBCA art. 5.03(M) provided that for the purposes of TBCA art. 5.03: "To the extent a shareholder of a corporation has standing to institute or maintain derivative litigation on or behalf of the corporation immediately before a merger, nothing in this article may be construed to limit or extinguish the shareholder's standing." (Substantially the same language was initially included in TBOC § 21.552(b)). At least one federal court interpreting Texas law has suggested that under TBCA art. 5.03(M) a shareholder who could have properly brought a derivative suit prior to a merger will maintain that right, even after a merger has rendered the corporation in question nonexistent. *Marron v. Ream*, Civil Action No. H-06-1394, 2006 WL 2734267, 2006 U.S. Dist. LEXIS 72831, at *23 (S.D. Tex. May 5, 2006). But the *Somers* opinion dismissed this analysis, holding that *Marron* did not squarely address the issue of standing and that the federal court's suggestion that TBCA art. 5.03(M) might support survival was merely dicta. *Somers* also held that "because of the abundant authority stating that a director's or officer's fiduciary duty runs only to the corporation, not to individual shareholders, we decline to recognize the existence of a fiduciary relationship owed directly by a director to a shareholder in the context of a cash-out merger" and, thus, that a direct class action could not be brought against directors and officers for their role in a cash-out merger. *Id.* at 13.

127 S.B. 1568 (*available at* http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB1568) in the 2011 Texas Legislature Session by Sen. Craig Estes clarified that a derivative plaintiff must own stock at the time of filing the derivative action and continuously to the completion of the action by deleting TBOC § 21.552(b) effective September 1, 2011. S.B. 1568 provided:

> SECTION 1. Section 21.552, Business Organization Code, is amended read as follows:
>
> ~~(a)~~ A shareholder may not institute or maintain a derivative proceeding unless:
>
> (1) the shareholder:
>
> (A) was a shareholder of the corporation at the time of the act or omission complained of; or
>
> (B) became a shareholder by operation of law from a person that was a shareholder at the time of the act or omission complained of; and
>
> (2) the shareholder fairly and adequately represents the interests of the corporation in enforcing the right of the corporation.

allows for direct suit in some fiduciary duty cases,[128] *Gearhart* held that under Texas law fiduciary claims in connection with a merger are the right of the corporation itself, not individual shareholders.[129]

CHAPTER 7. SPECIAL LITIGATION COMMITTEES.

In *Zapata Corporation v. Maldonado*,[130] the Delaware Supreme Court established a two-step analysis that must be applied to a motion to dismiss a derivative claim based on the recommendation of a Special Litigation Committee ("SLC" or a "*Zapata* Committee") established by a Board in a demand-excused case. The first step of the analysis is a court review of the independence of SLC members and whether the SLC conducted a good faith investigation of reasonable scope that yielded reasonable bases supporting its conclusions.[131] The second step of the analysis is the Court applying its own business judgment to the facts to determine whether the corporation's best interests would be served by dismissing the suit, and it is a discretionary step designed for situations in which the technical requirements of step one are met but the result does not appear to satisfy the spirit of the requirements.[132]

The court treats the SLC's motion in a manner similar to a motion for summary judgment. The SLC bears the burden of demonstrating that there are no genuine issues of material fact as to its independence, the reasonableness and good faith of its investigation and that there are reasonable bases for its conclusions.[133] If the court determines that a material fact is in dispute on any of these issues, it must deny the SLC's motion to dismiss.[134] If an SLC's motion to dismiss is denied, control of the litigation is returned to the plaintiff shareholder.[135]

The *Zapata* test was applied in *London v. Tyrrell*,[136] in which a two member SLC was found to have failed to show that it was independent and that the scope of its investigation was reasonable. As to independence, the Court stressed that the SLC must carry the burden of "fully convinc[ing] the Court that the SLC can act with integrity and objectivity." The two member SLC failed because one committee member was the husband of the defendant's cousin, and the other was a former colleague of the defendant who felt indebted to the defendant for getting him "a good price" in the prior sale of a company. The Court commented that "it will be nigh unto impossible" to show independence where "the SLC member and a director defendant have a family relationship" or where an SLC member "feels he owes something to an interested director." The Court was also concerned with deposition testimony and notes suggesting that the SLC members viewed their job as "attacking" the plaintiffs' complaint. As to the SLC's

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> (b) To the extent a shareholder of a corporation has standing to institute or maintain a derivative proceeding on behalf of the corporation immediately before a merger, Subchapter J or Chapter 10 may not be construed to limit or terminate the shareholder's standing after the merger.
>
> SECTION 2. This Act takes effect September 1, 2011.

128 *See* EGAN ON ENTITIES notes 533 and 650 and related text.

129 *Gearhart Indus., Inc. v. Smith Int'l. Inc.*, 741 F.2d 707, 721 (5th Cir. 1984).

130 430 A.2d 779, 788 (Del. 1981).

131 *Id.* at 789.

132 *Id.* at 789.

133 *Kaplan v. Wyatt*, 484 A.2d 501, 506-507 (Del. Ch. 1984), *aff'd*, 499 A.2d 1184 (Del. 1985).

134 *Id.* at 508.

135 *Id.* at 509.

136 C.A. No. 3321-CC, 2010 Del. Ch. LEXIS 54, at *40 (Del. Ch. Mar. 11, 2010).

investigation, the Court found that the SLC wrongly concluded that some claims were barred by the exculpation provision in the corporation's Charter, made key mistakes of fact, and systematically failed to pursue evidence that might suggest liability. Although the Court denied the SLC's motion to dismiss and authorized the plaintiffs to pursue the action, the Court commented that the SLC process remains "a legitimate mechanism" in Delaware corporate law, and in an appropriate case an SLC can serve the corporate interest by short-circuiting ill-advised litigation and restoring the Board's management authority to determine corporate litigation policy.

ANNEX I

86R6926 ATP-F

By: Martinez Fischer H.B. No. 3603

A BILL TO BE ENTITLED

AN ACT

relating to derivative proceedings on behalf of for-profit corporations, limited liability companies, and limited partnerships.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF TEXAS:

SECTION 1. Section 21.551(2), Business Organizations Code, is amended to read as follows:

(2) "Shareholder" means a shareholder as defined by Section 1.002 or [~~includes~~] a beneficial owner whose shares are held in a voting trust or by a nominee on the beneficial owner's behalf.

SECTION 2. Section 21.552, Business Organizations Code, is amended to read as follows:

Sec. 21.552. STANDING TO BRING PROCEEDING. (a) Subject to Subsection (b), a [~~A~~] shareholder may not institute or maintain a derivative proceeding unless:

(1) the shareholder:

(A) was a shareholder of the corporation at the time of the act or omission complained of; or

(B) became a shareholder by operation of law originating from a person that was a shareholder at the time of the act or omission complained of; and

(2) the shareholder fairly and adequately represents the interests of the corporation in enforcing the right of the corporation.

(b) If a corporation is the surviving form of an entity in a conversion, a shareholder of that entity may not institute or maintain a derivative proceeding based on an act or omission that occurred with respect to the converting entity before the date of the conversion unless:

(1) the shareholder was an equity owner of the converting entity at the time of the act or omission; and

(2) the shareholder fairly and adequately represents the interests of the corporation in enforcing the right of the corporation.

SECTION 3. Section 21.553(b), Business Organizations Code, is amended to read as follows:

(b) The waiting period required by Subsection (a) before a derivative proceeding may be instituted is not required or, if applicable, shall terminate if:

(1) the shareholder has been [~~previously~~] notified that the demand has been rejected by the corporation;

(2) the corporation is suffering irreparable injury; or

(3) irreparable injury to the corporation would result by waiting for the expiration of the 90-day period.

SECTION 4. Section 21.554, Business Organizations Code, is amended to read as follows:

Sec. 21.554. DETERMINATION BY DIRECTORS OR INDEPENDENT PERSONS. (a) A determination of how to proceed on allegations made in a demand or petition relating to a derivative proceeding must be made by an affirmative vote of the majority of:

(1) all [~~the~~] independent and disinterested directors of the corporation, regardless of whether [~~present at a meeting of the board of directors of the corporation at which interested directors are not present at the time of the vote if~~] the independent and disinterested directors constitute a quorum of the board of directors;

(2) a committee consisting of one [~~two~~] or more independent and disinterested directors appointed by an affirmative vote of the majority of one or more independent and disinterested directors [~~present at a meeting of the board of directors~~], regardless of whether the independent and disinterested directors constitute a quorum of the board of directors; or

(3) a panel of one or more independent and disinterested individuals [~~persons~~] appointed by the court on a motion by the corporation listing the names of the individuals [~~persons~~] to be appointed and stating that, to the best of the corporation's knowledge, the individuals [~~persons~~] to be appointed are disinterested and qualified to make the determinations contemplated by Section 21.558.

(b) The court shall appoint a panel under Subsection (a)(3) if the court finds that the individuals [~~persons~~] recommended by the corporation are independent and disinterested and are otherwise qualified with respect to expertise, experience, independent judgment, and other factors considered appropriate by the court under the circumstances to make the determinations. An individual [~~A person~~] appointed by the court to a panel under this section may not be held liable to the corporation or the corporation's shareholders for an action taken or omission made by the individual [~~person~~] in that capacity, except for an act or omission constituting fraud or wilful misconduct.

SECTION 5. Section 21.555, Business Organizations Code, is amended to read as follows:

Sec. 21.555. STAY OF PROCEEDING. (a) If the [~~domestic or foreign~~] corporation that is the subject of a derivative proceeding commences an inquiry into the allegations made in a demand or petition and the person or group of persons described by Section 21.554 is conducting an active review of the allegations in good faith, the court shall stay a derivative proceeding for not more than 60 days until the review is completed and a determination is made by the person or group regarding what further action, if any, should be taken.

(b) To obtain a stay, the [~~domestic or foreign~~] corporation must [~~shall~~] provide the court with a written statement agreeing to advise the court and the shareholder making the demand of the determination promptly on the completion of the review of the matter.

(c) A stay, on motion [~~application~~], may be reviewed every 60 days for continuation [~~the continued necessity~~] of the stay if the corporation provides the court and the shareholder with a written statement of the status of the review and the reasons why an extension for a period not to exceed 60 additional days is appropriate. An extension shall be granted for a period not to exceed 60 days if the court determines that the continuation is appropriate in the interests of the corporation.

[~~(c) If the review and determination made by the person or group is not completed before the 61st day after the stay is ordered by the court, the stay may be renewed for one or more additional 60-day periods if the domestic or foreign corporation provides the court and the shareholder with a written statement of the status of the review and the reasons why a continued extension of the stay is necessary.~~]

SECTION 6. Section 21.556, Business Organizations Code, is amended to read as follows:

Sec. 21.556. DISCOVERY. (a) If a [~~domestic or foreign~~] corporation proposes to dismiss a derivative proceeding under Section 21.558, discovery by a shareholder after the filing of the derivative proceeding in accordance with this subchapter shall be limited to:

(1) facts relating to whether the person or [~~group of~~] persons described by Section 21.554 are [~~21.558 is~~] independent and disinterested;

(2) the good faith of the inquiry and review by the person or group; and

(3) the reasonableness of the procedures followed by the person or group in conducting the review.

(b) Discovery described by Subsection (a) may not be expanded to include a fact or substantive matter regarding the act, omission, or other matter that is the subject matter of the derivative proceeding

but the scope of discovery shall not be so limited [~~. The scope of discovery may be expanded~~] if the court determines after notice and hearing that a good faith review of the allegations [~~for purposes of Section 21.558~~] has not been made by an independent and disinterested person or group in accordance with Sections 21.554 and 21.558 [~~that section~~].

SECTION 7. Section 21.557, Business Organizations Code, is amended to read as follows:

Sec. 21.557. TOLLING OF STATUTE OF LIMITATIONS. A written demand filed with the corporation under Section 21.553 tolls the statute of limitations on the claim on which demand is made until the later [~~earlier~~] of:

(1) the 31st [~~91st~~] day after the expiration of any waiting period under Section 21.553 [~~date of the demand~~]; or

(2) the 31st day after the expiration of any stay granted under Section 21.555, including all continuations of the stay [~~date the corporation advises the shareholder that the demand has been rejected or the review has been completed~~].

SECTION 8. Section 21.558, Business Organizations Code, is amended to read as follows:

Sec. 21.558. DISMISSAL OF DERIVATIVE PROCEEDING. (a) A court, sitting in equity as the finder of fact, shall dismiss a derivative proceeding on a motion by the corporation if the person or group of persons described by Section 21.554 determines in good faith, after conducting a reasonable inquiry and based on factors the person or group considers appropriate under the circumstances, that continuation of the derivative proceeding is not in the best interests of the corporation.

(b) In determining whether the requirements of Subsection (a) have been met, the burden of proof shall be on:

(1) the plaintiff shareholder if:

(A) the majority of the board of directors consists of independent and disinterested directors at the time the determination is made;

(B) the determination is made by a panel of one or more independent and disinterested persons appointed under Section 21.554(a)(3); or

(C) the corporation presents prima facie evidence that demonstrates that the applicable person or persons making the determination [~~directors appointed~~] under Section 21.554(a) [~~21.554(a)(2)~~] are independent and disinterested; or

(2) the corporation in any other circumstance.

SECTION 9. Section 21.559, Business Organizations Code, is amended to read as follows:

Sec. 21.559. ALLEGATIONS [~~PROCEEDING INSTITUTED~~] AFTER DEMAND REJECTED. If a derivative proceeding is instituted after a demand is rejected, the petition must allege with particularity facts that establish that the rejection was not made in accordance with the requirements and standards under [~~of~~] Sections 21.554 and 21.558.

SECTION 10. Section 21.561, Business Organizations Code, is amended to read as follows:

Sec. 21.561. PAYMENT OF EXPENSES. (a) In this section, "expenses" means reasonable expenses incurred by a party in a derivative proceeding, including:

(1) attorney's fees;

(2) costs in pursuing an investigation of the matter that was the subject of the derivative proceeding; or

(3) expenses for which the [~~domestic or foreign~~] corporation [~~or a corporate defendant~~] may be required to indemnify another person.

(b) On termination of a derivative proceeding, the court may order:

(1) the [~~domestic or foreign~~] corporation to pay [~~the~~] expenses the plaintiff incurred in the proceeding if the court finds the proceeding has resulted in a substantial benefit to the [~~domestic or foreign~~] corporation;

(2) the plaintiff to pay [~~the~~] expenses the [~~domestic or foreign~~] corporation or other defendant incurred in investigating and defending the proceeding if the court finds the proceeding has been instituted or maintained without reasonable cause or for an improper purpose; or

(3) a party to pay [~~the~~] expenses incurred by another party relating to the filing of a pleading, motion, or other paper if the court finds the pleading, motion, or other paper:

(A) was not well grounded in fact after reasonable inquiry;

(B) was not warranted by existing law or a good faith argument for the application, extension, modification, or reversal of existing law; or

(C) was interposed for an improper purpose, such as to harass, cause unnecessary delay, or cause a needless increase in the cost of litigation.

SECTION 11. Section 21.562, Business Organizations Code, is amended to read as follows:

Sec. 21.562. APPLICATION TO FOREIGN CORPORATIONS. (a) In a derivative proceeding brought in the right of a foreign corporation, the matters covered by this subchapter are governed by the laws of the jurisdiction of formation [~~incorporation~~] of the foreign corporation, except for Sections 21.555, 21.560, and 21.561, which are procedural provisions and do not relate to the internal affairs of the foreign corporation, unless applying the laws of the jurisdiction of formation of the foreign corporation requires otherwise with respect to Section 21.555.

(b) In the case of matters relating to a foreign corporation under Section 21.555 [~~21.554~~], a reference to a person or group of persons described by Section 21.554 [~~that section~~] refers to a person or group entitled under the laws of the jurisdiction of formation [~~incorporation~~] of the foreign corporation

to make the determination described by Section 21.554(a) [~~review and dispose of a derivative proceeding~~]. The standard of review of a determination [~~decision~~] made by the person or group [~~to dismiss the derivative proceeding~~] shall be governed by the laws of the jurisdiction of formation [~~incorporation~~] of the foreign corporation.

SECTION 12. Section 21.563, Business Organizations Code, is amended to read as follows:

Sec. 21.563. CLOSELY HELD CORPORATION. (a) In this section, "closely held corporation" means a corporation that has:

(1) fewer than 35 shareholders; and

(2) no shares listed on a national securities exchange or regularly quoted in an over-the-counter market by one or more members of a national securities association.

(b) Sections 21.552-21.560 [~~21.552-21.559~~] do not apply to a claim or a derivative proceeding by a shareholder of a closely held corporation against a director, officer, or shareholder of the corporation. In the event the claim or derivative proceeding is also made against a person who is not that director, officer, or shareholder, this subsection applies only to the claim or derivative proceeding against the director, officer, or shareholder.

(c) If Sections 21.552-21.560 do not apply because of Subsection (b) and if justice requires:

(1) 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 the shareholder's own benefit; and

(2) a recovery in a direct or derivative proceeding by a shareholder may be paid directly to the plaintiff or to the corporation if necessary to protect the interests of creditors or other shareholders of the corporation.

(d) Other provisions of state law govern whether a shareholder has a direct cause of action or right to sue a director, officer, or shareholder, and this section may not be construed to create that direct cause of action or right to sue.

SECTION 13. Section 101.451, Business Organizations Code, is amended by amending Subdivision (2) and adding Subdivision (3) to read as follows:

(2) "Managing entity" means an entity that is either:

(A) a manager of a limited liability company that is managed by managers; or

(B) a member of a limited liability company that is managed by members who are entitled to manage the company.

(3) "Member" means [~~includes~~] a person who is a member or is an assignee of a membership interest or a person who beneficially owns a membership interest through a voting trust or a nominee on the person's behalf.

SECTION 14. Section 101.452, Business Organizations Code, is amended to read as follows:

Sec. 101.452. STANDING TO BRING PROCEEDING. (a) Subject to Subsection (b), a [~~A~~] member may not institute or maintain a derivative proceeding unless:

(1) the member:

(A) was a member of the limited liability company at the time of the act or omission complained of; or

(B) became a member by operation of law originating from a person that was a member at the time of the act or omission complained of; and

(2) the member fairly and adequately represents the interests of the limited liability company in enforcing the right of the limited liability company.

(b) If a limited liability company is the surviving form of an entity in a conversion, a member of that entity may not institute or maintain a derivative proceeding based on an act or omission that occurred with respect to the converting entity before the date of the conversion unless:

(1) the member was an equity owner of the converting entity at the time of the act or omission; and

(2) the member fairly and adequately represents the interests of the limited liability company in enforcing the right of the limited liability company.

SECTION 15. Section 101.453(b), Business Organizations Code, is amended to read as follows:

(b) The waiting period required by Subsection (a) before a derivative proceeding may be instituted is not required or, if applicable, shall terminate if:

(1) the member has been [~~previously~~] notified that the demand has been rejected by the limited liability company;

(2) the limited liability company is suffering irreparable injury; or

(3) irreparable injury to the limited liability company would result by waiting for the expiration of the 90-day period.

SECTION 16. Section 101.454, Business Organizations Code, is amended to read as follows:

Sec. 101.454. DETERMINATION BY GOVERNING OR INDEPENDENT PERSONS. (a) The determination of how to proceed on allegations made in a demand or petition relating to a derivative proceeding must be made by an affirmative vote of the majority of:

(1) the independent and disinterested governing persons of the limited liability company, whether one or more, even if the independent and disinterested governing persons are not a majority of the governing persons of the limited liability company [~~present at a meeting of the governing authority at~~

~~which interested governing persons are not present at the time of the vote if the independent and disinterested governing persons constitute a quorum of the governing authority~~];

(2) a committee consisting of one [~~two~~] or more independent and disinterested governing persons appointed by the majority of one or more independent and disinterested governing persons of the limited liability company, even if the appointing independent and disinterested governing persons are not a majority of the governing persons of the limited liability company [~~present at a meeting of the governing authority, regardless of whether the independent and disinterested governing persons constitute a quorum of the governing authority~~]; or

(3) a panel of one or more independent and disinterested individuals [~~persons~~] appointed by the court on a motion by the limited liability company listing the names of the individuals [~~persons~~] to be appointed and stating that, to the best of the limited liability company's knowledge, the individuals [~~persons~~] to be appointed are disinterested and qualified to make the determinations contemplated by Section 101.458.

(b) An entity is independent and disinterested only if its decision with respect to the limited liability company's derivative proceeding is made by a majority of its governing persons who are independent and disinterested with respect to that derivative proceeding, even if those governing persons are not a majority of its governing persons. This section applies to an entity that is:

(1) a managing entity of the limited liability company; or

(2) directly, or indirectly through one or more other entities, a governing person of that managing entity.

(c) The court shall appoint a panel under Subsection (a)(3) if the court finds that the individuals [~~persons~~] recommended by the limited liability company are independent and disinterested and are otherwise qualified with respect to expertise, experience, independent judgment, and other factors

considered appropriate by the court under the circumstances to make the determinations. An individual [~~A person~~] appointed by the court to a panel under this section may not be held liable to the limited liability company or the limited liability company's members for an action taken or omission made by the individual [~~person~~] in that capacity, except for acts or omissions constituting fraud or wilful misconduct.

SECTION 17. Section 101.455, Business Organizations Code, is amended to read as follows:

Sec. 101.455. STAY OF PROCEEDING. (a) If the [~~domestic or foreign~~] limited liability company that is the subject of a derivative proceeding commences an inquiry into the allegations made in a demand or petition and the person or group of persons described by Section 101.454 is conducting an active review of the allegations in good faith, the court shall stay a derivative proceeding for not more than 60 days until the review is completed and a determination is made by the person or group regarding what further action, if any, should be taken.

(b) To obtain a stay, the [~~domestic or foreign~~] limited liability company must [~~shall~~] provide the court with a written statement agreeing to advise the court and the member making the demand of the determination promptly on the completion of the review of the matter.

(c) A stay, on motion, may be reviewed every 60 days for continuation [~~the continued necessity~~] of the stay if the limited liability company provides the court and the member with a written statement of the status of the review and the reasons why an extension for a period not to exceed 60 additional days is appropriate. An extension shall be granted for a period not to exceed 60 days if the court determines that the continuation is appropriate in the interests of the limited liability company.

[~~(c) If the review and determination made by the person or group is not completed before the 61st day after the date on which the court orders the stay, the stay may be renewed for one or more additional 60-day periods if the domestic or foreign limited liability company provides the court and the member~~

~~with a written statement of the status of the review and the reasons why a continued extension of the stay is necessary.~~]

SECTION 18. Section 101.456, Business Organizations Code, is amended to read as follows:

Sec. 101.456. DISCOVERY. (a) If a [~~domestic or foreign~~] limited liability company proposes to dismiss a derivative proceeding under Section 101.458, discovery by a member after the filing of the derivative proceeding in accordance with this subchapter shall be limited to:

(1) facts relating to whether the person or [~~group of~~] persons described by Section 101.454 are [~~101.458 is~~] independent and disinterested;

(2) the good faith of the inquiry and review by the person or group; and

(3) the reasonableness of the procedures followed by the person or group in conducting the review.

(b) Discovery described by Subsection (a) may not be expanded to include a fact or substantive matter regarding the act, omission, or other matter that is the subject matter of the derivative proceeding but the scope of discovery shall not be so limited [~~. The scope of discovery may be expanded~~] if the court determines after notice and hearing that a good faith review of the allegations [~~for purposes of Section 101.458~~] has not been made by an independent and disinterested person or group in accordance with Sections 101.454 and 101.458 [~~that section~~].

SECTION 19. Section 101.457, Business Organizations Code, is amended to read as follows:

Sec. 101.457. TOLLING OF STATUTE OF LIMITATIONS. A written demand filed with the limited liability company under Section 101.453 tolls the statute of limitations on the claim on which demand is made until the later [~~earlier~~] of:

(1) the 31st [~~91st~~] day after the expiration of any waiting period under Section 153.403 [~~date of the demand~~]; or

(2) the 31st day after the expiration of any stay granted under Section 153.405, including all continuations of the stay [~~date the limited liability company advises the member that the demand has been rejected or the review has been completed~~].

SECTION 20. Section 101.458, Business Organizations Code, is amended to read as follows:

Sec. 101.458. DISMISSAL OF DERIVATIVE PROCEEDING. (a) A court, sitting in equity as the finder of fact, shall dismiss a derivative proceeding on a motion by the limited liability company if the person or group of persons described by Section 101.454 determines in good faith, after conducting a reasonable inquiry and based on factors the person or group considers appropriate under the circumstances, that continuation of the derivative proceeding is not in the best interests of the limited liability company.

(b) In determining whether the requirements of Subsection (a) have been met, the burden of proof shall be on:

(1) the plaintiff member if:

(A) the applicable person or persons making the determination under Section 101.454(a)(1) or (2) are [~~majority of the governing authority consists of~~] independent and disinterested [~~persons~~] at the time the determination is made;

(B) the determination is made by a panel of one or more independent and disinterested persons appointed under Section 101.454(a)(3); or

(C) the limited liability company presents prima facie evidence that demonstrates that the applicable person or persons making the determination [~~appointed~~] under Section 101.454(a) [~~101.454(a)(2)~~] are independent and disinterested; or

(2) the limited liability company in any other circumstance.

SECTION 21. Section 101.459, Business Organizations Code, is amended to read as follows:

Sec. 101.459. ALLEGATIONS AFTER [~~IF~~] DEMAND REJECTED. If a derivative proceeding is instituted after a demand is rejected, the petition must allege with particularity facts that establish that the rejection was not made in accordance with the requirements and standards under [~~of~~] Sections 101.454 and 101.458.

SECTION 22. Section 101.461, Business Organizations Code, is amended to read as follows:

Sec. 101.461. PAYMENT OF EXPENSES. (a) In this section, "expenses" means reasonable expenses incurred by a party in a derivative proceeding, including:

(1) attorney's fees;

(2) costs in [~~of~~] pursuing an investigation of the matter that was the subject of the derivative proceeding; or

(3) expenses for which the [~~domestic or foreign~~] limited liability company may be required to indemnify another person.

(b) On termination of a derivative proceeding, the court may order:

(1) the [~~domestic or foreign~~] limited liability company to pay [~~the~~] expenses the plaintiff incurred in the proceeding if the court finds the proceeding has resulted in a substantial benefit to the [~~domestic or foreign~~] limited liability company;

(2) the plaintiff to pay [~~the~~] expenses the [~~domestic or foreign~~] limited liability company or other defendant incurred in investigating and defending the proceeding if the court finds the proceeding has been instituted or maintained without reasonable cause or for an improper purpose; or

(3) a party to pay [~~the~~] expenses incurred by another party relating to the filing of a pleading, motion, or other paper if the court finds the pleading, motion, or other paper:

(A) was not well grounded in fact after reasonable inquiry;

(B) was not warranted by existing law or a good faith argument for the application, extension, modification, or reversal of existing law; or

(C) was interposed for an improper purpose, such as to harass, cause unnecessary delay, or cause a needless increase in the cost of litigation.

SECTION 23. Section 101.462, Business Organizations Code, is amended to read as follows:

Sec. 101.462. APPLICATION TO FOREIGN LIMITED LIABILITY COMPANIES. (a) In a derivative proceeding brought in the right of a foreign limited liability company, the matters covered by this subchapter are governed by the laws of the jurisdiction of formation [~~organization~~] of the foreign limited liability company, except for Sections 101.455, 101.460, and 101.461, which are procedural provisions and do not relate to the internal affairs of the foreign limited liability company, unless applying the laws of the jurisdiction of formation of the foreign limited liability company requires otherwise with respect to Section 101.455.

(b) In the case of matters relating to a foreign limited liability company under Section 101.455 [~~101.454~~], a reference to a person or group of persons described by Section 101.454 [~~that section~~] refers to a person or group entitled under the laws of the jurisdiction of formation [~~organization~~] of the foreign limited liability company to make the determination described by Section 101.454(a) [~~review and dispose of a derivative proceeding~~]. The standard of review of a determination [~~decision~~] made by the person or group [~~to dismiss the derivative proceeding~~] shall be governed by the laws of the jurisdiction of formation [~~organization~~] of the foreign limited liability company.

SECTION 24. Section 101.463, Business Organizations Code, is amended to read as follows:

Sec. 101.463. CLOSELY HELD LIMITED LIABILITY COMPANY. (a) In this section, "closely held limited liability company" means a limited liability company that has:

(1) fewer than 35 members; and

(2) no membership interests listed on a national securities exchange or regularly quoted in an over-the-counter market by one or more members of a national securities association.

(b) Sections 101.452-101.460 [~~101.452-101.459~~] do not apply to a claim or a derivative proceeding by a member of a closely held limited liability company against a governing person, member, or officer of the limited liability company. In the event the claim or derivative proceeding is also made against a person who is not that governing person, member, or officer, this subsection applies only to the claim or derivative proceeding against the governing person, member, or officer.

(c) If Sections 101.452-101.460 do not apply because of Subsection (b) and if justice requires:

(1) a derivative proceeding brought by a member of a closely held limited liability company may be treated by a court as a direct action brought by the member for the member's own benefit; and

(2) a recovery in a direct or derivative proceeding by a member may be paid directly to the plaintiff or to the limited liability company if necessary to protect the interests of creditors or other members of the limited liability company.

(d) Other provisions of state law govern whether a member has a direct cause of action or right to sue a governing person, member, or officer, and this section may not be construed to create that direct cause of action or right to sue.

SECTION 25. Section 153.401, Business Organizations Code, is amended to read as follows:

Sec. 153.401. DEFINITIONS [~~RIGHT TO BRING ACTION~~]. In this subchapter:

(1) "Derivative proceeding" means a civil suit in the right of a domestic limited partnership or, to the extent provided by Section 153.412, in the right of a foreign limited partnership.

(2) "Limited partner" means a person who is a limited partner or is an assignee of a partnership interest, including the partnership interest of a general partner [~~A limited partner may bring an~~

~~action in a court on behalf of the limited partnership to recover a judgment in the limited partnership's favor if:~~

[~~(1) all general partners with authority to bring the action have refused to bring the action; or~~

[~~(2) an effort to cause those general partners to bring the action is not likely to succeed~~].

SECTION 26. Section 153.402, Business Organizations Code, is amended to read as follows:

Sec. 153.402. STANDING TO BRING PROCEEDING [~~PROPER PLAINTIFF~~]. (a) Subject to Subsection (b), a limited partner may not institute or maintain a derivative proceeding unless:

(1) the limited partner:

(A) was a limited partner of the limited partnership at the time of the act or omission complained of; or

(B) became a limited partner by operation of law originating from a person that was a limited partner or general partner at the time of the act or omission complained of; and

(2) the limited partner fairly and adequately represents the interests of the limited partnership in enforcing the right of the limited partnership.

(b) If a limited partnership is the surviving form of an entity in a conversion, a limited partner of that entity may not institute or maintain a derivative proceeding based on an act or omission that occurred with respect to the converting entity before the date of the conversion unless:

(1) the limited partner was an equity owner of the converting entity at the time of the act or omission; and

(2) the limited partner fairly and adequately represents the interests of the limited partnership in enforcing the right of the limited partnership [~~In a derivative action, the plaintiff must be a limited partner when the action is brought and:~~

[~~(1) the person must have been a limited partner at the time of the transaction that is the subject of the action; or~~

[~~(2) the person's status as a limited partner must have arisen by operation of law or under the terms of the partnership agreement from a person who was a limited partner at the time of the transaction~~].

SECTION 27. Section 153.403, Business Organizations Code, is amended to read as follows:

Sec. 153.403. DEMAND [~~PLEADING~~]. (a) A limited partner may not institute a derivative proceeding until the 91st day after the date a written demand is filed with the limited partnership stating with particularity the act, omission, or other matter that is the subject matter of the claim or challenge and requesting that the limited partnership take suitable action.

(b) The waiting period required by Subsection (a) before a derivative proceeding may be instituted is not required or, if applicable, shall terminate if:

(1) the limited partner has been notified that the demand has been rejected by the limited partnership;

(2) the limited partnership is suffering irreparable injury; or

(3) irreparable injury to the limited partnership would result by waiting for the expiration of the 90-day period [~~In a derivative action, the complaint must contain with particularity:~~

[~~(1) the effort, if any, of the plaintiff to secure initiation of the action by a general partner; or~~

[~~(2) the reasons for not making the effort~~].

SECTION 28. Section 153.404, Business Organizations Code, is amended to read as follows:

Sec. 153.404. DETERMINATION BY INDEPENDENT PERSONS [~~SECURITY FOR EXPENSES OF DEFENDANTS~~]. (a) A determination of how to proceed on allegations made in a

demand or petition relating to a derivative proceeding must be made by an affirmative vote of the majority of:

(1) the independent and disinterested general partners of the limited partnership, whether one or more, even if the independent and disinterested general partners are not a majority of the general partners of the limited partnership;

(2) a committee consisting of one or more independent and disinterested general partners appointed by a majority of one or more independent and disinterested general partners of the limited partnership, even if the appointing independent and disinterested general partners are not a majority of the general partners of the limited partnership; or

(3) a panel of one or more independent and disinterested individuals appointed by the court on a motion by the limited partnership listing the names of the individuals to be appointed and stating that, to the best of the limited partnership's knowledge, the individuals to be appointed are disinterested and qualified to make the determinations contemplated by Section 153.408 [~~In a derivative action, the court may require the plaintiff to give security for the reasonable expenses incurred or expected to be incurred by a defendant in the action, including reasonable attorney's fees~~].

(b) An entity is independent and disinterested only if its decision with respect to the limited partnership's derivative proceeding is made by a majority of its governing persons who are independent and disinterested with respect to that derivative proceeding, even if those governing persons are not a majority of its governing persons. This section applies to an entity that is:

(1) a general partner of the limited partnership; or

(2) directly, or indirectly through one or more other entities, a governing person of that general partner [~~The court may increase or decrease at any time the amount of the security on a showing that the security provided is inadequate or excessive~~].

(c) The court shall appoint a panel under Subsection (a)(3) if the court finds that the individuals recommended by the limited partnership are independent and disinterested and are otherwise qualified with respect to expertise, experience, independent judgment, and other factors considered appropriate by the court under the circumstances to make the determinations. An individual appointed by the court to a panel under this section may not be held liable to the limited partnership or the limited partnership's partners for an action taken or omission made by the individual in that capacity, except for an act or omission constituting fraud or wilful misconduct [~~If a plaintiff is unable to give security, the plaintiff may file an affidavit in accordance with the Texas Rules of Civil Procedure~~].

[~~(d) Except as provided by Subsection (c), if a plaintiff fails to give the security within a reasonable time set by the court, the court shall dismiss the suit without prejudice.~~

[~~(e) The court, on final judgment for a defendant and on a finding that suit was brought without reasonable cause against the defendant, may require the plaintiff to pay reasonable expenses, including reasonable attorney's fees, to the defendant, regardless of whether security has been required.~~]

SECTION 29. Section 153.405, Business Organizations Code, is amended to read as follows:

Sec. 153.405. STAY OF PROCEEDING [~~EXPENSES OF PLAINTIFF~~]. (a) If the limited partnership that is the subject of a derivative proceeding commences an inquiry into the allegations made in a demand or petition and the person or group of persons described by Section 153.404 is conducting an active review of the allegations in good faith, the court shall stay a derivative proceeding for not more than 60 days until the review is completed and a determination is made by the person or group regarding what further action, if any, should be taken.

(b) To obtain a stay, the limited partnership must provide the court with a written statement agreeing to advise the court and the limited partner making the demand of the determination promptly on the completion of the review of the matter.

(c) A stay, on motion, may be reviewed every 60 days for continuation of the stay if the limited partnership provides the court and the limited partner with a written statement of the status of the review and the reasons why an extension for a period not to exceed 60 additional days is appropriate. An extension shall be granted for a period not to exceed 60 days if the court determines that the continuation is appropriate in the interests of the partnership [~~If a derivative action is successful, wholly or partly, or if anything is received by the plaintiff because of a judgment, compromise, or settlement of the action or claim constituting a part of the action, the court may award the plaintiff reasonable expenses, including reasonable attorney's fees, and shall direct the plaintiff to remit to a party identified by the court the remainder of the proceeds received by the plaintiff~~].

SECTION 30. Subchapter I, Chapter 153, Business Organizations Code, is amended by adding Sections 153.406, 153.407, 153.408, 153.409, 153.410, 153.411, 153.412, and 153.413 to read as follows:

Sec. 153.406. DISCOVERY. (a) If a limited partnership proposes to dismiss a derivative proceeding under Section 153.408, discovery by a limited partner after the filing of the derivative proceeding in accordance with this subchapter shall be limited to:

(1) facts relating to whether the person or persons described by Section 153.404 are independent and disinterested;

(2) the good faith of the inquiry and review by the person or group; and

(3) the reasonableness of the procedures followed by the person or group in conducting the review.

(b) Discovery described by Subsection (a) may not be expanded to include a fact or substantive matter regarding the act, omission, or other matter that is the subject matter of the derivative proceeding, but the scope of discovery shall not be so limited if the court determines after notice and hearing that a

good faith review of the allegations has not been made by an independent and disinterested person or group in accordance with Sections 153.404 and 153.408.

Sec. 153.407. TOLLING OF STATUTE OF LIMITATIONS. A written demand filed with the limited partnership under Section 153.403 tolls the statute of limitations on the claim on which demand is made until the later of:

(1) the 31st day after the expiration of any waiting period under Section 153.403; or

(2) the 31st day after the expiration of any stay granted under Section 153.405, including all continuations of the stay.

Sec. 153.408. DISMISSAL OF DERIVATIVE PROCEEDING. (a) A court, sitting in equity as the finder of fact, shall dismiss a derivative proceeding on a motion by the limited partnership if the person or group of persons described by Section 153.404 determines in good faith, after conducting a reasonable inquiry and based on factors the person or group considers appropriate under the circumstances, that continuation of the derivative proceeding is not in the best interests of the limited partnership.

(b) In determining whether the requirements of Subsection (a) have been met, the burden of proof shall be on:

(1) the plaintiff limited partner if:

(A) the applicable person or persons making the determination under Section 153.404(a)(1) or (2) are independent and disinterested at the time the determination is made;

(B) the determination is made by a panel of one or more independent and disinterested individuals appointed under Section 153.404(a)(3); or

(C) the limited partnership presents prima facie evidence that demonstrates that the applicable person or persons making the determination under Section 153.404(a) are independent and disinterested; or

(2) the limited partnership in any other circumstance.

Sec. 153.409. ALLEGATIONS AFTER DEMAND REJECTED. If a derivative proceeding is instituted after a demand is rejected, the petition must allege with particularity facts that establish that the rejection was not made in accordance with the requirements and standards under Sections 153.404 and 153.408.

Sec. 153.410. DISCONTINUANCE OR SETTLEMENT. (a) A derivative proceeding may not be discontinued or settled without court approval.

(b) The court shall direct that notice be given to the affected partners if the court determines that a proposed discontinuance or settlement may substantially affect the interests of other partners.

Sec. 153.411. PAYMENT OF EXPENSES. (a) In this section, "expenses" means reasonable expenses incurred by a party in a derivative proceeding, including:

(1) attorney's fees;

(2) costs in pursuing an investigation of the matter that was the subject of the derivative proceeding; or

(3) expenses for which the limited partnership may be required to indemnify another person.

(b) On termination of a derivative proceeding, the court may order:

(1) the limited partnership to pay expenses the plaintiff incurred in the proceeding if the court finds the proceeding has resulted in a substantial benefit to the limited partnership;

(2) the plaintiff to pay expenses the limited partnership or other defendant incurred in investigating and defending the proceeding if the court finds the proceeding has been instituted or maintained without reasonable cause or for an improper purpose; or

(3) a party to pay expenses incurred by another party relating to the filing of a pleading, motion, or other paper if the court finds the pleading, motion, or other paper:

(A) was not well grounded in fact after reasonable inquiry;

(B) was not warranted by existing law or a good faith argument for the application, extension, modification, or reversal of existing law; or

(C) was interposed for an improper purpose, such as to harass, cause unnecessary delay, or cause a needless increase in the cost of litigation.

Sec. 153.412. APPLICATION TO FOREIGN LIMITED PARTNERSHIPS. (a) In a derivative proceeding brought in the right of a foreign limited partnership, the matters covered by this subchapter are governed by the laws of the jurisdiction of formation of the foreign limited partnership, except for Sections 153.405, 153.410, and 153.411, which are procedural provisions and do not relate to the internal affairs of the foreign limited partnership, unless applying the laws of the jurisdiction of formation of the foreign limited partnership requires otherwise with respect to Section 153.405.

(b) In the case of matters relating to a foreign limited partnership under Section 153.405, a reference to a person or group of persons described by Section 153.404 refers to a person or group entitled under the laws of the jurisdiction of formation of the foreign limited partnership to make the determination described by Section 153.404(a). The standard of review of a determination made by the person or group shall be governed by the laws of the jurisdiction of formation of the foreign limited partnership.

Sec. 153.413. CLOSELY HELD LIMITED PARTNERSHIP. (a) In this section, "closely held limited partnership" means a limited partnership that has:

(1) fewer than 35 limited partners; and

(2) no partnership interests listed on a national securities exchange or regularly quoted in an over-the-counter market by one or more members of a national securities association.

(b) Sections 153.402-153.410 do not apply to a claim or a derivative proceeding by a limited partner of a closely held limited partnership against a general partner, limited partner, or officer of the limited partnership. In the event the claim or derivative proceeding is also made against a person who is not that general partner, limited partner, or officer, this subsection shall apply only to the claim or derivative proceeding against the general partner, limited partner, or officer.

(c) If Sections 153.402-153.410 do not apply because of Subsection (b) and if justice requires:

(1) a derivative proceeding brought by a limited partner of a closely held limited partnership may be treated by a court as a direct action brought by the limited partner for the limited partner's own benefit; and

(2) a recovery in a direct or derivative proceeding by a limited partner may be paid directly to the plaintiff or to the limited partnership if necessary to protect the interests of creditors or other partners of the limited partnership.

(d) Other provisions of state law govern whether a limited partner has a direct cause of action or right to sue a general partner, limited partner, or officer, and this section may not be construed to create that direct cause of action or right to sue.

SECTION 31. The changes in law made by this Act apply only to a derivative proceeding instituted on or after the effective date of this Act. A derivative proceeding instituted before the effective date of this Act is governed by the law in effect on the date the proceeding was instituted, and the former law is continued in effect for that purpose.

SECTION 32. This Act takes effect September 1, 2019.