How to Deal with Fiduciary Duties in Conflict Transactions In Texas and Delaware

By

BYRON F. EGAN
Jackson Walker L.L.P.
2323 Ross Avenue, Suite 600
Dallas, Texas 75201
began@jw.com

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TABLE OF CONTENTS

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Byron F. Egan, Dallas, TX

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CHAPTER 1. INTRODUCTION

Both Texas[1] and Delaware[2] have well developed bodies of statutory and case law governing corporations, partnerships and limited liability companies ("***LLCs***"). Generally the statutes in both states leave to the common law the fiduciary duty "issues" that arise whenever directors, officers or controlling persons deal with their corporations, partnerships or LLCs. Whether the "issue" becomes a "problem" or "fiduciary duty breach" is usually determined by how the board of directors or other governing persons (collectively, the "***Board***") of the entity address and resolve or otherwise deal with the issue. This paper will address the Texas and Delaware case and statutory law regarding this subject.

Byron F. Egan is a partner of Jackson Walker L.L.P. in Dallas, Texas. Mr. Egan is a member of the ABA Business Law Section's Mergers & Acquisitions Committee, serves as Senior Vice Chair of the Committee and Chair of its Executive Council and served as Co-Chair of its Asset Acquisition Agreement Task Force which prepared the ABA Model Asset Purchase Agreement with Commentary. Mr. Egan is the author of *EGAN ON ENTITIES: Corporations, Partnerships and Limited Liability Companies in Texas* (2nd Ed. 2018) ("***EGAN ON ENTITIES***"), which addresses the formation, governance and sale of business entities, including an analysis of the fiduciary duties of their governing persons in a variety of situations. EGAN ON ENTITIES is available from Corporation Service Company and LexisNexis: https://www.cscglobal.com/blog/csc-publishing-egan-on-entities/

1 In 2006, the Texas Legislature enacted the Texas Business Organizations Code (the "***TBOC***") which codifies 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. 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 Texas 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***"). 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. 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. 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.

2 The Delaware statutes governing corporations, partnerships (general and limited) and LLCs include the Delaware General Corporation Law (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 a corporation, LLC or limited partnership ("***LP***") and its officers are generally owed to the entity they serve and not to any individual owners.[3] Thus, a cause of action against a director or other governing person 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.[4] Statutes in both Texas[5] and Delaware[6] authorize derivative action to be brought in the right of the entity by an owner against its Board for breach of fiduciary duty, although Texas and Delaware also recognize situations where a derivative claim may be treated by the court as a direct action by the injured stakeholder.[7] 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,[8] a disinterested Board would generally have the power to determine whether to bring or dismiss a breach of fiduciary duty claim for the entity.[9]

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3 *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.

4 *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.").

5 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.

6 Del. Ct. of Chancery R. 23.1.

7 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 earned"); *see 2055 Inc. v. McTague*, No. 05-08-01057-CV, 2009 WL 2506342, at *8 (Tex. App.—Dallas Aug. 18, 2009, no pet) (mem.op.) and *EGAN ON ENTITITES* § 2.6.7.

8 *See* Delaware Chancery Court Rule 23.1 and DGCL § 141(a) for corporations, and Delaware Chancery Court Rule 2.3.2 and DRLPA § § 17-001-17-003 for LPs and DLLCA § § 18-001-18-004 for LLCs; *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 corporations are in TBOC § § 21.551-21.560, for LLCs are in TBOC § 101.451 – 463 and for LPs are in TBOC § 153.401 – 153.413.

9 *See EGAN ON ENTITITES* § 2.6.7; *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").

CHAPTER 2. CORPORATIONS

2.1. Primacy of Charter. In both Texas and Delaware a for-profit corporation is formed by filing with the applicable Secretary of State a charter document,[10] which is the highest governing document of a corporation. In Delaware this takes the form of a certificate of incorporation, while in Texas this document is called a certificate of formation (hereinafter for both states, the "Charter").[11] In Delaware, the Charter's primacy comes from DGCL § 109, which provides that "[t]he bylaws may contain any provision, not inconsistent with law *or with the certificate of incorporation*, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers, or employees" (emphasis added).[12] Texas has similar statutory authority from TBOC § 21.057 which states: "The bylaws may contain provisions for the regulation and management of the affairs of the corporation that are consistent with law and *the corporation's certificate of formation*" (emphasis added).[13]

2.2. Corporate Fiduciary Duties.

2.2.1. General Principles. The concepts that underlie the fiduciary duties of corporate directors have their origins in English common law of both trusts and agency from over two hundred years ago. The current concepts of those duties in both Texas and Delaware are still largely matters of evolving common law.[14] Fiduciary duty principles articulated in the context of public companies are applicable to private companies in both Texas and Delaware, although the application of those principles is contextual and the corporate process required to comply with those principles can vary depending on the circumstances.[15]

Both the Tex. Corp. Stats. and the DGCL provide that the business and affairs of a corporation are to be managed under the direction of its Board. While the Tex. Corp. Stats. and the DGCL provide statutory guidance as to matters such as the issuance of securities, the payment of dividends, the notice and voting procedures for meetings of directors and shareholders, and the ability of directors to rely on specified persons and information, the nature of a director's "fiduciary" duty to the corporation and the shareholders has been largely defined by the courts through damage and injunctive actions. In Texas, the

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10 TBOC §§ 3.001-3.008; DGCL § 101.

11 DGCL § 101; TBOC §§ 1.002(6); 3.001.

12 DGCL § 109.

13 TBOC § 21.057(b).

14 The "fiduciary duties of corporate officers and directors . . . are creatures of state common law[.]" *Gearhart Indus., Inc. v. Smith Int'l., Inc.*, 741 F.2d 707, 719 (5th Cir. 1984) (citing *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 549 (1949)); *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 697 (Del. Ch. 2005) ("Unlike ideals of corporate governance, a fiduciary's duties do not change over time"), *aff'd*, 906 A.2d 27 (Del. 2006); *see also Burks v. Lasker*, 441 U.S. 471, 477-478 (1979). Federal courts generally apply applicable state common law in fiduciary duty cases. *See e.g. Floyd v. Hefner*, C.A. No. H-03-5693, 2006 WL 2844245, at *8-9, 2006 U.S. Dist. LEXIS 70922, at *20 (S.D. Tex. Sept. 29, 2006), *on reconsideration other grounds*, 556 F.Supp.2d 617 (S.D. Tex. 2008).

15 Under TBOC § 21.563(a) a corporation is "closely held" if it has fewer than 35 shareholders and its stock is not publicly traded. *See Ritchie v. Rupe,* 443 S.W.3d 856, 860-63 (Tex. 2014), *reh'g denied* (Oct. 24, 2014) (in the context of discussing the role of "the honest exercise of business judgment and discretion" by a Board in determining whether a receivership is an appropriate remedy in a shareholder oppression case, the Texas Supreme Court wrote that Texas law "does not distinguish between closely held and other types of corporations."). *See infra* notes regarding oppression of minority shareholders in the context of closely held entities.

fiduciary duty of a director has been characterized as including duties of loyalty (including good faith), care and obedience, and is owed to the corporation and its shareholders collectively. In Delaware, the fiduciary duties include those of loyalty (including good faith) and care. Importantly, the duty of loyalty gives rise to an important corollary fiduciary precept – namely, the so-called "duty of disclosure," which requires the directors to disclose full and accurate information when communicating with stockholders. The term "duty of disclosure," however, is somewhat of a misnomer because no separate duty of disclosure actually exists. Rather, as indicated, the fiduciary obligations of directors with respect to the disclosures involve a contextually-specific application of the duty of loyalty.

2.2.2. Applicable Law; Internal Affairs Doctrine. "The internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs,"[16] and "under the commerce clause a state has no interest in regulating the internal affairs of foreign corporations."[17] "Internal corporate affairs" are "those matters which are peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders,"[18] and are to be distinguished from matters which are not unique to corporations:

> It is essential to distinguish between acts which can be performed by both corporations and individuals, and those activities which are peculiar to the corporate entity. Corporations and individuals alike enter into contracts, commit torts, and deal in personal and real property. Choice of law decisions relating to such corporate activities are usually determined after consideration of the facts of each transaction. . . . The internal affairs doctrine has no applicability in these situations.[19]

Under the internal affairs doctrine followed by Texas and most other states, the law of the state of organization of an entity governs its internal affairs,[20] including the liability of an owner or governing person of the entity for actions taken in that capacity.[21] Thus, the internal affairs doctrine in Texas mandates that courts apply the law of a corporation's state of incorporation in adjudications regarding director fiduciary duties.[22] Delaware also subscribes to the internal affairs doctrine.[23]

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16 *Edgar v. MITE Corp.*, 457 U.S. 624, 645 (1982).

17 *McDermott, Inc. v. Lewis*, 531 A.2d 206, 217 (Del. 1987) (internal quotations omitted); Frederick Tung, *Before Competition: Origins of the Internal Affairs Doctrine*, 32 J. CORP. L. 33, 39 (Fall 2006).

18 *McDermott*, 531 A.2d at 214.

19 *McDermott*, 531 A.2d at 214-15 (citing *Edgar*, 457 U.S. at 645).

20 The internal affairs doctrine is codified in TBOC §§ 1.101-1.105 (2015). TBOC § 1.105 provides:

> Sec. 1.105. INTERNAL AFFAIRS. For purposes of this code, the internal affairs of an entity include:
>
> (1) the rights, powers, and duties of its governing authority, governing persons, officers, owners, and members; and
>
> (2) matters relating to its membership or ownership interests.

21 TBOC § 1.104.

22 *Hollis v. Hill*, 232 F.3d 460, 465 (5th Cir. 2000); *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984); *A. Copeland Enters., Inc. v. Guste*, 706 F. Supp. 1283, 1288 (W.D. Tex. 1989).

23 *See VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108, 1115-1118 (Del. 2005) (considering whether a class of preferred stock would be entitled to vote as a separate class on the approval of a merger agreement and ruled that Delaware law, rather than California law, governed and did not require the approval of the holders of the preferred stock voting separately as a class for approval of the merger. In reaching that conclusion, the Court held that the DGCL exclusively

2.2.3. Fiduciary Duties in Texas Cases. Texas has its own body of precedent with respect to director fiduciary duties. In *Gearhart Industries, Inc. v. Smith International*, the Fifth Circuit sharply criticized the parties' arguments based on Delaware cases and failure to cite Texas jurisprudence in their briefing on director fiduciary duties:

> We are both surprised and inconvenienced by the circumstances that, despite their multitudinous and voluminous briefs and exhibits, neither plaintiffs nor defendants seriously attempt to analyze officers' and directors' fiduciary duties or the business judgment rule under Texas law. This is a particularly so in view of the authorities cited in their discussions of the business judgment rule: Smith and Gearhart argue back and forth over the applicability of the plethora of out-of-state cases they cite, yet they ignore the fact that we are obligated to decide these aspects of this case under Texas law.[24]

The Fifth Circuit stated in *Gearhart* that under Texas law "[t]hree broad duties stem from the fiduciary status of corporate directors; namely the duties of obedience, loyalty, and due care," and commented that (i) the duty of obedience requires a director to avoid committing *ultra vires* acts, i.e., acts beyond the scope of the authority of the corporation as defined by its articles of incorporation or the laws of the state of incorporation, (ii) the duty of loyalty dictates that a director must act in good faith and must not allow his personal interests to prevail over the interests of the corporation, and (iii) the duty of due care requires that a director must handle his corporate duties with such care as an ordinarily prudent man would use under similar circumstances.[25] Good faith under *Gearhart* is an element of the duty of loyalty. *Gearhart* remains the seminal case for defining the fiduciary duties of directors in Texas. Many Texas fiduciary duty cases arise in the context of closely held corporations.[26]

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governs the internal corporate affairs of a Delaware corporation and that Section 2115 of the California Corporations Code, which requires a corporation with significant California contacts (sometimes referred to as a "quasi-California corporation") to comply with certain provisions of the California Corporations Code even if the corporation is incorporated in another state, such as Delaware, is unconstitutional and, as a result of Delaware rather than California law governing, the approval of the merger did not require the approval of the holders of the preferred stock voting separately as a class). *See infra* notes and related text.

The California courts, however, tend to uphold California statutes against internal affairs doctrine challenges. *See Friese v. Superior Court of San Diego County*, 36 Cal. Rptr. 3d 558, 698 (Cal. Ct. App. 2005), *as modified on denial of reh'g* (Dec. 29, 2005), *as modified* (Jan. 24, 2006), in which a California court allowed insider trading claims to be brought against a director of a California based Delaware corporation and wrote "while we agree that the duties officers and directors owe a corporation are in the first instance defined by the law of the state of incorporation, such duties are not the subject of California's corporate securities laws in general or [Corporate Securities Law] section 25502.5 in particular . . . . Because a substantial portion of California's marketplace includes transactions involving securities issued by foreign corporations, the corporate securities laws have been consistently applied to such transactions."

24 *Gearhart Indus., Inc. v. Smith Int'l*, 741 F.2d 707, 719 n.4 (5th Cir. 1984).

25 *Id.* at 719-21; *McCollum v. Dollar*, 213 S.W. 259, 260 (Tex. Comm'n App. 1919, holding approved); *see Landon v. S & H Mktg. Group, Inc.*, 82 S.W.3d 666, 672 (Tex. App.—Eastland 2002, no pet.) (quoting and repeating the summary of Texas fiduciary duty principles from *Gearhart*).

26 *See generally Flanary v. Mills*, 150 S.W.3d 785, 794-96 (Tex. App.—Austin 2004, pet. denied) (examining situation where uncle and nephew incorporated 50%/50% owned roofing business, but never issued stock certificates or had board or shareholder meetings; uncle used corporation's banking account as his own, told nephew business doing poorly and sent

The Texas Supreme Court's June 20, 2014 opinion in *Ritchie v. Rupe*[27] is most often cited for its holding that for claims of "minority shareholder oppression" – essentially, acts of a majority shareholder group that are harmful to a minority shareholder without necessarily harming the corporation itself[28] – the sole remedy available under Texas law is a statutory receivership, but the opinion is equally important for its holding that common law fiduciary duties, as articulated in *Gearhart*, are still the appropriate lens through which to evaluate the conduct of directors of Texas corporations. The Supreme Court in *Ritchie v. Rupe* explained that the robustness of those fiduciary duty claims was one of its reasons for holding that in Texas there is not separate cause of action of shareholder oppression, and cited *Gearhart* as authoritative for its description of the common law fiduciary duties that directors owe the corporations they serve by virtue of being a director:

> Directors, or those acting as directors, owe a fiduciary duty to the corporation in their directorial actions, and this duty "includes the dedication of [their] uncorrupted business judgment for the sole benefit of the corporation." *Int'l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 577 (Tex. 1963); *see also Gearhart Indus., Inc. v. Smith Intern., Inc.*, 741 F.2d 707, 723-24 (5th Cir. 1984) (describing corporate director's fiduciary duties of obedience, loyalty, and due care).[29]

Director and officer fiduciary duties are owed to the corporation and its shareholders collectively, but not to individual shareholders, unless some contract or special relationship exists between them separate from the corporate relationship.[30] A shareholder has no individual cause of action for personal damages caused solely by a wrong done to the corporation.[31]

Conflicts of interest do not per se result in a breach of a director's fiduciary duties. Rather, it is the manner in which an interested director handles a conflict and the processes invoked to ensure fairness to the corporation and its shareholders that will determine the propriety of the director's conduct and the validity of the particular action.[32] Only material personal interests or influences will imbue a transaction with fiduciary duty implications.

In Texas there are two types of fiduciary relationships out of which fiduciary duties arise.[33] The first is a formal fiduciary relationship, which arises as a matter of law.[34] The second is an informal fiduciary

check to nephew for $7,500 as his share of proceeds of business for four years; the Court held uncle liable for breach of fiduciary duties that we would label loyalty and candor.)

27 443 S.W.3d 856, 860 (Tex. 2014). *See Landon v. S & H Mktg. Group, Inc.*, 82 S.W.3d 666, 672 (Tex. App.—Eastland 2002, no pet.) (quoting and repeating the summary of Texas fiduciary duty principles from *Gearhart*).

28 *See infra* notes regarding oppression of minority shareholders in the context of closely held entities.

29 443 S.W.3d at 868.

30 *Gerra v. Guera*, 2011 Tex. App. LEXIS 6730 (Tex. App.—San Antonio 2011).

31 *Id.*; *see Wingate v. Hajdik*, 795 S.W.2d 717, 719 (Tex. 1990).

32 See TBOC § 21.418(b); infra notes 250-255.

33 *Meyer v. Cathey*, 167 S.W.3d 327, 330–31 (Tex. 2005); *Chapman Children's Trust v. Porter & Hedges, L.L.P.*, 32 S.W.3d 429, 439 (Tex. App.—Houston [14th Dist.] 2000, pet. denied).

34 *Abetter Trucking Co., Inc. v. Arizpe*, 113 S.W.3d 503, 508 (Tex. App.—Houston [1st Dist.] 2003, no pet.) (citing *Ins. Co. of N. Am. v. Morris*, 981 S.W.2d 667, 674 (Tex.1998)).

relationship, which may arise from a moral, social, domestic or purely personal relationship of trust and confidence, generally called a confidential relationship.[35]

Whether undisputed facts give rise to a formal fiduciary relationship is a question of law.[36] Whether an informal fiduciary relationship exists is ordinarily a question of fact because the underlying material facts are disputed.[37] When the underlying facts are undisputed, however, the determination of whether a fiduciary relationship exists is a question of law for the court.[38]

Controlling shareholders generally do not owe formal fiduciary duties to minority shareholders.[39] In *Ritchie v. Rupe*, the Supreme Court stated: "this Court has never recognized a formal fiduciary duty between majority and minority shareholders in a closely held corporation."[40] In certain circumstances, an officer or director of a closely-held company "may become" a fiduciary to individual shareholders when the corporation repurchases the shareholder's stock.[41] A controlling shareholder may owe informal fiduciary duties to the minority shareholders.[42] Since Texas courts generally do not distinguish between publicly held and closely held corporations, these principles should apply equally to Texas corporations whose shares are publicly traded.

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35 *Id.* (quoting *Assoc. Indem. Corp. v. CAT Contracting, Inc.*, 964 S.W.2d 276, 287 (Tex. 1998)); *see supra* notes 87-91 and related text.

36 *Envtl. Procedures, Inc. v. Guidry*, 282 S.W.3d 602, 627 (Tex. App.—Houston [14th Dist.] 2009, pet. denied).

37 *Hoggett v. Brown*, 971 S.W.2d 472, 488 (Tex. App.—Houston [14th Dist.] 1997, pet. denied).

38 *Meyer v. Cathey*, 167 S.W.3d 327, 330 (Tex. 2005).

39 *See Herring Bancorp, Inc. v. Mikkelsen*, No. 07-15-00327-CV, 2017 WL 4020555, 2017 Tex. App. LEXIS 8585 (Tex. App.—Amarillo Sep. 8, 2017, no pet. h.), in which the Court of Appeals wrote:

> The Texas Supreme Court has never recognized a formal fiduciary duty between a majority and minority shareholder in a closely-held corporation. *Hughes*, 436 S.W.3d at 791 n.1. One's status as a co-shareholder in a closely-held corporation alone does not automatically create a fiduciary relationship between co-shareholders. *Opperman*, 2013 Tex. App. LEXIS 14867, at *11. "A co-shareholder [*25] in a closely held corporation does not as a matter of law owe a fiduciary duty to his co-shareholder." *Id.* (citing *Pabich v. Kellar*, 71 S.W.3d 500, 504 (Tex. App.—Fort Worth 2002, pet. denied)).

40 443 S.W. 3d 874-75 n.27.

41 *In re Estate of Fawcett*, 55 S.W.3d 214, 220 (Tex. App.—Eastland 2001, pet. denied) (emphasis added) (holding summary judgment evidence raised a fact issue on whether fiduciary relationship existed); *see also Willis v. Donnelly*, 118 S.W.3d 10, 31–32 (Tex. App.—Houston [14th Dist.] 2003), *aff'd in part, rev'd in part*, 199 S.W.3d 262 (Tex. 2006) (stating that fiduciary relationship may be created "through the repurchase of a shareholder's stock in a closely held corporation" or "in certain circumstances in which a majority shareholder in a closely held corporation dominates control over the business"); *Allen v. Devon Energy Holdings, L.L.C.*, 367 S.W.3d 355, 391-97 (Tex. App.—Houston [1st Dist.] 2012, pet. granted, *judgment set aside and remanded by agreement*, 2013 Tex. LEXIS 20 (Tex. Jan. 11, 2013) (case settled in 2013 while writ of error pending); *Redmon v. Griffith*, 202 S.W.3d 225, 237, 240 (Tex. App.—Tyler 2006, pet. denied), *disapproved of by Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014) (a contract for the repurchase of a shareholder's stock in a closely-held corporation may also create a fiduciary relationship when a majority shareholder dominates control over the business or the shareholders operate more as partners than in strict compliance with corporate formalities); *Miller v. Miller*, 700 S.W.2d 941, 945–46 (Tex. App.—Dallas 1985, writ ref'd n.r.e.) (concluding, in lawsuit brought to rescind transfer of stock in closely-held corporation based on purchaser's nondisclosure of information, that jury's finding of confidential relationship was supported by evidence of the defendant's position as a founder, officer, and director of company with inside knowledge of its affairs and prospects).

42 *See infra* notes 87-91 and related text.

(a) Loyalty.

(1) Good Faith. The duty of loyalty in Texas is a duty that dictates that the director act in good faith and not allow his personal interest to prevail over that of the corporation.[43] Whether there exists a personal interest by the director will be a question of fact.[44] The good faith of a director will be determined on whether the director acted with an intent to confer a benefit to the corporation.[45] In Texas "good faith" has been held to mean "[a] state of mind consisting in (1) honesty of belief or purpose, (2) faithfulness to one's duty or obligation, ... or (4) absence of intent to defraud or to seek unconscionable advantage."[46]

(2) Self-Dealing Transactions. In general, a director will not be permitted to derive a personal profit or advantage at the expense of the corporation and must act solely with an eye to the best interest of the corporation, unhampered by any pecuniary interest of his own.[47] The Court in *Gearhart* summarized Texas law with respect to the question of whether a director is "interested" in the context of self-dealing transactions:

> A director is considered "interested" if he or she (1) makes a personal profit from a transaction by dealing with the corporation or usurps a corporate opportunity . . .; (2) buys or sells assets of the corporation . . . ; (3) transacts business in his director's capacity with a second corporation of which he is also a director or significantly financially associated . . . ; or (4) transacts business in his director's capacity with a family member.[48]

In *Ritchie v. Rupe*,[49] the Supreme Court elaborated that:

> [T]he duty of loyalty that officers and directors owe to the corporation specifically prohibits them from misapplying corporate assets for their personal gain or wrongfully diverting corporate opportunities to themselves. Like most of the actions we have already discussed, these types of actions may be redressed through a derivative action, or through a direct action brought by the corporation, for breach of fiduciary duty. (citations omitted)

Texas courts also hold that a fiduciary owes to its principal a strict duty of "good faith and candor,"[50] including full disclosure respecting matters affecting the principal's interests.[51] There is a "general

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43 *Gearhart*, 741 F.2d at 719.

44 *Int'l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 578 (Tex. 1963).

45 *Id.* at 577 (indicating that good faith conduct requires a showing that the directors had an intent to confer a benefit to the corporation).

46 *Johnson v. Jackson Walker, L.L.P.*, 247 S.W.3d 765, 772 (Tex. App.—Dallas 2008, pet. denied) (quoting BLACK'S LAW DICTIONARY 701 (7th ed. 1999)).

47 *A. Copeland Enters. Inc. v. Guste*, 706 F. Supp. 1283, 1291 (W.D. Tex. 1989); *Milam v. Cooper Co.*, 258 S.W.2d 953, 956 (Tex. Civ. App.—Waco 1953, writ ref'd n.r.e.); *see* Kendrick, *The Interested Director in Texas*, 21 SW. L.J. 794 (1967).

48 *Gearhart*, 741 F.2d at 719-20 (citations omitted); *see Landon v. S & H Mktg. Group, Inc.*, 82 S.W.3d 666, 672 (Tex. App.—Eastland 2002, no pet.) (citing and repeating the "independence" test articulated in *Gearhart*). *See also infra* notes 247-255 and related text.

49 443 S.W.3d at 887.

50 *See infra* notes 67-68 and related text.

51 *Icom Systems, Inc. v. Davies*, 990 S.W.2d 408, 410 (Tex. App.—Texarkana 1999, no pet.).

prohibition against the fiduciary using his relationship with the corporation to benefit his personal interest."[52] As conflicts of interest do not per se result in a breach of the duty of loyalty, the issue is the manner in which an interested director handles a conflict, the processes invoked to ensure fairness to the corporation and its shareholders and the materiality of the director's personal interests or influences.[53]

The Tex. Corp. Stats. have embraced the principle that a transaction or contract between a director or officer and the corporation served is presumed to be valid and will not be void or voidable solely by reason of the interest of the director or officer as long as certain statutory conditions are met. In general, the Tex. Corp. Stats. provide that a transaction between a corporation and one or more of its directors or officers will not be voidable solely by reason of that relationship if the transaction is approved by shareholders or disinterested directors after disclosure of the interest, or if the transaction is otherwise fair.[54] A contract or transaction is "fair" if it is "characterized by honesty and justice" and "free from fraud, injustice, prejudice, or favoritism."[55]

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52 *NRC, Inc. v. Huddleston*, 886 S.W.2d 526, 530 (Tex. App.—Austin 1994, no writ) (citing *Chien v. Chen*, 759 S.W.2d 484, 495 (Tex. App.—Austin 1988, no writ)).

53 *Popperman v. Rest Haven Cemetery, Inc.*, 162 Tex. 255, 259, 345 S.W.2d 715, 717 (1961) ("[W]ell-established rule that transactions between an officer or director and the corporation are subject to strict scrutiny; it was stated in *Zorn v. Brooks*, 125 Tex. 614, 83 S.W.2d 949 (1935), 'that a contract between a corporation and one or all of its officers and directors is not void per se, but that it may be avoided for unfairness or fraud'"); in *Tenison v. Patton*, 95 Tex. 284, 293-94, 67 S.W. 92, 95 (1902), the Texas Supreme Court, in holding that a sale was not void due to the director's interest on both sides of the transaction and did not conclusively establish its voidability, explained:

> We are therefore of the opinion that . . . the mere fact that Tenison was a director of the corporation and was interested on both sides of the transaction in question does not conclusively establish its voidability. That, at the worst, it was only voidable nearly all of the authorities agree, the principal difference being upon the question whether or not it was voidable at the mere option of beneficiaries without inquiry into its inherent fairness.

See also W. Inn Corp. v. Heyl, 452 S.W.2d 752, 758 (Tex. Civ. App.—Fort Worth 1970) in which the Court of Appeals wrote:

> To the same effect, but stated in another way, the appellees say that "The issue here is whether or not it is unlawful for officers and directors of the corporation to loan money to a corporation in desperate financial circumstances, take security therefor and then foreclose upon the loans." In support of their contention that such action is not unlawful the appellees rely upon the following authorities, which we believe to be controlling of the issues involved: Kendrick, in "The Interested Director in Texas," 21 S.W.L.J. 794, 801, which reads: "There is also a line of cases which hold that an interested director transaction is always voidable at the option of the corporation even though fair; but this is a minority rule and has little support. Canadian Country Club v. Johnson, an early Texas case, held that such a transaction could be 'avoided at the corporation's option whether the transaction be fair or not.' But this view has not prevailed in later Texas cases." International Bankers Life Ins. Co. v. Holloway, 368 S.W. 2d 567 (Tex. Sup., 1963); Popperman v. Rest Haven Cemetery, Inc., 162 Tex. 255, 345 S.W. 2d 715 (Tex. Sup., 1961); Phil H. Pierce Co. v. Rude, 291 S.W. 974 (Dallas Tex.Civ.App., 1927, writ dism.). In accord with this view is Lebowitz, "Director Misconduct and Shareholder Ratification in Texas", 6 Baylor Law Review 1 (1953); Pruitt v. Westbrook, 11 S.W. 2d 562 (Fort Worth Tex.Civ.App., 1928, no writ hist.); Wiberg v. Gulf Coast Land & Development Company, 360 S.W. 2d 563 (Beaumont Tex.Civ.App., 1962, ref., n.r.e.).

54 TBOC § 21.418; TBCA art. 2.35-1. *See infra* notes 250-255 and related text.

55 *Twenty First Century Holdings, Inc. v. Precision Geothermal Drilling, Inc.*, No. 03-13-00081-CV, 2015 Tex. App. LEXIS 4046 (Tex. App.—Austin Apr. 23, 2015), *vacated, app. dismissed,* No. 03-13-00081-CV, 2015 Tex. App. LEXIS 9154 (Tex. App.—Austin Aug. 28, 2015).

The Tex. Corp. Stats. permit a corporation to renounce any interest in business opportunities presented to the corporation or one or more of its officers, directors or shareholders in its certificate of formation or by action of its board of directors.[56]

(3) Oversight. In Texas, an absence of good faith may also be found in situations where there is a severe failure of director oversight. In *FDIC v. Harrington*,[57] a Federal District Court applying Texas law held that there is an absence of good faith when a board "abdicate[s] [its] responsibilities and fails to exercise any judgment."

(4) Business Opportunities. The "corporate opportunity doctrine," also called the "business opportunity doctrine," deals with when a fiduciary of a corporation may take personal advantage of a business opportunity that arguably "belongs" to the corporation.[58] It arises out of the fiduciary duty of loyalty, which generally provides that a director or officer of a corporation may not place his individual interests over the interests of the corporation or its stockholders. Corporate opportunity claims often are instances in which officers or directors use for their personal advantage information obtained in their corporate capacity, and arise where the fiduciary and the corporation compete against each other to buy something, whether it be a patent, license, or an entire business.[59] The central question is whether or not the director has appropriated something for himself that, in all fairness, should belong to his corporation.[60]

Landon v. S & H Marketing Group, Inc.[61] summarizes the Texas law on usurpation of corporate opportunities as follows:

> To establish a breach of fiduciary duty by usurping a corporate opportunity, the corporation must prove that an officer or director misappropriated a business opportunity that properly belongs to the corporation. *International Bankers Life Insurance Company v. Holloway*, supra at 576-78; *Icom Systems, Inc. v. Davies*, 990 S.W.2d 408, 410 (Tex. App.—Texarkana 1999, no writ). The business opportunity arises where a corporation has a legitimate interest or expectancy in and the financial resources to take advantage of a particular business opportunity. * * * A corporation's financial inability to take advantage of a corporate opportunity is one of the defenses which may be asserted in a suit involving an alleged appropriation of a corporate opportunity. * * * A corporation's abandonment of a business opportunity is another defense to a suit alleging usurpation of a corporate opportunity. * * * The burden of pleading and proving corporate abandonment and

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56 TBOC § 2.101(21), TBCA art. 2.02(20); *see infra* note 245 and related text.

57 844 F. Supp. 300, 306 (N.D. Tex. 1994).

58 *See Alexander v. Sturkie*, 909 S.W.2d 166 (Tex. App.—Houston [14th Dist.] 1995) (In shareholder derivative action alleging that the chief executive officer had usurped the corporation's business opportunity to acquire its own shares, the court began with the proposition that a corporation has no special interest in the opportunity to purchase its own shares, and a director violates no duty to the corporation by dealing in its stock for his own account and, if there is a struggle for control, the corporation would normally occupy a neutral position; but where the Board was taking affirmative steps toward the corporation's purchasing the shares and had communicated an interest in acquiring the stock, a fact finder could conclude that the purchase gave rise to a corporate opportunity, which made summary judgment for the director inappropriate).

59 *Thorpe v. CERBCO, Inc.,* 676 A.2d 436 (Del. 1996).

60 *Equity Corp. v. Milton*, 221 A.2d 494, 497 (Del. 1966).

61 82 S.W.3d 666, 672 (Tex. App.—Eastland 2002, no pet.).

corporate inability is placed upon the officer or director who allegedly appropriated the corporate opportunity. * * *

Texas recognizes that a fiduciary may independently generate an opportunity in which his principal has no ownership expectations.[62] The duty of candor, however, may not allow a director to unilaterally determine that a business opportunity would not be pursued by his corporation and may require that the opportunity be presented formally to the corporation's Board for its determination.[63] The burden of pleading and proving that the corporation was unable to take advantage of the opportunity is on the director or officer who allegedly appropriated the opportunity.[64] However, a finding that the corporation would not have exercised the opportunity at issue under the same terms and conditions as the officer or director is immaterial. A fiduciary cannot escape the duty to disclose an opportunity presented by securing an after-the-fact finding that the corporation was unable to take advantage of or would have rejected the business opportunity seized by the fiduciary had it been offered. When an officer or director usurps a corporate opportunity, he has breached the fiduciary duty of loyalty. To prove usurpation where the business opportunity is oil and gas leasehold interests, the entity may have to establish the specific leases in the opportunity acquired as a result of the fiduciary duty breach in order to establish a remedial constructive trust thereon.[65] To recover monetary damages for usurpation, the corporation must prove the amount of the profits (not revenues) it lost as a result.[66]

TBOC § 2.101(21) permits a corporation to renounce, in its certificate of formation or by action of its Board, any interest or expectancy of the corporation in specified business opportunities, or a specified class thereof, presented to the corporation or one or more of its officers, directors or shareholders. Since TBOC § 2.101(21) does not appear to authorize blanket renunciations of all business opportunities, a boilerplate renunciation may be less protective than one tailored to each situation. Further, although TBOC § 2.101(21) allows a corporation to specifically forgo individual corporate opportunities or classes of opportunities, the level of judicial scrutiny applied to the decision to make any such renunciation of corporate opportunities will generally be governed by a traditional common law fiduciary duty analysis, which means that a Board decision to renounce corporate opportunities should be made by informed and disinterested directors.

(5) <u>Candor</u>. In Texas the duty of loyalty includes a fiduciary duty of candor when communicating with shareholders. Texas courts also hold that a fiduciary owes to its principal a strict duty of "good faith and candor," including full disclosure respecting matters affecting the principal's interests.[67]

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62 *Scruggs Mgmt. Servs., Inc. v. Hanson*, No. 2-05-413-CV, 2006 WL 3438243, at *7-*8, 2006 Tex. App. LEXIS 10272, at *21-*22 (Tex. App.—Fort Worth, Nov. 30, 2006, pet. denied).

63 *Imperial Group (Texas), Inc. v. Scholnick*, 709 S.W.2d 358, 363 (Tex. App.—Tyler 1986, writ ref'd n.r.e.); *Icom Systems, Inc. v. Davies*, 990 S.W.2d 408, 410 (Tex. App.—Texarkana 1999, no pet.).

64 *Landon v. S & H Marketing Group, Inc.*, 82 S.W.3d 666, 681 (Tex. App.—Eastland 2002, no pet.).

65 *Longview Energy Co. v. Huff Energy Fund LP*, No. 15-0968, 60 Tex. Sup. Ct. J. 1195, 2017 WL 2492004, 2017 Tex. LEXIS 525 (June 9, 2017).

66 *Id.* In the *Longview* case, there was evidence to support the jury's finding of damages based on lost revenues, but the Supreme Court held that damages must be supported by competent evidence of lost profits, which the Court found had not been established.

67 *Icom Systems, Inc. v. Davies*, 990 S.W.2d 408, 410 (Tex. App.—Texarkana 1999, no pet.).

The duty of candor applies when a director is communicating with the corporation regarding a business opportunity.[68]

(b) Care.

(1) Business Judgment Rule. The duty of care in Texas requires the director to handle his duties with such care as an ordinarily prudent man would use under similar circumstances. In performing this obligation, the director must be diligent and informed and exercise honest and unbiased business judgment in pursuit of corporate interests.[69]

In general, the duty of care will be satisfied if the director's actions comport with the standard of the business judgment rule. In *Sneed v. Webre*,[70] which involved the application of the business judgment rule to a shareholder derivative suit on behalf of a closely held Texas corporation with fewer than 35 shareholders, the Texas Supreme Court on May 29, 2015 held: "[t]he 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." Following *Ritchie v. Rupe*[71] the year before and the Fifth Circuit in *Gearhart*,[72] the Texas Supreme Court in *Sneed v. Webre* cited and quoted from the early Texas decision of *Cates v. Sparkman*[73] as setting the standard for judicial intervention in cases involving duty of care issues:

> In Texas, the business judgment rule protects corporate officers and directors from being held liable to the corporation for alleged breach of duties 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." *Cates*, 11 S.W. at 849. "Directors, or those acting as directors, owe a fiduciary duty to the corporation in their directorial actions, and this duty 'includes the dedication of [their] uncorrupted business judgment for the sole benefit of the corporation.'" *Ritchie*, 443 S.W.3d at 868 (quoting *Int'l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 577 (Tex. 1963)). The business judgment rule also applies to protect the board of directors' decision to pursue or forgo corporate causes of action.[74]

In *Gearhart* the Court commented that, in spite of the requirement that a corporate director handle his duties with such care as an ordinarily prudent man would use under similar circumstances, Texas courts will not impose liability upon a *noninterested* corporate director unless the challenged action is *ultra vires* or is tainted by fraud. In a footnote in the *Gearhart* decision, the Fifth Circuit stated:

> The business judgment rule is a defense to the duty of care. As such, the Texas business judgment rule precludes judicial interference with the business judgment of directors absent

[68] *See supra* note 63 and related text.

[69] *Gearhart*, 741 F.2d at 719; *McCollum v. Dollar*, 213 S.W. 259, 260 (Tex. Comm'n App. 1919, holding approved).

[70] 465 S.W.3d 169, 173 (Tex. 2015).

[71] *Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014).

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

[73] *Cates v. Sparkman*, 11 S.W. 846, 849 (Tex. 1889).

[74] 465 S.W.3d at 178.

a showing of fraud or an *ultra vires* act. If such a showing is not made, then the good or bad faith of the directors is irrelevant.[75]

> The Fifth Circuit further explained that "[e]ven though *Cates* was decided in 1889, and despite the ordinary care standard announced in *McCollum v. Dollar,* [213 S.W. 259, 260 (Tex. Comm'n App. 1919, holding approved)], Texas courts to this day will not impose liability upon a noninterested corporate director unless the challenged action is *ultra vires* or is tainted by fraud."[76]

None of *Sneed v. Webre*, *Ritchie v. Rupe*, *Gearhart* nor the earlier Texas cases on which they relied referenced "gross negligence" as a standard for director liability. The business judgment rule as articulated in these cases protects grossly negligent conduct. Earlier Federal District Court decisions in the context of lawsuits by the Federal Deposit Insurance Corporation ("FDIC") and the Resolution Trust Company ("RTC") arising out of failed financial institutions, declined to interpret Texas law this broadly and held that the Texas business judgment rule does not protect "any breach of the duty of care that amounts to gross negligence" or "directors who abdicate their responsibilities and fail to exercise any judgment."[77] These decisions, however, "appear to be the product of the special treatment banks may receive under Texas law" and likely will not be followed to hold directors "liable for gross negligence under Texas law as it exists now" in other businesses.[78]

Gross negligence in Texas is defined as "that entire want of care which would raise the belief that the act or omission complained of was the result of a conscious indifference to the right or welfare of the person or persons to be affected by it."[79] In *FDIC v. Harrington*, the Court concluded "that a director's total abdication of duties falls within this definition of gross negligence."[80]

The business judgment rule in Texas does not necessarily protect a director with respect to transactions in which he is "interested." It simply means that the action will have to be challenged on duty of loyalty rather than duty of care grounds.[81]

(2) Reliance on Reports. Directors may in good faith and with ordinary care, rely on information, opinions, reports or statements, including financial statements and other financial data, prepared by officers or employees of the corporation, counsel, accountants, investment bankers or other

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75 *Gearhart*, 741 F.2d at 723 n.9.

76 *Gearhart*, 741 F.2d at 721.

77 *FDIC v. Harrington*, 844 F. Supp. 300, 306 (N.D. Tex. 1994); *see also FDIC v. Schreiner*, 892 F. Supp. 869, 882 (W.D. Tex. 1995); *FDIC v. Benson*, 867 F. Supp. 512, 522 (S.D. Tex. 1994); *RTC v. Acton*, 844 F. Supp., 307, 314 (N.D. Tex. 1994); *RTC v. Norris*, 830 F. Supp. 351, 357-58 (S.D. Tex. 1993); *FDIC v. Brown*, 812 F. Supp. 722, 726 (S.D. Tex. 1992); *cf. RTC v. Miramon*, 22 F.3d 1357, 1360 (5th Cir. 1994) (following *Harrington* analysis of § 1821(K) of the Financial Institutions Reform, Recovery and Enforcement Act ("FIRREA") which held that federal common law of director liability did not survive FIRREA and applied Texas' gross negligence standard for financial institution director liability cases under FIRREA).

78 *Floyd v. Hefner*, C.A. No. H-03-5693, 2006 WL 2844245, at *28, 2006 U.S. Dist. LEXIS 70922, at *73 (S.D. Tex. Sept. 29, 2006).

79 *Burk Royalty Co. v. Walls*, 616 S.W.2d 911, 920 (Tex. 1981) (citing *Missouri Pac. Ry. v. Shuford*, 10 S.W. 408, 411 (Tex. 1888)).

80 *Harrington*, 844 F. Supp. at 306 n.7.

81 *Gearhart*, 741 F.2d at 723 n.9.

persons as to matters the director reasonably believes are within the person's professional or expert competence.[82]

(3) Charter Limitations on Director Liability. The Tex. Corp. Stats. allow a Texas corporation to provide in its certificate of formation limitations on (or partial limitation of) director liability for monetary damages in relation to the duty of care.[83] The liability of directors may not be so limited or eliminated, however, in connection with breaches of the duty of loyalty, acts not in good faith, intentional misconduct or knowing violations of law, obtaining improper benefits or acts for which liability is expressly provided by statute.[84] Officers do not have the benefit of the limitation of director liability authorized in the Tex. Corp. Stats.[85]

(c) Other.

(1) Obedience. The duty of obedience in Texas requires a director to avoid committing *ultra vires* acts, i.e., acts beyond the scope of the powers of the corporation as defined by its articles of incorporation and Texas law.[86] An *ultra vires* act may be voidable under Texas law, but the director will not be held personally liable for such act unless the act is in violation of a specific statute or against public policy.

(2) Informal Fiduciary Duties. In *Ritchie v. Rupe*,[87] after reversing a lower court judgment on the ground that minority shareholder oppression is not a cause of action in Texas, the Texas Supreme Court remanded to the Court of Appeals plaintiff's fiduciary duty claim against directors of the corporation that was "not based on the formal fiduciary duties that officers and directors owe to the corporation by virtue of their management action," but on "an informal fiduciary relationship that 'existed between'

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82 TBOC § 3.102 provides:

> Sec. 3.102. RIGHTS OF GOVERNING PERSONS IN CERTAIN CASES. (a) In discharging a duty or exercising a power, a governing person, including a governing person who is a member of a committee, may, in good faith and with ordinary care, rely on information, opinions, reports, or statements, including financial statements and other financial data, concerning a domestic entity or another person and prepared or presented by:
>
> (1) an officer or employee of the entity;
>
> (2) legal counsel;
>
> (3) a certified public accountant;
>
> (4) an investment banker;
>
> (5) a person who the governing person reasonably believes possesses professional expertise in the matter; or
>
> (6) a committee of the governing authority of which the governing person is not a member.
>
> (b) A governing person may not in good faith rely on the information described by Subsection (a) if the governing person has knowledge of a matter that makes the reliance unwarranted.

83 TBOC § 7.001; TMCLA art. 1302-7.06; *see supra* notes 69-81 and related text.

84 TBOC § 7.001; TMCLA art. 1302-7.06.

85 *See* TBOC § 7.001.

86 *Gearhart*, 741 F.2d at 719.

87 443 S.W.3d 856 (Tex. 2014); *see supra* notes 27 and 71.

plaintiff and defendant."[88] The Supreme Court in a footnote explained that "an informal fiduciary duty may arise from 'a moral, social, domestic or purely personal relationship of trust and confidence,' and its existence is generally a question of fact for the jury."[89]

On remand, the Court of Appeals held that "there is no evidence of a relationship of trust and confidence to support a finding of an informal fiduciary duty" and thus did not address whether an informal fiduciary duty was breached.[90] The Court of Appeals explained informal fiduciary duties as follows:

> The fiduciary duty alleged in this case is an informal fiduciary duty between Rupe and Dennard, Ritchie, and Lutes. Informal fiduciary relationships may "arise from 'a moral, social, domestic, or purely personal relationship of trust and confidence.'" *Meyer v. Cathey*,

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88 443 S.W.3d at 891-92.

89 443 S.W.3d at 892 n.63; *see Carr v. Weiss*, 984 S.W.2d 753, 765 (Tex. App. — Amarillo 1999, pet. denied) (to find a confidential, or informal, fiduciary relationship, the evidence must show that the dealings between the parties "continued for such a time that one party is justified in relying on the other to act in his best interest"); *Robinson v. Garcia*, 804 S.W.2d 238 (Tex. App.—Corpus Christi, 1991, writ denied) (an informal fiduciary relationship may end when the recipient is no longer justified in relying on the other to act in his best interest; a confidential relationship also does not continue to exist after one of the parties files suit against the other); *cf. Lee v. Hasson*, 286 S.W.3d 1, 15 (Tex. App.—Houston 2007, pet. denied) (insurance broker/financial advisor had an informal fiduciary relationship with friend whom he advised regarding the division of property in friend's divorce); *W. Reserve Life Assur. Co. of Ohio v. Graben*, 233 S.W.3d 360 (Tex. App.—Fort Worth 2007, no pet.) (a confidential relationship of trust found when an individual assumed the role of financial advisor separately to two different clients and represented that he would monitor and manage their investments).

90 *Ritchie v. Rupe*, No. 05-08-00615-CV, 2016 WL 145581, at *2-*3, 2016 Tex. App. LEXIS, at *5-*6 (Tex. App.—Dallas Jan. 12, 2016, pet. denied); the jury charge (the wording of which was not at issue on appeal as no objection was raised thereto by either party at trial) asked the jury:

> Did a relationship of trust and confidence exist between any of the below-named individuals and Ann Rupe, as Trustee for the Dallas Gordon Rupe, III 1995 Family Trust?
>
> [1.] A relationship of trust and confidence existed if Ann Rupe, as Trustee for the Dallas Gordon Rupe, III 1995 Family Trust, justifiably placed trust and confidence in those named below to act in the Dallas Gordon Rupe, III 1995 Family Trust's best interest. Ann Rupe's subjective trust and feelings alone do not justify transforming arm's-length dealings into a relationship of trust and confidence.
>
> [2.] A confidential relationship exists where influence has been acquired and abused, and confidence has been reposed and betrayed.
>
> [3.] Co-shareholders in a closely held corporation typically do not owe fiduciary duties to fellow shareholders. While corporate officers owe fiduciary duties to the corporation they serve, they do not generally owe fiduciary duties to individual shareholders unless a contract or confidential relationship exists between them in addition to the corporate relationship. For a majority shareholder to owe a fiduciary duty to minority shareholders, you must find that the majority shareholder dominates control over the business.
>
> The jury answered "Yes" as to each of Dennard, Ritchie, and Lutes as co-trustees of their respective trusts.
>
> Because the parties had not objected at trial to the wording of the foregoing jury instructions, the Court of Appeals accepted them as the law of the case and did not address whether those jury instructions would be appropriate for another case or accurately state the Texas law on informal fiduciary duties. *Cf.* PJC 104.1 Question and Instruction—Existence of Relationship of Trust and Confidence, *Texas Pattern Jury Charges* (2014) for another form of question and instruction to submit the existence of an informal fiduciary relationship (which it said is commonly referred to as a "relationship of trust and confidence" or a "confidential relationship") to a jury.

> 167 S.W.3d 327, 331 (Tex. 2005) (quoting *Associated Indem. Corp. v. CAT Contracting, Inc.*, 964 S.W.2d 276, 287 (Tex. 1998)). Informal fiduciary duties are not owed in business transactions unless the special relationship of trust and confidence existed prior to, and apart from, the transaction(s) at issue in the case. *Id.* (quoting *Associated Indem.*, 964 S.W.2d at 288).
>
> An informal fiduciary relationship exists "where, because of family relationship or otherwise, [one party] is in fact accustomed to be guided by the judgment or advice" of the other. *Thigpen v. Locke*, 363 S.W.2d 247, 253 (Tex. 1962). "The existence of the fiduciary relationship is to be determined from the actualities of the relationship between the persons involved." *Id.* "In order to give full force to contracts, we do not create such a relationship lightly." *Schlumberger Tech. Corp. v. Swanson*, 959 S.W.2d 171, 177 (Tex. 1997).
>
> The Texas Supreme Court has held that a confidential relationship "exists where a special confidence is reposed in another who in equity and good conscience is bound to act in good faith and with due regard to the interest of the one reposing confidence." *See Tex. Bank & Trust Co. v. Moore*, 595 S.W.2d 502, 507 (Tex. 1980) (quoting *Lappas v. Barker*, 375 S.W.2d 248, 251 (Ky. 1964)). Thus, "[a] person is justified in placing confidence in the belief that another party will act in his or her best interest only where he or she is accustomed to being guided by the judgment or advice of the other party, and there exists a long association in a business relationship, as well as personal relationship." *Hoggett v. Brown*, 971 S.W.2d 472, 488 (Tex. App.—Houston [14th Dist.] 1997, pet. denied). Confidential relationships may arise when the parties have dealt with each other in such a manner for a long period of time that one party is justified in expecting the other to act in its best interest. *Ins. Co. of N. Am. v. Morris*, 981 S.W.2d 667, 674 (Tex. 1998).
>
> "[M]ere subjective trust alone is not enough to transform arms-length dealing into a fiduciary relationship." *Thigpen*, 363 S.W.2d at 253. Rather, in order to establish the existence of an informal fiduciary relationship, the record must show that one of the parties actually relied on the other "for moral, financial, or personal support or guidance." *Trostle v. Trostle*, 77 S.W.3d 908, 915 (Tex. App.—Amarillo 2002, no pet.). An informal fiduciary relationship requires proof that, because of a close or special relationship, the plaintiff "is in fact accustomed to be guided by the judgment or advice" of the other. *Gregan v. Kelly*, 355 S.W.3d 223, 228 (Tex. App.—Houston [1st Dist.] 2011, no pet.) (quoting *Thigpen*, 363 S.W.2d at 253).[91]

In holding that the defendants did not owe informal fiduciary duties to plaintiff, the Court of Appeals recited evidence that one of the defendants had family relationships with plaintiff and another one of the defendants had done unrelated legal work for plaintiff's family, but also recited (and found controlling) evidence that showed plaintiff had serious disagreements with defendants over various family matters. In so holding the Court of Appeals in effect read the jury instructions[92] as requiring for a jury finding of the "relationship of trust and confidence" necessary for finding an informal fiduciary duty the existence of each of (i) "justifiably placed trust and confidence," (ii) "a confidential relationship ... where

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91 *Ritchie v. Rupe*, 2016 WL 145581, at *4, 2016 Tex. App. LEXIS, at *9-*11.

92 *See supra* note 90.

influence has been acquired and abused, and confidence has been reposed and betrayed," and (iii) "a contract or confidential relationship … between them in addition to the corporate relationship … [because] [f]or a majority shareholder to owe a fiduciary duty to minority shareholders, [the jury] must find that the majority shareholder dominates control over the business." Thus, being a controlling shareholder alone would not support a finding of an informal fiduciary relationship under those jury instructions as interpreted by the Court of Appeals, and the evidence of disagreements between the minority shareholder and the alleged controllers made any reliance upon the controllers unjustifiable in that case. Because the parties had not objected at trial to the wording of those jury instructions, the Court of Appeals accepted them as the law of the case and did not address whether those jury instructions would be appropriate for another case or accurately state the Texas law on informal fiduciary duties.

2.2.4. Fiduciary Duties in Delaware Cases.

(a) Loyalty.

(1) Conflicts of Interest. In Delaware, the duty of loyalty mandates "that there shall be no conflict between duty and self-interest."[93] It demands that the best interests of the corporation and its stockholders take precedence over any personal interest or bias of a director that is not shared by stockholders generally.[94] The Delaware Court of Chancery has summarized the duty of loyalty as follows:

> Without intending to necessarily cover every case, it is possible to say broadly that the duty of loyalty is transgressed when a corporate fiduciary, whether director, officer or controlling shareholder, uses his or her corporate office or, in the case of a controlling shareholder, control over corporate machinery, to promote, advance or effectuate a transaction between the corporation and such person (or an entity in which the fiduciary has a substantial economic interest, directly or indirectly) and that transaction is not substantively fair to the corporation. That is, breach of loyalty cases inevitably involve conflicting economic or other interests, even if only in the somewhat diluted form present in every "entrenchment" case.[95]

Importantly, conflicts of interest do not per se result in a breach of the duty of loyalty. Rather, it is the manner in which an interested director handles a conflict and the processes invoked to ensure fairness to the corporation and its stockholders that will determine the propriety of the director's conduct and the validity of the particular transaction.[96] Moreover, the Delaware courts have emphasized that only material personal interests or influences will imbue a transaction with duty of loyalty implications.

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93 *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939).

94 *Cede & Co. v. Technicolor, Inc.,* 634 A.2d 345, 361 (Del. 1993).

95 *Solash v. Telex Corp.,* No. 9518, 9528, 9525, 1988 WL 3587, at *7, 1988 Del. Ch. LEXIS 7, at *19-*20 (Del. Ch. Jan. 19, 1988). Some of the procedural safeguards typically invoked to assure fairness in transactions involving Board conflicts of interest are discussed in more detail *infra*, in connection with the entire fairness standard of review.

96 *See* DGCL § 144(a)(2); *McGowan v. Ferro*, 859 A.2d 1012, 1029 (Del. Ch. 2004), *judgment entered sub nom. McGowan v. Ferro, Jr.* (Del. Ch. Dec. 1, 2004), *aff'd sub nom. McGowan v. Ferro*, 873 A.2d 1099 (Del. 2005) and *aff'd sub nom. McGowan v. Ferro*, 873 A.2d 1099 (Del. 2005): "In order to rebut the presumption of director disinterestedness and independence, a stockholder must show that the directors' self-interest materially affected their independence. In other words "[t]o be disqualifying, the nature of the director interest must be substantial," not merely "incidental." A de minimus departure from the requirement

The duty of loyalty may be implicated in connection with numerous types of corporate transactions, including, for example, the following: contracts between the corporation and directors or entities in which directors have a material interest; management buyouts; dealings by a parent corporation with a subsidiary; corporate acquisitions and reorganizations in which the interests of a controlling stockholder and the minority stockholders might diverge;[97] usurpations of corporate opportunities; competition by directors or officers with the corporation; use of corporate office, property or information for purposes unrelated to the best interest of the corporation;[98] insider trading; and actions that have the purpose or practical effect of perpetuating directors in office. In Delaware, a director can be found guilty of a breach of duty of loyalty by approving a transaction in which the director did not personally profit, but did approve a transaction that benefited the majority stockholder to the detriment of the minority stockholders.[99]

Like Texas, Delaware embraces the principle that a transaction or contract between a director or officer and the corporation served is presumed to be valid and will not be void or voidable solely by reason of the interest of the director or officer as long as certain statutory conditions are met. DGCL § 144 provides that a contract between a director or officer and the corporation served will not be voidable due to the interest of the director or officer if (i) the transaction or contract is approved in good faith by a

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that all stockholders be treated equally does not "amount to an actionable breach of fiduciary duty."; *infra* notes 247-249 and related text.

97 *See New Jersey Carpenters Pension Fund v. infoGROUP, Inc.*, C.A. No. 5334-VCN, 2011 Del. Ch. LEXIS 147, at *27-28 (Del. Ch. Sept. 30, 2011), *revised* (Oct. 6, 2011), in which the Court of Chancery refused to dismiss a breach of fiduciary duty claim where the plaintiff had adequately pled that the founder and largest stockholder of defendant *info*GROUP, Inc. dominated his fellow directors and forced them to approve a sale of the company at an unfair price in order to provide himself with some much-needed liquidity; *but see In re Synthes, Inc. S'holder Litig.*, 50 A.3d 1022, 1024 (Del. Ch. 2012), in which plaintiff stockholders argued that a controlling stockholder refused to consider an acquisition offer that would have cashed out all the minority stockholders of the defendant Synthes, Inc., but required the controlling stockholder to remain as an investor in Synthes; instead, the controlling stockholder worked with the other directors of Synthes and, after affording a consortium of private equity buyers a chance to make an all-cash, all-shares offer, ultimately accepted a bid made by Johnson & Johnson for 65% stock and 35% cash, and consummated a merger in which the controlling stockholder received the same treatment as the other stockholders. In *Synthes*, Chancellor Strine commented that although the controller was allowed by Delaware law to seek a premium for his own controlling position, he did not and instead allowed the minority to share ratably in the control premium paid by J&J, and in granting defendants' motion to dismiss the Chancellor wrote:

> I see no basis to conclude that the controlling stockholder had any conflict with the minority that justifies the imposition of the entire fairness standard. The controlling stockholder had more incentive than anyone to maximize the sale price of the company, and Delaware does not require a controlling stockholder to penalize itself and accept less than the minority, in order to afford the minority better terms. Rather, pro rata treatment remains a form of safe harbor under our law."

98 *Kahn v. Kolberg Kravis Roberts & Co., L.P.*, 23 A.3d 831, 837-838 (Del. 2011) ("[A] fiduciary cannot use confidential corporate information for his own benefit. As the court recognized in *Brophy*, it is inequitable to permit the fiduciary to profit from using confidential corporate information. Even if the corporation did not suffer actual harm, equity requires disgorgement of that profit."); *Brophy v. Cities Service Co.*, 70 A.2d 5, 7-8 (Del. Ch. 1949). To plead a claim under *Brophy v. Cities Service Co.* (a "*Brophy* claim"), a plaintiff must be able to allege that "1) the corporate fiduciary possessed material, nonpublic company information; and 2) the corporate fiduciary used that information improperly by making trades because she was motivated, in whole or in part, by the substance of that information." *In re Oracle Corp. Derivative Litig.*, 867 A.2d 904, 934 (Del. Ch. 2004), *aff'd*, 872 A.2d 960 (Del. 2005); *see also In re Primedia, Inc. S'holders Litig. (Primedia III)*, Consolidated C.A. No. 6511-VCL, 2013 WL 6797114, at *1, *13, 2013 Del. Ch. LEXIS 306, at *2-3, *43 (Del. Ch. Dec. 20, 2013); *In re Primedia, Inc. S'holders Litig. (Primedia II)*, 67 A.3d 455, 459 (Del. Ch. 2013).

99 *Crescent/Mach I Partners, L.P. v. Turner*, 846 A.2d 963, 983 n.50 (Del. Ch. 2000); *Strassburger v. Earley*, 752 A.2d 557, 581 (Del. Ch. 2000).

majority of the disinterested directors after the material facts as to the relationship or interest and as to the transaction or contract are disclosed or known to the directors, (ii) the transaction or contract is approved in good faith by shareholders after the material facts as to the relationship or interest and as to the transaction or contract is disclosed or known to the shareholders, or (iii) the transaction or contract is fair to the corporation as of the time it is authorized, approved, or ratified by the directors or shareholders of the corporation.[100]

(2) Good Faith. Good faith is far from a new concept in Delaware fiduciary duty law.[101] Good faith long was viewed by the Delaware courts as an integral component of the duty of loyalty. Then in 1993 *Cede & Co. v. Technicolor, Inc.*[102] recognized the duty of good faith as a distinct directorial duty.[103] The doctrinal concept that good faith is a separate leg in a triad of fiduciary duties died with the Delaware Supreme Court's 2006 holding in *Stone v. Ritter* that good faith is not a separate fiduciary duty and is embedded in the duty of loyalty.[104] In *Stone v. Ritter*,[105] the Delaware Supreme Court explained that "good faith" is not a separate fiduciary duty like the duties of care and loyalty, but rather is embedded in the duty of loyalty:

> [F]ailure to act in good faith results in two additional doctrinal consequences. First, although good faith may be described colloquially as part of a "triad" of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly. The second doctrinal consequence is that the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest.

The concept of good faith is also a limitation on the ability of entities to rely on Delaware statutes.[106] In one of the early, landmark decisions analyzing the contours of the duty of loyalty, the Delaware Supreme Court observed that "no hard and fast rule can be formatted" for determining whether a director has acted in "good faith."[107] While that observation remains true today, the case law and

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100 *See infra* notes 247-249 and related text.

101 *See* Leo E. Strine Jr., Lawrence A. Hamermesh, R. Franklin Balotti and Jeffrey M. Gorris, *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 93 GEO. L. J. 629 (2010), *available at* http://ssrn.com/abstract=1349971.

102 634 A.2d 345, 361 (Del. 1993), *decision modified on reargument*, 636 A.2d 956 (Del. 1994).

103 *See* Strine et al, *supra* note 101.

104 911 A.2d 362, 369-370 (Del. 2006). *See infra* notes 129-140 and related text.

105 911 A.2d 362 at 370.

106 In summarizing the Delaware doctrine of "independent legal significance" and that it is subject to the requirement of good faith, Leo E. Strine, Jr. wrote in *The Role of Delaware in the American Corporate Governance System, and Some Preliminary Musings on the Meltdown's Implications for Corporate Law*, Governance of the Modern Firm 2008, Molengraaff Institute for Private Law, Utrecht University, Utrecht, The Netherlands (December 13, 2008):

> The [DGCL] provides transactional planners with multiple routes to accomplish identical ends. Under the doctrine of independent legal significance, a board of directors is permitted to effect a transaction through whatever means it chooses in *good faith*. Thus, if one method would require a stockholder vote, and another would not, the board may choose the less complicated and more certain transactional method. (Emphasis added).

107 *See Guth*, 5 A.2d at 510.

applicable commentary provide useful guidance regarding some of the touchstone principles underlying the duty of good faith.[108]

Good faith requires directors to act honestly, in the best interest of the corporation, and in a manner that is not knowingly unlawful or contrary to public policy. While the Court's review requires it to examine the Board's subjective motivation, the Court will utilize objective facts to infer such motivation. Like a duty of care analysis, such review likely will focus on the process by which the Board reached the decision under review. Consistent with earlier articulations of the level of conduct necessary to infer bad faith (or irrationality), more recent case law suggests that only fairly egregious conduct (such as a knowing and deliberate indifference to a potential risk of harm to the corporation) will rise to the level of "bad faith."[109]

The impetus for an increased focus on the duty of good faith is the availability of damages as a remedy against directors who are found to have acted in bad faith. DGCL § 102(b)(7) authorizes corporations to include in their certificates of incorporation a provision eliminating or limiting directors' liability for breaches of the fiduciary duty of care.[110] However, DGCL § 102(b)(7) also expressly provides that directors cannot be protected from liability for either actions not taken in good faith[111] or breaches of the duty of loyalty.[112] A finding of a lack of good faith has profound significance for directors not only because they may not be exculpated from liability for such conduct, but also because a prerequisite to eligibility for indemnification under DGCL § 145 of the DGCL is that the directors who were unsuccessful in their litigation nevertheless must demonstrate that they have acted "in good faith and in a manner the person reasonably believed was in or not opposed to the best interests of the corporation."[113] Accordingly, a director who has breached the duty of good faith not only is exposed to personal liability, but also may not be able to seek indemnification from the corporation for any judgment obtained against her or for expenses incurred (unsuccessfully) litigating the issue of liability.[114] Thus, in cases involving decisions

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108 *See generally Stone v. Ritter*, 911 A.2d 362, 364 (Del. 2006); *In re The Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 62 (Del. 2006); John F. Grossbauer and Nancy N. Waterman, *The (No Longer) Overlooked Duty of Good Faith Under Delaware Law*, VIII Deal Points No. 2 of 6, The Newsletter of the ABA Business Law Section Committee on Negotiated Acquisitions, No. 2 (Summer 2003).

109 *In re Disney*, 906 A.2d at 63.

110 *DGCL* § 102(b)(7) does not limit the liability of officers.

111 *See* Leo E. Strine Jr., Lawrence A. Hamermesh, R. Franklin Balotti and Jeffrey M. Gorris, *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law* (February 26, 2009), Georgetown Law Journal, Forthcoming; Widener Law School Legal Studies Research Paper No. 09-13; Harvard Law & Economics Discussion Paper No. 630, *available at* http://ssrn.com/abstract=1349971, 39-45 regarding the meaning of good faith in the context of DGCL § 102(b)(7) and the circumstances surrounding the addition of the good faith exclusion in DGCL § 102(b)(7).

112 Specifically, DGCL § 102(b)(7) authorizes the inclusion in a certificate of incorporation of:

> A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability or a director: (i) for any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under §174 of this title [dealing with the unlawful payment of dividends or unlawful stock purchase or redemption]; or (iv) for any transaction from which the director derived an improper personal benefit.

113 DGCL §§ 145(a)-(b).

114 In contrast, it is at least theoretically possible that a director who has been found to have breached his or her duty of loyalty could be found to have acted in good faith and, therefore, be eligible for indemnification of expenses (and, in non-derivative

made by directors who are disinterested and independent with respect to a transaction (and where, therefore, the duty of loyalty is not implicated), the duty of good faith still provides an avenue for asserting personal liability claims against the directors. Moreover, these claims, if successful, create barriers to indemnification of amounts paid by directors in judgment or settlement.[115]

(3) Waste. "Waste" constitutes "bad faith."[116] Director liability for waste requires proof that the directors approved an "exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration."[117] Waste is a derivative claim.[118]

(4) Oversight/Caremark. Directors also may be found to have violated the duty of loyalty when they fail to act in the face of a known duty to act[119] – i.e., they act in bad faith.[120] In an important Delaware Chancery Court decision on this issue, *In re Caremark International, Inc. Derivative Litigation*,[121] the settlement of a derivative action that involved claims that Caremark's Board breached its fiduciary duty to the company in connection with alleged violations by the company of anti-referral provisions of Federal Medicare and Medicaid statutes was approved. In so doing, the Court discussed the scope of a Board's duty to supervise or monitor corporate performance and stay informed about the business of the corporation as follows:

> [I]t would . . . be a mistake to conclude . . . that corporate boards may satisfy their obligations to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are

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cases, amounts paid in judgment or settlement) by the corporation. *See Blasius Indus., Inc. v. Atlas Corp.,* 564 A.2d 651, 663 (Del. Ch. 1988) (finding directors to have acted in good faith but nevertheless breached their duty of loyalty).

115 The availability of directors and officers liability insurance also may be brought into question by a finding of bad faith. Policies often contain exclusions that could be cited by carriers as a basis for denying coverage.

116 *In re MeadWestvaco Stockholders Litigation*, C.A. No. 10617-CG (Aug. 17, 2017) (to state a valid claim of bad faith, "a plaintiff must show either [1] an *extreme* set of facts to establish that disinterested directors were *intentionally* disregarding their duties or [2] that the decision under attack is so far beyond the bounds of reasonable judgment that it seems essentially *inexplicable* on any ground other than bad faith" (emphasis added).

117 *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 137 (Del. Ch. 2009). *See Sample v. Morgan*, 914 A.2d 647, 669-70 (Del. Ch. 2007).

118 *Thornton v. Bernard Tech., Inc.*, C.A. No. 962-VCN, 2009 WL 426179, at *3, 2009 Del. Ch. LEXIS 29, at *10-*11 (Del. Ch. Feb. 20, 2009) ("When a director engages in self-dealing or commits waste, he takes from the corporate treasury and any recovery would flow directly back into the corporate treasury.").

119 *See* Appendix D (*Business Leaders Must Address Cybersecurity Risk*) to Byron F. Egan, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations*, UTCLE 37th Annual Conference on Securities Regulation and Business Law, Feb. 13, 2015, *available at* http://www.jw.com/publications/article/2033; *see also* John F. Olson, Jonathan C. Dickey, Amy L. Goodman and Gilliam McPhee, *Current Issues in Director and Officer Indemnification and Insurance*, INSIGHTS: THE CORPORATE & SECURITIES LAW ADVISOR, 8 (Jul. 31, 2013) ("As part of the board's risk oversight function, the board should have an understanding of the cyber risks the company faces in operating its business and should be comfortable that the company has systems in place to identify and manage cyber risks, prevent cyber breaches and respond to cyber incidents when they occur. This should include an understanding of the extent to which a company's insurance may provide protection in the event of a major cyber incident.").

120 In *Stone v. Ritter*, the Delaware Supreme Court held that "the requirement to act in good faith is a subsidiary element, i.e., a condition, of the fundamental duty of loyalty." 911 A.2d at 370 (internal quotations omitted).

121 698 A.2d 959, 970 (Del. Ch. 1996); *see* Regina F. Burch, *Director Oversight and Monitoring: The Standard of Care and The Standard of Liability Post-Enron*, 6 WYO. L. REV. 482, 485 (2006).

reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.[122]

Stated affirmatively, "a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may . . . render a director liable."[123] While *Caremark* recognizes a cause of action for uninformed inaction, the holding is subject to the following:

First, the Court held that "only a sustained or systematic failure of the board to exercise oversight — such as an utter failure to attempt to assure a reasonable information and reporting system exists — will establish the lack of good faith that is a necessary condition to liability."[124] It is thus not at all clear that a plaintiff could recover based on a single example of director inaction, or even a series of examples relating to a single subject.

Second, *Caremark* noted that "the level of detail that is appropriate for such an information system is a question of business judgment,"[125] which indicates that the presence of an existing information and reporting system will do much to cut off any derivative claim, because the adequacy of the system itself will be protected.

Third, *Caremark* considered it obvious that "no rationally designed information system . . . will remove the possibility" that losses could occur.[126] As a result, "[a]ny action seeking recovery for losses would logically entail a judicial determination of proximate cause."[127] This holding indicates that a loss to the corporation is not itself evidence of an inadequate information and reporting system. Instead, the Court will focus on the adequacy of the system overall and whether a causal link exists.[128]

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122 *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d at 970.

123 *Id.*

124 *Id.* at 971.

125 *Id.* at 970.

126 *Id.*

127 *Id.* at 970 n.27.

128 *See generally* Eisenberg, *Corporate Governance The Board of Directors and Internal Control*, 19 CARDOZO L. REV. 237 (1997); Pitt, et al., *Talking the Talk and Walking the Walk: Director Duties to Uncover and Respond to Management Misconduct*, 1005 PLI/CORP. 301, 304 (1997); Gruner, *Director and Officer Liability for Defective Compliance Systems: Caremark and Beyond*, 995 PLI/CORP. 57, 64-70 (1997); Funk, *Recent Developments in Delaware Corporate Law: In re Caremark International Inc. Derivative Litigation: Director Behavior, Shareholder Protection, and Corporate Legal Compliance*, 22 DEL. J. CORP. L. 311 (1997). *Cf. In re Abbott Laboratories Derivative Shareholders Litigation*, 325 F.3d 795, 804 (7th Cir. 2003) (the Seventh Circuit applying Illinois law in a shareholders derivative suit denied motion to dismiss and distinguished *Caremark* on the grounds that in the latter, there was no evidence indicating that the directors "conscientiously permitted a known violation of law by the corporation to occur," unlike evidence to the contrary in *Abbott*, but nonetheless relied on *Caremark* language regarding the connection between a board's systemic failure of oversight and a lack of good faith); *Connolly v. Gasmire*, 257 S.W.3d 831, 851 (Tex. App.—Dallas 2008, no pet.) (a Texas court in a derivative action involving a Delaware corporation declined to follow *Abbott* as the Court found no Delaware case in which *Abbott* had been followed).

In *Stone v. Ritter*[129] the Delaware Supreme Court affirmed *Caremark* as the standard for assessing director oversight responsibility. *Stone v. Ritter* was a "classic *Caremark* claim" arising out of a bank paying $50 million in fines and penalties to resolve government and regulatory investigations pertaining principally to the failure of bank employees to file Suspicious Activity Reports ("SARs") as required by the Bank Secrecy Act ("BSA") and various anti money laundering regulations. The Chancery Court dismissed the plaintiffs' derivative complaint which alleged that "the defendants had utterly failed to implement any sort of statutorily required monitoring, reporting or information controls that would have enabled them to learn of problems requiring their attention." In affirming the Chancery Court, the Delaware Supreme Court commented, "[i]n this appeal, the plaintiffs acknowledge that the directors neither 'knew [n]or should have known that violations of law were occurring,' i.e., that there were no 'red flags' before the directors" and held "[c]onsistent with our opinion in *In re Walt Disney Co. Derivative Litigation*,[130] . . . that *Caremark* articulates the necessary conditions for assessing director oversight liability and . . . that the *Caremark* standard was properly applied to evaluate the derivative complaint in this case."

The Supreme Court of Delaware explained the doctrinal basis for its holding as follows and, in so doing, held that "good faith" is not a separate fiduciary duty and is embedded in the duty of loyalty:

> As evidenced by the language quoted above, the *Caremark* standard for so-called "oversight" liability draws heavily upon the concept of director failure to act in good faith. That is consistent with the definition(s) of bad faith recently approved by this Court in its recent *Disney* decision, where we held that a failure to act in good faith requires conduct that is qualitatively different from, and more culpable than, the conduct giving rise to a violation of the fiduciary duty of care (i.e., gross negligence). In *Disney*, we identified the following examples of conduct that would establish a failure to act in good faith:
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>> A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.
>
> The third of these examples describes, and is fully consistent with, the lack of good faith conduct that the *Caremark* Court held was a "necessary condition" for director oversight liability, i.e., "a sustained or systematic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reasonable information and reporting system exists . . . ." Indeed, our opinion in *Disney* cited *Caremark* with approval for that proposition. Accordingly, the Court of Chancery applied the correct standard in assessing whether demand was excused in this case where failure to exercise oversight was the basis or theory of the plaintiffs' claim for relief.

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129 911 A.2d 362, 365 (Del. 2006).

130 *See In re The Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 63 (Del. 2006).

> It is important, in this context, to clarify a doctrinal issue that is critical to understanding fiduciary liability under *Caremark* as we construe that case. The phraseology used in *Caremark* and that we employ here – describing the lack of good faith as a "necessary condition to liability" – is deliberate. The purpose of that formulation is to communicate that a failure to act in good faith is not conduct that results, *ipso facto*, in the direct imposition of fiduciary liability. The failure to act in good faith may result in liability because the requirement to act in good faith "is a subsidiary element[,]" i.e., a condition, "of the fundamental duty of loyalty." It follows that because a showing of bad faith conduct, in the sense described in *Disney* and *Caremark*, is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty.
>
> This view of a failure to act in good faith results in two additional doctrinal consequences. First, although good faith may be described colloquially as part of a "triad" of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly. The second doctrinal consequence is that the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith. As the Court of Chancery aptly put it in *Guttman*, "[a] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest."
>
> We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.[131]

Stone v. Ritter was a "demand-excused" case in which the plaintiffs did not demand that the directors commence the derivative action because allegedly the directors breached their oversight duty and, as a result, faced a "substantial likelihood of liability" as a result of their "utter failure" to act in good faith to put into place policies and procedures to ensure compliance with regulatory obligations. The Court of Chancery found that the plaintiffs did not plead the existence of "red flags" – "facts showing that the board ever was aware that company's internal controls were inadequate, that these inadequacies would result in illegal activity, and that the board chose to do nothing about problems it allegedly knew existed."[132] In dismissing the derivative complaint, the Court of Chancery concluded:

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131 911 A.2d at 369-70.

132 *Id.* at 370.

> This case is not about a board's failure to carefully consider a material corporate decision that was presented to the board. This is a case where information was not reaching the board because of ineffective internal controls.... With the benefit of hindsight, it is beyond question that AmSouth's internal controls with respect to the Bank Secrecy Act and anti-money laundering regulations compliance were inadequate. Neither party disputes that the lack of internal controls resulted in a huge fine--$50 million, alleged to be the largest ever of its kind. The fact of those losses, however, is not alone enough for a court to conclude that a majority of the corporation's board of directors is disqualified from considering demand that AmSouth bring suit against those responsible.[133]

The adequacy of the plaintiffs' assertion that demand was excused turned on whether the complaint alleged facts sufficient to show that the defendant directors were potentially personally liable for the failure of non-director bank employees to file the required Suspicious Activity Reports. In affirming the Chancery Court, the Delaware Supreme Court wrote:

> For the plaintiffs' derivative complaint to withstand a motion to dismiss, "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability." As the *Caremark* decision noted:
>
> > Such a test of liability – lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight – is quite high. But, a demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a class, as it is in the board decision context, since it makes board service by qualified persons more likely, while continuing to act as a stimulus to *good faith performance of duty* by such directors.
>
> The KPMG Report – which the plaintiffs explicitly incorporated by reference into their derivative complaint – refutes the assertion that the directors "never took the necessary steps . . . to ensure that a reasonable BSA compliance and reporting system existed." KPMG's findings reflect that the Board received and approved relevant policies and procedures, delegated to certain employees and departments the responsibility for filing SARs and monitoring compliance, and exercised oversight by relying on periodic reports from them. Although there ultimately may have been failures by employees to report deficiencies to the Board, there is no basis for an oversight claim seeking to hold the directors personally liable for such failures by the employees.
>
> With the benefit of hindsight, the plaintiffs' complaint seeks to equate a bad outcome with bad faith. The lacuna in the plaintiffs' argument is a failure to recognize that the directors' good faith exercise of oversight responsibility may not invariably prevent employees from violating criminal laws, or from causing the corporation to incur significant financial liability, or both, as occurred in *Graham, Caremark* and this very case. In the absence of red flags, good faith in the context of oversight must be measured by the directors'

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133 *Id.* at 370-71.

> actions "to assure a reasonable information and reporting system exists" and not by second-guessing after the occurrence of employee conduct that results in an unintended adverse outcome. Accordingly, we hold that the Court of Chancery properly applied *Caremark* and dismissed the plaintiffs' derivative complaint for failure to excuse demand by alleging particularized facts that created reason to doubt whether the directors had acted in good faith in exercising their oversight responsibilities.[134]

Good faith in Delaware nevertheless requires active, engaged directorship including having a basis for confidence that the corporation's system of controls is adequate for its business, even if that business is in China and travel and foreign language skills are required:

> [I]f you're going to have a company domiciled for purposes of its relations with its investors in Delaware and the assets and operations of that company are situated in China … in order for you to meet your obligation of good faith, you better have your physical body in China an awful lot. You better have in place a system of controls to make sure that you know that you actually own the assets. You better have the language skills to navigate the environment in which the company is operating. You better have retained accountants and lawyers who are fit to the task of maintaining a system of controls over a public company…. Independent directors who step into these situations involving essentially the fiduciary oversight of assets in other parts of the world have a duty not to be dummy directors…. [Y]ou're not going to be able to sit in your home in the U.S. and do a conference call four times a year and discharge your duty of loyalty. That won't cut it…. You have a duty to think.[135]

In June 2019, *Caremark and Stone v. Ritter* were followed by the Delaware Supreme Court in *Marchand* v. *Barnhill,*[136] which involved Blue Bell Creameries USA, Inc., a Delaware subchapter S corporation headquartered in Brenham, Texas which through subsidiaries made and distributed ice cream tainted with *listeria* bacteria. As a consequence, eight people were sickened (three of whom died), Blue Bell had to recall its products, suspend operations and lay off over a third of its workforce. To avoid bankruptcy, it entered into a highly dilutive transaction with a private equity investor. Plaintiffs then sued the Blue Bell's board of directors in a derivative action to recoup their investment losses, alleging that the directors breached their fiduciary duty of loyalty under *Caremark* by not establishing and monitoring a system to monitor Blue Bell's food safety performance or compliance with FDA and state regulatory requirements.

The Court of Chancery dismissed the lawsuit because the Board did receive reports from management and outsiders as to the adequacy of the company's operations, and it found that plaintiff failed to plead any facts to support his *Caremark* claim that the Board "utterly failed to adopt or implement any reporting and compliance systems". Reversing in a unanimous opinion by Chief Justice Leo Strine, the Delaware Supreme Court in *Marchand* held that, while Blue Bell had certain food safety programs in place and "nominally complied with FDA regulations," "the complaint alleges that Blue Bell's board had no committee overseeing food safety, no full board-level process to address food safety issues, and no

134 *Id.* at 372-73.

135 *In re Puda Coal Stockholders' Litigation*, C.A. No. 6476-CS at 17-18, 21-22, (Del. Ch. Feb. 6, 2013) (bench ruling), *available at* www.davispolk.com/files/uploads/Puda_Coal_Transcript_Ruling.pdf.

136 212 A. 3d 805 (No. 533, 2018 Del. 2019)

process by which the board was expected to be advised of food safety reports and developments…. Thus, the complaint alleges specific facts that create a reasonable inference that the directors consciously failed 'to attempt to assure a reasonable information and reporting system exist[ed]'". To "satisfy their duty of loyalty," the Supreme Court held, "directors must make a good faith effort to put in place a reasonable system of monitoring and reporting about the corporation's central compliance risks." Without more, the existence of management-level compliance programs is not enough for the directors to avoid *Caremark* exposure in a monoline company that makes a single food product—ice cream—and in which the company's "mission critical" compliance issue is food safety.

In *American International Group, Inc. Consolidated Derivative Litigation; AIG, Inc. v. Greenberg*, the Court denied a motion to dismiss *Caremark* claims against former Chairman of American International Group, Inc. ("AIG") Maurice "Hank" Greenberg, three other directors (who were also executive officers part of Greenberg's "Inner Circle") and other AIG directors for harm AIG suffered when it was revealed that AIG's financial statements overstated the value of AIG by billions of dollars and that AIG had engaged in schemes to evade taxes and rig insurance markets.[137] The Court emphasized that the claims were not based on one instance of fraud, but rather a pervasive scheme of extraordinary illegal misconduct at the direction and under the control of defendant Greenberg and his Inner Circle, and wrote: "Our Supreme Court has recognized that directors can be liable where they 'consciously failed to monitor or oversee [the company's internal controls] thus disabling themselves from being informed of risks or problems requiring their attention.'"[138] Recognizing that this standard requires scienter, the Court found pled facts that supported an inference that two of the defendant directors were conscious of the fact that they were not doing their jobs.[139]

Shortly thereafter, in *In re Citigroup Inc. Shareholder Derivative Litigation*,[140] the Chancery Court distinguished *AIG* and dismissed *Caremark* claims[141] brought against current and former directors of Citigroup for failing to properly monitor and manage the risks that Citigroup faced concerning problems in the subprime lending market. Plaintiffs claimed that there were extensive "red flags" that should have put defendants on notice about problems "that were brewing in the real estate and credit markets," and that defendants ignored the warnings and sacrificed the long term viability of Citigroup for short term

137 965 A.2d 763, 774 (Del. Ch. 2009).

138 *Id.* at 799 (citation omitted).

139 Breach of fiduciary duty claims were also not dismissed against AIG directors alleged to have used insider information to profit at the expense of innocent buyers of stock, with the Court writing: "Many of the worst acts of fiduciary misconduct have involved frauds that personally benefited insiders as an indirect effect of directly inflating the corporation's stock price by the artificial means of cooking the books."

140 964 A.2d 106, 111 (Del. Ch. 2009).

141 Plaintiffs had not made demand on the Board, alleging that it would have been futile since the directors were defendants in the action and faced substantial liability if the action succeeded. Chancellor Chandler disagreed that demand was excused. He started his analysis by referring to the test articulated by the Delaware Supreme Court in *Aronson v. Lewis*, 473 A.2d 805, 809 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244, 253-54 (Del. 2000), for demand futility where plaintiffs must provide particularized factual allegations that raise a reasonable doubt that the directors are disinterested and that the challenged transaction was otherwise the product of a valid exercise of business judgment, but found that the plaintiffs were complaining about board "inaction" and as a result, the *Aronson* test did not apply. Instead, in order to show demand futility in this situation, the applicable standard is from *Rales v. Blasband*, 634 A.2d 927, 933 (Del. 1993), which requires that a 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 the demand."

profits.[142] In analyzing the plaintiffs' theory of director liability under the teachings of *Caremark*, the Court found that the plaintiffs' claims were in essence that the defendants failed to monitor the Company's "business risk" with respect to Citigroup's exposure to the subprime mortgage market.

Since Citigroup had a DGCL § 102(b)(7) provision in its certificate of incorporation[143] and the plaintiffs had not alleged that the directors were interested in the transaction, the plaintiffs had to allege with particularity that the directors acted in bad faith. The Court said that a plaintiff can "plead bad faith by alleging with particularity that a director *knowingly* violated a fiduciary duty or failed to act in violation of a *known* duty to act, demonstrating a *conscious* disregard for her duties."[144] In addressing whether the director consciously disregarded an obligation to be reasonably informed about the business and the risks or consciously disregard the duty to monitor and oversee the business, the Court wrote:

> The presumption of the business judgment rule, the protection of an exculpatory § 102(b)(7) provision, and the difficulty of proving a Caremark claim together function to place an extremely high burden on a plaintiff to state a claim for personal director liability for failure to see the extent of a company's business risk.
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> To the extent the Court allows shareholder plaintiffs to succeed on a theory that a director is liable for a failure to monitor business risk, the Court risks undermining the well settled policy of Delaware law by inviting Courts to perform a hindsight evaluation of the reasonableness or prudence of directors' business decisions. Risk has been defined as the chance that a return on an investment will be different that [sic] expected. The essence of the business judgment of managers and directors is deciding how the company will evaluate the trade-off between risk and return. Businesses—and particularly financial institutions—make returns by taking on risk; a company or investor that is willing to take on more risk can earn a higher return. Thus, in almost any business transaction, the parties go into the deal with the knowledge that, even if they have evaluated the situation correctly, the return could be different than they expected.
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> It is almost impossible for a court, in hindsight, to determine whether the directors of a company properly evaluated risk and thus made the "right" business decision. In any investment there is a chance that returns will turn out lower than expected, and generally a smaller chance that they will be far lower than expected. When investments turn out poorly, it is possible that the decision-maker evaluated the deal correctly but got "unlucky" in that a huge loss—the probability of which was very small—actually happened. It is also possible that the decision-maker improperly evaluated the risk posed by an investment and that the company suffered large losses as a result.
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> Business decision-makers must operate in the real world, with imperfect information, limited resources, and an uncertain future. To impose liability on directors for making a "wrong" business decision would cripple their ability to earn returns for investors by taking business risks. Indeed, this kind of judicial second guessing is what the

142 *Citigroup*, 964 A.2d at 111.

143 *See supra* notes 112-113 and related text.

144 *Citigroup*, 964 A.2d at 125.

> business judgment rule was designed to prevent, and even if a complaint is framed under a *Caremark* theory, this Court will not abandon such bedrock principles of Delaware fiduciary duty law. With these considerations and the difficult standard required to show director oversight liability in mind, I turn to an evaluation of the allegations in the Complaint.[145]

In light of the "extremely high burden" placed on plaintiffs, the Court concluded that plaintiffs' conclusory allegations (and thus their failure to plead particularized facts) were insufficient to state a *Caremark* claim thereby excusing demand. The Court compared *Citigroup* with the *American International Group, Inc. Consolidated Derivative Litigation*[146] where, unlike the allegations against the Citigroup directors, the defendant directors in the *AIG* case were charged with failure to exercise reasonable oversight over pervasive *fraudulent* and *criminal* conduct:

> This Court's recent decision in *American International Group, Inc. Consolidated Derivative Litigation* demonstrates the stark contrast between the allegations here and allegations that are sufficient to survive a motion to dismiss. In *AIG*, the Court faced a motion to dismiss a complaint that included "well-pled allegations of pervasive, diverse, and substantial financial fraud involving managers at the highest levels of AIG." In concluding that the complaint stated a claim for relief under Rule 12(b)(6), the Court held that the factual allegations in the complaint were sufficient to support an inference that AIG executives running those divisions knew of and approved much of the wrongdoing. The Court reasoned that huge fraudulent schemes were unlikely to be perpetrated without the knowledge of the executive in charge of that division of the company. Unlike the allegations in this case, the defendants in *AIG* allegedly failed to exercise reasonable oversight over pervasive *fraudulent* and *criminal* conduct. Indeed, the Court in *AIG* even stated that the complaint there supported the assertion that top AIG officials were leading a "criminal organization" and that "[t]he diversity, pervasiveness, and materiality of the alleged financial wrongdoing at AIG is extraordinary."
>
> Contrast the *AIG* claims with the claims in this case. Here, plaintiffs argue that the Complaint supports the reasonable conclusion that the director defendants acted in bad faith by failing to see the warning signs of a deterioration in the subprime mortgage market and failing to cause Citigroup to change its investment policy to limit its exposure to the subprime market. Director oversight duties are designed to ensure reasonable reporting and information systems exist that would allow directors to know about and prevent wrongdoing that could cause losses for the Company. There are significant differences between failing to oversee employee fraudulent or criminal conduct and failing to recognize the extent of a Company's business risk. Directors should, indeed must under Delaware law, ensure that reasonable information and reporting systems exist that would put them on notice of fraudulent or criminal conduct within the company. Such oversight programs allow directors to intervene and prevent frauds or other wrongdoing that could expose the company to risk of loss as a result of such conduct. While it may be tempting to say that

145 *Id.* at 125-26; *cf In re The Goldman Sachs Group, Inc. Shareholder Litigation*, C.A. No. 5215-VCG, 2011 WL 4826104, at *23, 2011 Del. Ch. LEXIS 151, at *72 (Del. Ch. Oct. 12, 2011) (court refrained from reading into Caremark a further duty to "monitor business risk").

146 *See supra* note 137 and related text.

directors have the same duties to monitor and oversee business risk, imposing *Caremark*-type duties on directors to monitor business risk is fundamentally different. Citigroup was in the business of taking on and managing investment and other business risks. To impose oversight liability on directors for failure to monitor "excessive" risk would involve courts in conducting hindsight evaluations of decisions at the heart of the business judgment of directors. Oversight duties under Delaware law are not designed to subject directors, even expert directors, to *personal liability* for failure to predict the future and to properly evaluate business risk.[147]

The reasoning for the foregoing statement of Delaware law was explained by means of the following query by the Court in footnote 78:

> Query: if the Court were to adopt plaintiffs' theory of the case-that the defendants are personally liable for their failure to see the problems in the subprime mortgage market and Citigroup's exposure to them-then could not a plaintiff succeed on a theory that a director was personally liable for failure to predict the extent of the subprime mortgage crisis and profit from it, even if the company was not exposed to losses from the subprime mortgage market? If directors are going to be held liable for losses for failing to accurately predict market events, then why not hold them liable for failing to profit by predicting market events that, in hindsight, the director should have seen because of certain red (or green?) flags? If one expects director prescience in one direction, why not the other?[148]

The Court observed that the plaintiffs were asking it to engage in the exact kind of judicial second guessing that the business judgment rule proscribes. Especially in a case with staggering losses, it would be tempting to examine why the decision was wrong, but the presumption of the business judgment rule against an objective review of business decisions by judges is no less applicable when losses to the company are large.

(5) Business Opportunities. Like its Texas counterpart, the corporate opportunity doctrine in Delaware prohibits an officer or director of a corporation from diverting a business opportunity presented to, or otherwise rightfully belonging to, the corporation to himself or any of his affiliates. In Delaware, the corporate opportunity doctrine dictates that a corporate officer or director may not take a business opportunity for his own if: (1) the corporation is financially able to exploit the opportunity; (2) the opportunity is within the corporation's line of business; (3) the corporation has an interest or expectancy in the opportunity; and (4) by taking the opportunity for his own the corporate fiduciary will thereby be placed in a position inimical to his duties to the corporation. *Guth v. Loft, Inc.*[149] sets forth a widely quoted test for determining whether a director or officer wrongfully has diverted a corporate opportunity:

> if there is presented to a corporate officer or director a business opportunity which the corporation is financially able to undertake, is, from its nature, in the line of the corporation's business and is of practical advantage to it, is one in which the corporation has an interest or a reasonable expectancy, and, by embracing the opportunity, the self-

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147 *Citigroup*, 964 A.2d at 130-31.

148 *Id.* at 131 n.78.

149 5 A.2d 503, 510-11 (Del. 1939).

> interest of the officer or director will be brought into conflict with that of the corporation, the law will not permit him to seize the opportunity for himself.

Guth was explained and updated in 1996 by the Delaware Supreme Court in *Broz v. Cellular Info. Systems, Inc.*[150] as follows:

> The corporate opportunity doctrine, as delineated by *Guth* and its progeny, holds that a corporate officer or director may not take a business opportunity for his own if: (1) the corporation is financially able to exploit the opportunity; (2) the opportunity is within the corporation's line of business; (3) the corporation has an interest or expectancy in the opportunity; and (4) by taking the opportunity for his own, the corporate fiduciary will thereby be placed in a position inimicable to his duties to the corporation. The Court in *Guth* also derived a corollary which states that a director or officer *may* take a corporate opportunity if: (1) the opportunity is presented to the director or officer in his individual and not his corporate capacity; (2) the opportunity is not essential to the corporation; (3) the corporation holds no interest or expectancy in the opportunity; and (4) the director or officer has not wrongfully employed the resources of the corporation in pursuing or exploiting the opportunity. *Guth*, 5 A.2d at 509.
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> Thus, the contours of this doctrine are well established. It is important to note, however, that the tests enunciated in *Guth* and subsequent cases provide guidelines to be considered by a reviewing court in balancing the equities of an individual case. No one factor is dispositive and all factors must be taken into account insofar as they are applicable. * * *

Under Delaware law, even if the corporation cannot establish its financial capability to have exploited the opportunity, the element will be met if the usurping party had a parallel contractual obligation to present corporate opportunities to the corporation. The question of whether a director has usurped a business opportunity requires a fact-intensive analysis. Further, the defendant has the burden of proof to show that he did not usurp an opportunity that belonged to the corporation.

Like Texas, Delaware law allows a corporation to renounce any interest in business opportunities presented to the corporation or one or more of its officers, directors or shareholders in its certificate of formation or by action of its Board.[151] While this permits a corporation to specifically forgo individual corporate opportunities or classes of opportunities, the type of judicial scrutiny applied to the decision to make any such renunciation of corporate opportunities will generally be governed by a traditional common law fiduciary duty analysis.

(6) <u>Confidentiality</u>. A director may not use confidential company information, or disclose it to third parties, for personal gain without authorization from his fellow directors.[152] This principle is often

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150 673 A.2d 148 (Del. 1996).

151 DGCL § 122(17).

152 *Hollinger Int'l Inc. v. Black*, 844 A.2d 1022, 1062 (Del. Ch., 2004), *aff'd sub. nom.*, *Black v. Hollinger Int'l Inc.*, 872 A.2d 559 (Del. 2005); *Agranoff v. Miller*, C.A. No. 16795, 1999 WL 219650, at *19, 1999 Del. Ch. LEXIS 78, at *63-*64 (Del. Ch. Apr. 12, 1999), *aff'd as modified*, 737 A.2d 530 (Del. 1999).

memorialized in corporate policies.[153] In *Shocking Technologies, Inc. v. Michael*,[154] a director ("Michael") of a privately held Delaware corporation in dire financial straits who was on the Board as the representative of two series of preferred stock, was sued by the corporation for breaching his duty of loyalty by leaking negative confidential information about the company to another preferred shareholder considering an additional investment in the company. The Delaware Court of Chancery found that Michael disclosed the confidential information (i) to encourage the potential investor to withhold funds the corporation desperately needed, thereby making the company accommodating to the governance changes sought by Michael, or (ii) if the investor nevertheless decided to invest, to help the investor get a "better deal" which would include Board representation for such investor (thereby changing the balance of power on the Board in Michael's favor). In holding that Michael had violated his duty of loyalty, the Chancery Court explained:

> The fiduciary duty of loyalty imposes on a director "an affirmative obligation to protect and advance the interests of the corporation" and requires a director "absolutely [to] refrain from any conduct that would harm the corporation". Encompassed within the duty of loyalty is a good faith aspect as well. "To act in good faith, a director must act at all times with an honesty of purpose and in the best interest and welfare of the corporation. **A director acting in subjective good faith may, nevertheless, breach his duty of loyalty. The "essence of the duty of loyalty" stands for the fundamental proposition that a director, even if he is a shareholder, may not engage in conduct that is "adverse to the interests of [his] corporation**." (Emphasis added)[155]

The *Shocking Technologies* case involved a dissident director who was the sole Board representative of two series of preferred stock. Over time, significant disagreements between Michael and the other Board members arose over executive compensation and whether there should be increased Board representation for the preferred stock. Michael argued that the company's governance problems would need to be resolved before it could attract additional equity funding. The other directors believed, however, that these disagreements were a pretext for Michael's desire to increase his influence and control over the Board at a time when the company faced financial difficulties.

As the disagreements escalated, Michael contacted another holder of preferred stock who represented the company's only remaining source of capital to discourage the holder from exercising its warrants to purchase additional shares of the company's stock. Michael also told the potential investor that the company was in a dire financial situation, that the investor was the only present source of financing, and that the investor should use this leverage to negotiate for more favorable terms, such as a lower price or Board representation. The Court found that Michael shared this confidential information with the potential investor because Michael anticipated that he would be more likely to achieve his goals

153 *See Disney v. Walt Disney Co.*, C.A. No. 234-N, 2005 WL 1538336, 2005 Del. Ch. LEXIS 94 (June 20, 2005) (Remand Opinion), discussing a written confidentiality policy of The Walt Disney Company that bars present and former directors from disclosing information entrusted to them by reason of their positions, including information about discussions and deliberations of the Board). *See* The Walt Disney Company Code of Business Conduct and Ethics for Directors available at http://thewaltdisneycompany.com/content/code-business-conduct-and-ethics-directors.

154 C.A. No. 7164-VCN, 2012 WL 4482838, at *9-*14, 2012 Del. Ch. LEXIS 224, at *3 (Del. Ch. Oct. 1, 2012), , *vacated* due to Shocking bankruptcy proceedings, 2015 Del. Ch. LEXIS 154 (Del. Ch. May 29, 2015).

155 2012 WL 4482838, at *8, 2012 Del. Ch. LEXIS 224, at *28-*29.

if the investor either (i) withheld any additional investment in the company, thereby leaving the company desperate for funding,[156] or (ii) used the confidential information to get better deal terms, which Michael believed would undercut the authority of the balance of the Board.

In rejecting Michael's argument that his efforts were intended to "better the corporate governance structure" of the company and "reduce [the CEO's] domination" of the Board, the Court wrote:

> Michael may, for some period of time, have been motivated by idealistic notions of corporate governance. It was no doubt convenient that his corporate governance objectives aligned nicely with his self-interest.[157] When he and his fellow B/C [series of preferred stock] investors bought into Shocking, they did so knowing that they collectively only had one out of six board slots. Apparently, Michael came to regret that decision and worked to avoid the deal that he made. He contrasted the one out of six board seats designated by the B/C investors with B/C investors' substantial shares of all funds invested in Shocking.[158] That disparity annoyed him, but it was the board representation which he negotiated. In the abstract, his argument that board representation should be more proportional to investment is plausible. To describe it as a matter of good corporate governance—something that he may have believed or rationalized in contravention of the investment commitments that he made—strikes an observer from a distance as somewhere between disingenuous and self-righteous self-interest.
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> Regardless of how one might prioritize Michael's corporate governance concepts, those objectives would not justify pushing the Company to the brink of—or beyond—a debilitating cash shortfall. It is not an act of loyalty for a director to seek to impose his subjective views of what might be better for the Company by exercising whatever power he may have to threaten the Company's survival. In short, even if Michael had reasonable goals, he chose improper means, including disclosure of confidential information, in an attempt to achieve them.
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> Michael's conduct had a foreseeable (and intended) consequence: depriving the Company of a cash infusion necessary for its short-term survival. It turns out that a predictable result of his actions did not occur. In these circumstances, a director may not put the existence of a corporation at risk in order to bolster his personal views of corporate governance. The lesson to be learned from these facts must be carefully confined, however. First, fair debate may be an important aspect of board performance. A board majority may not muzzle a minority board member simply because it does not like what she may be saying. Second, criticism of the conduct of a board majority does not necessarily equate with criticism of the corporation and its mission. The majority may be managing the

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156 The company alleged that Michael was seeking to force the company into a new down round share issuance in which Michael could purchase shares on the cheap and dilute the other stockholders.

157 *See City Capital Assocs. Ltd. P'ship v. Interco. Inc.*, 551 A.2d 787, 796 (Del. Ch. 1988) ("human nature may incline *even one acting in subjective good faith* to rationalize as right that which is merely personally beneficial").

158 Michael believed that the B/C series investors had contributed 70% of the capital paid in to the company.

> business and affairs of the corporation, but a dissident board member has significant freedom to challenge the majority's decisions and to share her concerns with other shareholders. On the other hand, internal disagreement will not generally allow a dissident to release confidential corporate information. Fiduciary obligations are shaped by context. A balancing of the various conflicting factors will be necessary, and sometimes the judgments will be difficult. Here, the most logical objective of Michael's actions—strangling the Company with a potentially catastrophic cash shortfall—cannot be reconciled with his 'unremitting' duty of loyalty. Thus, Michael did breach his fiduciary duty of loyalty to Shocking.[159]

The Court recognized that the crucible of director debate can be good for the corporation, albeit frustrating to the protagonists:

> Shareholders and directors, sometimes to the chagrin of a majority of the board of directors, may seek to change corporate governance ambiance and board composition. That is not merely permitted conduct; such efforts may be entitled to affirmative protection as part of the shareholder franchise. Michael's objectives as to his corporate governance agenda were not proscribed. They may have been prudent, or they may have been irresponsible. Nonetheless, it was his right to make such policy choices.
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> The steps that a shareholder-director may take to achieve objectives are not without limits. A director may not harm the corporation by, for example, interfering with crucial financing efforts in an effort to further such objectives. Moreover, he may not use confidential information, especially information gleaned because of his board membership, to aid a third party which has a position necessarily adverse to that of the corporation.[160]

The Court in *Shocking Technologies*, however, found that the director went too far in pursuing his objective by his disclosure of confidential information to a third party dealing with the corporation:

> Michael may have hoped that his disclosure of confidential information to Dickinson [the investor] would have ultimately resulted in better corporate governance practices for Shocking [the corporation]. That hope, however, cannot outweigh or somehow otherwise counterbalance the foreseeable harm that he would likely cause Shocking. Notwithstanding his good intentions, his taking steps that would foreseeably

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159 2012 WL 4482838, at *10-*11, 2012 Del. Ch. LEXIS 224, at *34-*38.

160 2012 WL 4482838, at *9, 2012 Del. Ch. LEXIS 224, at *31; *cf. Sherwood v. Chan Tze Ngon*, C.A. No. 7106-VCP, 2011 Del. Ch. LEXIS 202, at *25 (Del. Ch. Dec. 20, 2011), which involved an action over disclosures about a Board's decision not to renominate a director for election at the company's annual meeting, and in which the Court found that the plaintiff had adequately alleged disclosure claims where the proxy statement suggested that the director's "questionable and disruptive personal behavior was the only reason that motivated the board to remove him from the Company's slate." The Court commented that it is "important that directors be able to register effective dissent" and that "[a] reasonable shareholder likely would perceive a material difference between, on the one hand, an unscrupulous, stubborn and belligerent director as implied by the Proxy Supplement and, on the other hand, a zealous advocate of a policy position who may go to tactless extremes on occasion." *See infra* note 203 and related text.

cause significant harm to Shocking amounts to nothing less than a breach of the fiduciary duty of loyalty.[161]

The Court, however, did not award damages to the corporation as it did not find that there were any material damages suffered by the corporation and found that the director did not manifest the "subjective bad faith" required for an award of attorney's fees to the corporation. The Court appeared concerned that shifting fees may be too much of a penalty for a dissident director, and may make it too easy for the majority to use as a "hammer" to silence those members of the Board who dissent, explaining: "The line separating fair and aggressive debate from disloyal conduct may be less than precise."[162]

The *Shocking Technologies* case illustrates the risk that a director takes when he leaks confidential information to achieve his objectives, however laudable he may believe them to be. The case also shows the difficulties corporations face when dealing with directors who will take steps that may damage the corporation to achieve their personal objectives.

Where a Board reasonably concludes that its fiduciary duties to preserve the confidentiality of sensitive information so require, the Board may condition its seating of a director upon the director's signing a confidentiality agreement providing that the individual will maintain the confidentiality of information received as a director and not disclose it to the private equity firm that designated the director pursuant to a contractual right to designate a director.[163]

(7) Candor/Disclosure in Proxy Statements and Prospectuses. Under Delaware law, when directors solicit stockholder action, they must "disclose fully and fairly all material information within the Board's control."[164] Delaware has adopted the standard of materiality used under the federal securities laws that information is material "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[165] Information is material if, from the perspective of a reasonable stockholder, there is a substantial likelihood that it "significantly alter[s] the 'total mix' of information made available."[166]

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161 2012 WL 4482838, at *10, 2012 Del. Ch. LEXIS 224, at *32-*33.

162 2012 WL 4482838, at *14 n.71, 2012 Del. Ch. LEXIS 224, at *47-*48 n.71.

163 *See Partners Healthcare Solutions Holdings, L.P. v. Universal American Corp.*, C.A. No. 9593-VCG (Del. Ch. June 17, 2015), in which the Delaware Chancery Court granted summary judgment to defendant Universal American Corp. ("UAM"), rejecting the contentions of one of UAM's largest stockholders, Partners Healthcare Solutions Holdings ("Partners"), that UAM had breached an agreement entitling Partners to designate an independent director by imposing conditions on the seating of Partners' designee to the UAM board that were not provided for in the agreement. In *Partners Healthcare*, the UAM Board required the plaintiff Partners' designee to the Board to sign a confidentiality agreement that provided, among other things, (1) that information learned as a UAM director would be used only in connection with that role, and explicitly that such information would not be used in the fraud litigation brought by Partners against UAM; (2) that the designee would not share non-public information concerning UAM with any third parties, explicitly including the law firm representing Partners in the litigation; and (3) that the designee would only share non-public information with Partners' employees on a need-to-know basis. In granting UAM's motion for summary judgment, the Court found that imposing such conditions on the designee was in the faithful discharge of the Board's fiduciary duties

164 *Stroud v. Grace*, 606 A.2d 75, 84 (Del. 1992); *In re Trulia, Inc. Stockholder Litigation*, 129 A.3d 884, 899 (Del. Ch. 2016).

165 *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 944 (Del. 1985) (adopting materiality standard of *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)); *Trulia*, 129 A.3d at 899.

166 *Arnold v. Soc'y for Sav. Bancorp*, 650 A.2d 1270, 1277 (Del. 199); *Trulia*, 129 A.3d at 896.

Where directors allow their companies to issue deceptive or incomplete communications to their stockholders, the directors can breach their duties of candor and good faith, which are subsets of the fiduciary duty of loyalty:

> When a Delaware corporation communicates with its shareholders, even in the absence of a request for shareholder action, shareholders are entitled to honest communication from directors, given with complete candor and in good faith. Communications that depart from this expectation, particularly where it can be shown that the directors involved issued their communication with the knowledge that it was deceptive or incomplete, violate the fiduciary duties that protect shareholders. Such violations are sufficient to subject directors to liability in a derivative claim.
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> Although directors have a responsibility to communicate with complete candor in all shareholder communications, those that are issued with respect to a request for shareholder action are especially critical. Where, as here, the directors sought shareholder approval of an amendment to a stock option plan that could potentially enrich themselves and their patron, their concern for complete and honest disclosure should make Caesar appear positively casual about his wife's infidelity.[167]

In another case, the contours of the duty of candor were further explained:

> Generally, directors have a duty to disclose all material information in their possession to shareholders when seeking shareholder approval for some corporate action. This "duty of disclosure" is not a separate and distinct fiduciary duty, but it clearly does impose requirements on a corporation's board. Those requirements, however, are not boundless. Rather, directors need only disclose information that is material, and information is material only "if there is a substantial likelihood that a reasonable stockholder would consider it important in deciding how to vote." It is not sufficient that information might prove helpful; to be material, it must "significantly alter the total mix of information made available." The burden of demonstrating a disclosure violation and of establishing the materiality of requested information lies with the plaintiffs.[168]

In *Gantler v. Stephens*, the Delaware Supreme Court addressed duty of candor issues in the context of a proxy statement for a stockholder vote on a going private proposal in which common stock held by small stockholders would be converted by an amendment to the certificate of incorporation into non-voting preferred stock.[169] With respect to the plaintiffs' claims that the proxy statement for the reclassification failed to disclose the circumstances of one bidder's withdrawal and insufficient deliberations by the Board before deciding to reject another's bid, the Court wrote:

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167 *In re infoUSA, Inc. S'holders Litig.*, 953 A.2d 963, 1001 (Del. Ch. 2007).

168 *In re CheckFree Corp.*, Consol. C.A. No. 3193-CC, 2007 WL 3262188, at *2, 2007 Del. Ch. LEXIS 148, at *7 (Del. Ch. Nov. 1, 2007).

169 965 A.2d 695, 710 (Del. 2009).

It is well-settled law that "directors of Delaware corporations [have] a fiduciary duty to disclose fully and fairly all material information within the board's control when it seeks shareholder action." That duty "attaches to proxy statements and any other disclosures in contemplation of stockholder action." The essential inquiry here is whether the alleged omission or misrepresentation is material. The burden of establishing materiality rests with the plaintiff, who must demonstrate "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

In the Reclassification Proxy, the Board disclosed that "[a]fter careful deliberations, the board determined in its business judgment that the [rejected merger] proposal was not in the best interest of the Company or our shareholders and rejected the [merger] proposal." Although boards are "not required to disclose all available information[,] . . ." "once [they] travel[] down the road of partial disclosure of . . . [prior bids] us[ing] . . . vague language. . . , they ha[ve] an obligation to provide the stockholders with an accurate, full, and fair characterization of those historic events."

By stating that they "careful[ly] deliberat[ed]," the Board was representing to the shareholders that it had considered the Sales Process on its objective merits and had determined that the Reclassification would better serve the Company than a merger. * * * [This] disclosure was materially misleading.

The Reclassification Proxy specifically represented that the [company] officers and directors "ha[d] a conflict of interest with respect to the [Reclassification] because he or she is in a position to structure it in a way that benefits his or her interests differently from the interests of unaffiliated shareholders." Given the defendant fiduciaries' admitted conflict of interest, a reasonable shareholder would likely find significant—indeed, reassuring—a representation by a conflicted Board that the Reclassification was superior to a potential merger which, after "careful deliberations," the Board had "carefully considered" and rejected. In such circumstances, it cannot be concluded as a matter of law, that disclosing that there was little or no deliberation would not alter the total mix of information provided to the shareholders.

* * *

We are mindful of the case law holding that a corporate board is not obligated to disclose in a proxy statement the details of merger negotiations that have "gone south," since such information "would be [n]either viably practical [n]or material to shareholders in the meaningful way intended by . . . case law." Even so, a board cannot properly claim in a proxy statement that it had carefully deliberated and decided that its preferred transaction better served the corporation than the alternative, if in fact the Board rejected the alternative transaction without serious consideration.[170]

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170 *Id.* at 710-11.

In *Pfeffer v. Redstone*[171] in a shareholder breach of fiduciary duty class action against a corporation's Board and controlling shareholder after the corporation divested itself of its controlling interest in a subsidiary by means of a special cash dividend followed by an offer to parent company stockholders to exchange their parent stock for subsidiary stock,[172] the Delaware Supreme Court explained that it was not a breach of the duty of candor to fail to disclose in the exchange offer prospectus an internal cash flow analysis which showed that the subsidiary would have cash flow shortfalls after the transactions, but which had been prepared by a lower level employee and never given to the Board:

> For the Viacom Directors to have either misstated or failed to disclose the cash flow analysis in the Prospectus, those directors must have had reasonable access to that Blockbuster information. "To state a claim for breach by omission of any duty to disclose, a plaintiff must plead facts identifying (1) material, (2) reasonably available (3) information that (4) was omitted from the proxy materials." "[O]mitted information is *material* if a reasonable stockholder would consider it important in deciding whether to tender his shares or would find that the information has altered the 'total mix' of information available." The Viacom Directors must fully and fairly disclose all material information within its control when seeking shareholder action. They are not excused from disclosing material facts simply because the Prospectus disclosed risk factors attending the tender offer. If the Viacom Directors did not know or have reason to know the allegedly missing facts, however, then logically the directors could not disclose them.[173]

(8) Candor/Disclosure in Business Combination Disclosures. Duty of candor allegations accompany many challenges to business combination transactions in which shareholder proxies are solicited for approval of the transaction. Sometimes the challenges are successful enough to lead the Chancery Court to order the postponement of meeting of shareholders until corrective disclosures are made in proxy materials.[174] In other instances, the omissions complained of are found to be immaterial.[175]

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171 965 A.2d 676, 681 (Del. 2009).

172 The Court found the exchange offer to be purely voluntary and non-coercive, and not to require entire fairness review even though it was with the controlling stockholder. Further, since there was no representation that the exchange ratio was fair, there was no duty to disclose the methodology for determining the exchange ratio, as would have been necessary to ensure a balanced presentation if there had been any disclosure to the effect that the exchange ratio was fair. As the exchange offer was non-coercive and voluntary, the parent had no duty to offer a fair price. The prospectus disclosed that the Boards of parent and subsidiary were not making any recommendation regarding whether stockholders should participate in the exchange offer and were not making any prediction of the prices at which the respective shares would trade after the exchange offer expired. 965 A.2d at 689.

173 *Pfeffer v. Redstone*, 965 A.2d 676, 686-87 (Del. 2009).

174 *See, e.g., Maric Capital Master Fund, Ltd., v. Plato Learning, Inc.*, 11 A.3d 1175, 1176 (Del. Ch. 2010) (merger enjoined until corrective disclosures, including correction of statement that management compensation arrangements were not negotiated prior to signing the merger agreement when, although there may not have been any agreement, the buyer communicated to the CEO that it liked to keep management after its acquisitions and outlined its typical compensation package); *In re Art Technology Group, Inc. Shareholders Litigation*, C.A. No. 5955-VCL, 2010 Del. Ch. LEXIS 257, at *1 (Del. Ch. Dec. 21, 2010) (bench ruling enjoining special meeting of stockholders to vote on merger based on target company's failure to disclose in its proxy statement the fees that its financial advisor had received from the buyer during the preceding two years in unrelated transactions).

175 In *In re Delphi Financial Group Shareholder Litigation*, C.A. No. 7144-VCG, 2012 WL 729232, at *18, 2012 Del. Ch. LEXIS 45, at *63 (Del. Ch. Mar. 6, 2012), Vice Chancellor Glasscock commented:

Directors can, and in larger transactions typically do, rely on expert advice in the form of an investment banker's ("banker") fairness opinion.[176] These opinions generally state that the merger consideration is "fair" (i.e. within the range of reasonableness) to the target's stockholders from a financial point of view, and are backed up by a presentation book ("banker's book" or "board book") presented by the banker to the Board containing financial projections and information about comparable transactions. The proxy statement for the transaction typically contains the fairness opinion and a description of how the banker reached its conclusion that the transaction is fair, but not the banker's book. Litigation frequently ensues in which the proxy statement disclosures regarding the banker's process and the underpinnings of the fairness opinion are challenged.[177]

The plaintiffs' bar favors duty of candor challenges to mergers because a colorable disclosure claim provides a hook for expedited proceedings and a preliminary injunction.[178] Thus, a "Denny's buffet" of disclosure claims is included in almost every complaint.[179] The pressure to get a deal to a shareholder vote results in frequent settlements.[180] Despite so much litigation, the law governing disclosure claims remains unsettled.

Skeen v. Jo-Ann Stores, Inc.[181] remains the seminal Delaware Supreme Court decision on what must be disclosed about a banker's book and related banker analyses. *Skeen* involved a cash-out merger following first-step tender offer. The information statement for the transaction included a copy of the fairness opinion given by target's investment banker, target's audited and unaudited financial statements through the day before signing and the target's quarterly market prices and dividends through the year then ended. Plaintiffs alleged that the information statement should have included, *inter alia*, (i) a summary of "methodologies used and range of values generated" by target's banker, (ii) management's projections of target's financial performance for the next five years, and (iii) more current financial statements. In rejecting plaintiffs' argument that "stockholders [must] be given all the financial data they would need if they were making an independent determination of fair value" and holding that the standard is "substantial likelihood that the undisclosed information would significantly alter the total mix of information already provided," the Supreme Court explained:

> Directors of Delaware corporations are fiduciaries who owe duties of due care, good faith and loyalty to the company and its stockholders. The duty of disclosure is a specific formulation of those general duties that applies when the corporation is seeking stockholder

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> In limiting the disclosure requirement to all "material" information, Delaware law recognizes that too much disclosure can be a bad thing. As this Court has repeatedly recognized, "a reasonable line has to be drawn or else disclosures in proxy solicitations will become so detailed and voluminous that they will no longer serve their purpose." If anything, Delphi's Proxy is guilty of such informational bloatedness, and not, as the Plaintiffs contend, insufficient disclosure.

176 *See supra* note 82, and *infra* notes 220,.

177 In 2014 94.9% of transactions over $100 million were subject to litigation (up from 39.3% in 2005). *In re Trulia, Inc. Stockholder Litigation*, 129 A.3d 884 (Del. Ch. 2016). *See* Hon. Justice Myron Steele, *Contemporary Issues for Traditional Director Fiduciary Duties*, University of Arizona (August 1, 2012).

178 Hon. Myron Steele, *supra* note 177.

179 Hon. Myron Steele, *supra* note 177.

180 Hon. Myron Steele, *supra* note 177.

181 750 A.2d 1170, 1172 (Del. 2000).

action. It requires that directors "disclose fully and fairly all material information within the board's control...." Omitted facts are material "if there is a substantial likelihood that a reasonable stockholder would consider [them] important in deciding how to vote." Stated another way, there must be "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable stockholder as having significantly altered the 'total mix' of information made available."

These disclosure standards have been expressed in much the same language over the past 25 years. In the merger context, the particular stockholder action being solicited usually is a vote, and the oft-quoted language from our cases refers to information the stockholders would find important in deciding how to vote. But the vote, if there is one, is only part of what the stockholders must decide. Appraisal rights are available in many mergers, and stockholders who vote against the merger also must decide whether to exercise those rights.

* * *

To state a disclosure claim, appellants "must provide some basis for a court to infer that the alleged violations were material....[They] must allege that facts are missing from the [information] statement, identify those facts, state why they meet the materiality standard and how the omission caused injury." Appellants have not met this pleading requirement. They offer no undisclosed facts concerning the supposed "plan" that would have been important to the appraisal decision.

* * *

Appellants also complain about several alleged deficiencies in the financial data that was disclosed. The Information Statement included a copy of the fairness opinion given by HF's investment banker, Donaldson, Lufkin & Jenrette (DLJ); the company's audited and unaudited financial statements through January 31, 1998; and HF's quarterly market prices and dividends through the year ended January 31, 1998. The complaint alleges that, in addition to this financial information, HF's directors should have disclosed: (1) a summary of "the methodologies used and ranges of values generated by DLJ" in reaching its fairness opinion; (2) management's projections of HF's anticipated performance from 1998 - 2003; (3) more current financial statements; and (4) the prices that HF discussed for the possible sale of some or all of the company during the year prior to the merger.

Appellants allege that this added financial data is material because it would help stockholders evaluate whether they should pursue an appraisal. They point out that the $4.25 per share merger price is 20% less than the company's book value. Since book value generally is a conservative value approximating liquidation value, they wonder how DLJ could conclude that the merger price was fair. If they understood the basis for DLJ's opinion, appellants say they would have a better idea of the price they might receive in an appraisal. Projections, more current financials and information about prices discussed with other possible acquirors, likewise, would help them predict their chances of success in a judicial determination of fair value.

The problem with appellants' argument is that it ignores settled law. Omitted facts are not material simply because they might be helpful. To be actionable, there must be a substantial likelihood that the undisclosed information would significantly alter the total mix of information already provided. The complaint alleges no facts suggesting that the undisclosed information is inconsistent with, or otherwise significantly differs from, the disclosed information. Appellants merely allege that the added information would be helpful in valuing the company.

Appellants are advocating a new disclosure standard in cases where appraisal is an option. They suggest that stockholders should be given all the financial data they would need if they were making an independent determination of fair value. Appellants offer no authority for their position and we see no reason to depart from our traditional standards. We agree that a stockholder deciding whether to seek appraisal should be given financial information about the company that will be material to that decision. In this case, however, the basic financial data were disclosed and appellants failed to allege any facts indicating that the omitted information was material. Accordingly, the complaint properly was dismissed for failure to state a claim.[182]

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182 *Id.* at 1172-74. In *McMullin v. Beran*, 765 A.2d 910, 925-26 (Del. 2000), the Delaware Supreme Court followed *Skeen* and elaborated as follows:

> In properly discharging their fiduciary responsibilities, directors of Delaware corporations must exercise due care, good faith and loyalty whenever they communicate with shareholders about the corporation's affairs. When shareholder action is requested, directors are required to provide shareholders with all information that is material to the action being requested and "to provide a balanced, truthful account of all matters disclosed in the communication with shareholders."] The materiality standard requires that directors disclose all facts which, "under all the circumstances, ... would have assumed actual significance in the deliberations of the reasonable shareholder." These disclosure standards are well established.
>
> Earlier this year, we decided another case involving alleged disclosure violations when minority shareholders were presented with the choice of either tendering their shares or being "cashed out" in a third-party merger transaction that had been pre-approved by the majority shareholder. In *Skeen*, it was argued that the minority shareholders should have been given all of the financial data they would need if they were making an independent determination of fair value. We declined to establish "a new disclosure standard where appraisal in an option." We adhere to our holding in *Skeen*.
>
> McMullin's Amended Complaint alleges that the Chemical Directors breached their fiduciary duty by failing to disclose to the minority shareholders material information necessary to decide whether to accept the Lyondell tender offer or to seek appraisal under 8 Del. C. § 262. The Court of Chancery summarized the plaintiff's allegations that the defendants breached their duty of disclosure by omitting from the 14D-9 the following information: indications of interest from other potential acquirers; the handling of these potential offers; the restrictions and constraints imposed by ARCO on the potential sale of Chemical; the information provided to Merrill Lynch and the valuation methodologies used by Merrill Lynch. In a similar context, the Court of Chancery has held the fact that the majority shareholder controls the outcome of the vote on the merger "makes a more compelling case for the application of the recognized disclosure standards."
>
> When a complaint alleges disclosure violations, courts are required to decide a mixed question of fact and law. In the specific context of this case, an answer to the complaint, discovery and a trial may all be necessary to develop a complete factual record before deciding whether, as a matter of law, the Chemical Directors breached their duty to disclose all material facts to the minority shareholders. The

In re Pure Resources, Incorporated Shareholders Litigation,[183] the SEC filings contained financial advisor opinions, historical financial information and projections. Chancellor (then Vice Chancellor) Strine addressed whether bankers' underlying financial analyses should be disclosed. The Court observed competing policies against disclosure (fear of "stepping on the SEC's toes" and worry of "encouraging prolix disclosures") and in favor of disclosure ("utility of such information" and Delaware case law encouraging banker analyses for Board decisions), cited *Skeen* and other cases as manifesting the "conflicting impulses," and concluded that more fulsome disclosure is required:

> As their other basis for attack, the plaintiffs argue that neither of the key disclosure documents provided to the Pure stockholders — the S-4 Unocal issued in support of its Offer and the 14D-9 Pure filed in reaction to the Offer — made materially complete and accurate disclosure. The general legal standards that govern the plaintiffs' disclosure claims are settled.
>
> In circumstances such as these, the Pure stockholders are entitled to disclosure of all material facts pertinent to the decisions they are being asked to make. In this case, the Pure stockholders must decide whether to take one of two initial courses of action: tender and accept the Offer if it proceeds or not tender and attempt to stop the Offer. If the Offer is consummated, the non-tendering stockholders will face two subsequent choices that they will have to make on the basis of the information in the S-4 and 14D-9: to accept defeat quietly by accepting the short-form merger consideration in the event that Unocal obtains 90% and lives up to its promise to do an immediate short-form merger or seek to exercise the appraisal rights described in the S-4. I conclude that the S-4 and the 14D-9 are important to all these decisions, because both documents state that Unocal will effect the short-form merger promptly if it gets 90%, and shareholders rely on those documents to provide the substantive information on which stockholders will be asked to base their decision whether to accept the merger consideration or to seek appraisal.
>
> As a result, it is the information that is material to these various choices that must be disclosed. In other words, the S-4 and the 14D-9 must contain the information that "a reasonable investor would consider important in tendering his stock," including the information necessary to make a reasoned decision whether to seek appraisal in the event Unocal effects a prompt short-form merger. In order for undisclosed information to be material, there must be a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable stockholder as having significantly altered the 'total mix' of information made available."
>
> The S-4 and 14D-9 are also required "to provide a balanced, truthful account of all matters" they disclose. Related to this obligation is the requirement to avoid misleading partial disclosures. When a document ventures into certain subjects, it must do so in a manner that is materially complete and unbiased by the omission of material facts.

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disclosure violations alleged in McMullin's Amended Complaint are, if true, sufficient to withstand a motion to dismiss.

183 808 A.2d 421, 448 (Del. Ch. 2002).

* * *

First and foremost, the plaintiffs argue that the 14D-9 is deficient because it does not disclose ***any*** substantive portions of the work of First Boston and Petrie Parlunan on behalf of the Special Committee, even though the bankers' negative views of the Offer are cited as a basis for the board's own recommendation not to tender. Having left it to the Pure minority to say no for themselves, the Pure board (the plaintiffs say) owed the minority the duty to provide them with material information about the value of Pure's shares, including, in particular, the estimates and underlying analyses of value developed by the Special Committee's bankers. This duty is heightened, the plaintiffs say, because the Pure minority is subject to an immediate short-form merger if the Offer proceeds as Unocal hopes, and will have to make the decision whether to seek appraisal in those circumstances.

* * *

This is a continuation of an ongoing debate in Delaware corporate law, and one I confess to believing has often been answered in an intellectually unsatisfying manner. Fearing stepping on the SEC's toes and worried about encouraging prolix disclosures, the Delaware courts have been reluctant to require informative, succinct disclosure of investment banker analyses in circumstances in which the bankers' views about value have been cited as justifying the recommendation of the board. But this reluctance has been accompanied by more than occasional acknowledgement of the utility of such information, an acknowledgement that is understandable given the substantial encouragement Delaware case law has given to the deployment of investment bankers by boards of directors addressing mergers and tender offers.

These conflicting impulses were manifested recently in two Supreme Court opinions. In one, *Skeen v. Jo-Ann Stores, Inc.*, the Court was inclined towards the view that a summary of the bankers' analyses and conclusions was not material to a stockholders' decision whether to seek appraisal. In the other, *McMullin v. Beran*, the Court implied that information about the analytical work of the board's banker could well be material in analogous circumstances.

In my view, it is time that this ambivalence be resolved in favor of a firm statement that stockholders are entitled to a fair summary of the substantive work performed by the investment bankers upon whose advice the recommendations of their board as to how to vote on a merger or tender rely. I agree that our law should not encourage needless prolixity, but that concern cannot reasonably apply to investment bankers' analyses, which usually address the most important issue to stockholders — the sufficiency of the consideration being offered to them for their shares in a merger or tender offer. Moreover, courts must be candid in acknowledging that the disclosure of the banker's "fairness opinion" alone and without more, provides stockholders with nothing other than a conclusion, qualified by a gauze of protective language designed to insulate the banker from liability.

The real informative value of the banker's work is not in its bottom-line conclusion, but in the valuation analysis that buttresses that result. This proposition is illustrated by the

> work of the judiciary itself, which closely examines the underlying analyses performed by the investment bankers when determining whether a transaction price is fair or a board reasonably relied on the banker's advice. Like a court would in making an after-the-fact fairness determination, a Pure minority stockholder engaging in the before-the-fact decision whether to tender would find it material to know the basic valuation exercises that First Boston and Petrie Parkman undertook, the key assumptions that they used in performing them, and the range of values that were thereby generated. After all, these were the very advisors who played the leading role in shaping the Special Committee's finding of inadequacy.[184]

In an effort to avoid being delayed by proceedings in the Chancery Court, M&A practice has evolved to reflect a *Pure* standard.[185] In *Kahn v. Chell*,[186] Vice Chancellor Laster commented:

> I think it's continuing to be somewhat surprising that despite now years of opinions, particularly from Vice Chancellor Strine, explaining that we expect these things to be disclosed, people don't disclose them. But as I've said in another transcript, what I think that speaks to is the desirability of getting releases as opposed to an actual desire to follow what the Delaware courts have said in terms of what's material information. And so, to the extent that people are consciously or can be inferred to have been consciously leaving things out that are covered by prior decisions, that's something we're going to have to take into account on an ongoing basis; not just me, but obviously my colleagues. But it is something that's somewhat troubling.

Later in *Stourbridge Investments LLC v. Bersoff*,[187] Vice Chancellor Laster commented:

> [T]he increase in disclosure-only settlements is troubling. Disclosure claims can be settled cheaply and easily, creating a cycle of supplementation that confers minimal, if any, benefits on the class.

A disclosure only settlement of class action litigation was dismissed in the *In re Trulia, Inc. Stockholder Litigation*,[188] with the Chancery Court explaining that the Delaware Chancery

> Court's willingness in the past to approve disclosure settlements of marginal value and to routinely grant broad releases to defendants and six-figure fees to plaintiffs' counsel in the process,[189] have caused deal litigation to explode in the United States beyond the realm of reason. In just the past decade, the percentage of transactions of $100 million or more that

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184 *Id.* at 447-49.

185 *See In re Netsmart Technologies, Inc. Shareholders Litigation*, 924 A.2d 171, 204 (Del. Ch. 2007).

186 Transcript of June 7, 2011 Teleconference (Laster, V.C.) at 12-13 (June 20, 2011) (CA6511).

187 Transcript of Mar. 13, 2012 Teleconference (Laster, V.C.) at 11-12 (Mar. 19, 2012) (CA7300).

188 129 A.3d 884, 894 (Del. Ch. 2016).

189 *See In re Sauer-Danfoss Inc. S'holders Litig.*, 65 A.3d 1116, 1135-43 (Del. Ch. 2011) (discussing disclosure settlements and compiling fee awards in various disclosure-only cases).

have triggered stockholder litigation in this country has more than doubled, from 39.3% in 2005 to a peak of 94.9% in 2014.[190]

Trulia involved a proposed settlement of a stockholder class action challenging Zillow, Inc.'s acquisition of Trulia, Inc. in a stock-for-stock merger that closed in February 2015. In explaining his rejection of the proposed settlement, Chancellor Bouchard wrote:

> Shortly after the public announcement of the proposed transaction, four Trulia stockholders filed essentially identical complaints alleging that Trulia's directors had breached their fiduciary duties in approving the proposed merger at an unfair exchange ratio. Less than four months later, after taking limited discovery, the parties reached an agreement-in-principle to settle.
>
> The proposed settlement is of the type often referred to as a "disclosure settlement." It has become the most common method for quickly resolving stockholder lawsuits that are filed routinely in response to the announcement of virtually every transaction involving the acquisition of a public corporation. In essence, Trulia agreed to supplement the proxy materials disseminated to its stockholders before they voted on the proposed transaction to include some additional information that theoretically would allow the stockholders to be better informed in exercising their franchise rights. In exchange, plaintiffs dropped their motion to preliminarily enjoin the transaction and agreed to provide a release of claims on behalf of a proposed class of Trulia's stockholders. If approved, the settlement will not provide Trulia stockholders with any economic benefits. The only money that would change hands is the payment of a fee to plaintiffs' counsel.
>
> Because a class action impacts the legal rights of absent class members, it is the responsibility of the Court of Chancery to exercise independent judgment to determine whether a proposed class settlement is fair and reasonable to the affected class members.
>
> The Chancellor concluded:
>
> that the terms of this proposed settlement are not fair or reasonable because none of the supplemental disclosures were material or even helpful to Trulia's stockholders, and thus the proposed settlement does not afford them any meaningful consideration to warrant providing a release of claims to the defendants. * * *
>
> On a broader level, this opinion discusses some of the dynamics that have led to the proliferation of disclosure settlements, noting the concerns that scholars, practitioners and members of the judiciary have expressed that these settlements rarely yield genuine benefits for stockholders and threaten the loss of potentially valuable claims that have not been investigated with rigor. * * *

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190 Matthew D. Cain & Steven Davidoff Solomon, *Takeover Litigation in 2015* 2 (Jan. 14, 2016), *available at* http://ssrn.com/abstract=2715890. The sample consists of transactions of at least $100 million with publicly traded targets, and includes both Delaware and non-Delaware corporations. Figures for 2015 are preliminary.

> Based on these considerations, this opinion offers the Court's perspective that disclosure claims arising in deal litigation optimally should be adjudicated outside of the context of a proposed settlement so that the Court's consideration of the merits of the disclosure claims can occur in an adversarial process without the defendants' desire to obtain an often overly broad release hanging in the balance.

The Chancellor further explained:

> that, to the extent that litigants continue to pursue disclosure settlements, they can expect that the Court will be increasingly vigilant in scrutinizing the "give" and the "get" of such settlements to ensure that they are genuinely fair and reasonable to the absent class members.[191]

(9) Candor/Disclosure in Notices and Other Disclosures. In *Berger v. Pubco Corp.*,[192] the Delaware Supreme Court addressed the nature and scope of the remedy available to minority stockholders when a controlling stockholder breaches its duty of disclosure in connection with a short form merger pursuant to DGCL § 253. The 90% stockholder of Pubco (a non-publicly traded Delaware corporation) formed a wholly-owned subsidiary, transferred his Pubco shares to the subsidiary and effected a short form merger under DGCL§ 253 in which Pubco's minority stockholders were cashed out. Prior to the merger, Pubco sent a written notice to its stockholders stating that the 90% stockholder intended to effect a short form merger and that the stockholders would be cashed out. The notice included a very short description of Pubco, but failed to include any information regarding its plans, prospects or operations, lumped all of its financial statements together and failed to provide any information about how the cashout price was determined. An outdated version of the Delaware appraisal statute was included with the notice. Plaintiff brought a class action lawsuit on behalf of all of Pubco's minority stockholders to recover the difference between the cashout price and the fair value of the shares based on defendants' failure to provide stockholders with all material information.

In *Pubco*, the Supreme Court agreed with the Court of Chancery that there were disclosure duty failures and that the optimal remedy for disclosure violations in this context is a "quasi-appraisal" action to recover the difference between "fair value" and the merger price. Unlike the Court of Chancery, however, the Supreme Court held that stockholders (i) would be treated automatically as members of the class and continue as members of the class unless and until they opt out after receiving the remedial supplemental disclosure and the notice of class action informing them of their opt-out right, and (ii) would not be required to escrow a portion of the merger proceeds that they already received.

In determining that minority stockholders would not have to opt in, the Supreme Court focused on the respective burdens of the parties. According to the Court, an opt-in requirement would potentially burden stockholders seeking appraisal recovery, who would bear the risk of forfeiture of their appraisal rights, whereas an opt-out requirement would avoid any such risk. To the company, on the other hand, neither option is more burdensome than the other. Under either alternative, "the company will know at a relatively early stage which shareholders are (and are not) members of the class."

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191 *In re Trulia*, 129 A.3d at 886-87.

192 976 A.2d 132, 140 (Del. 2009).

The Supreme Court recognized that removing the escrow requirement would provide the stockholders with the dual benefit of retaining merger proceeds while at the same time litigating to recover a higher amount – a benefit they would not have in an actual appraisal. The Court reasoned:

> Minority shareholders who fail to observe the appraisal statute's technical requirements risk forfeiting their statutory entitlement to recover the fair value of their shares. In fairness, majority stockholders that deprive their minority shareholders of material information should forfeit their statutory right to retain the merger proceeds payable to shareholders who, if fully informed, would have elected appraisal.[193]

In *Dubroff v. Wren Holdings, LLC* ("*Dubroff I*"),[194] the Court of Chancery found that the plaintiffs stated a claim for breach of the fiduciary duty of disclosure in connection with the notice sent to the stockholders pursuant to DGCL § 228[195] for a recapitalization transaction approved by the written consent of the defendants in which Wren Holdings and the other defendants (the "Wren Control Group") converted the subordinated debt they held into convertible preferred stock, thereby increasing their ownership of the company's stock from approximately 56% to 80%, while the remaining stockholders were greatly diluted. After the completion of the recapitalization, the nonconsenting stockholders received a DGCL notice, which provided, in part: "[the company] has recapitalized by converting its outstanding subordinated debt into shares of several new series of convertible preferred stock, and by declaring and implementing a one-four-twenty [sic] reverse stock split on all outstanding shares of common stock of the Company."[196] The notice did not, however, inform the stockholders that the defendants were the primary recipients of the new convertible preferred stock; nor did it inform the stockholders of the pricing of the conversion of the defendants' debt into convertible preferred stock. The plaintiffs argued that they were injured by this lack of disclosure because had the notice contained such information, they could have made a claim for rescissory relief.

The Chancery Court in *Dubroff I* recognized the Delaware case law had not addressed whether notice under DGCL § 228(e) requires a full disclosure akin to that required when stockholder approval is being solicited. While the Court left that inquiry for another time, it did find that regardless of the precise scope of required disclosure, the plaintiffs have stated a claim for breach of fiduciary duty. The Court reasoned that if the requirements under DGCL § 228(e) were akin to a disclosure seeking a stockholder vote (*i.e.*, to disclose all material information), the plaintiffs had pled facts sufficient to establish that the Board materially misled shareholders. If, on the other hand, the disclosure standard is less fulsome in this context, the Court could reasonably infer that the Board deliberately omitted material information with the goal of misleading the plaintiffs and other stockholders about the defendants' material financial interest in and benefit conferred by the recapitalization. Under Delaware law, whenever directors communicate publicly or directly with stockholders about corporate matters, they must do so honestly. Thus, the Court

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193 *Id.* at 144; the Court qualified its opinion by acknowledging that where a "technical and non-prejudicial" violation of DGCL § 253 occurs (*e.g.*, where stockholders receive an incomplete copy of the appraisal statute with their notice of merger), a "quasi-appraisal" remedy with opt-in and escrow requirements might arguably be supportable.

194 C.A. No. 3940-VCN, 2009 WL 1478697, at *6, 2009 Del. Ch. LEXIS 89, at *24-26 (Del. Ch. May 22, 2009) ("*Dubroff I*").

195 Under DGCL § 228(e) "[p]rompt notice of the taking of the corporate action without a meeting by less than unanimous written consent shall be given to those stockholders … who have not consented in writing."

196 *Dubroff I*, 2009 WL 1478697, at *5, 2009 Del. Ch. LEXIS 89, at *22.

determined that regardless of the scope of disclosure required pursuant to DGCL § 228(e), the plaintiffs had sufficiently pled a disclosure violation.

Subsequently, the Chancery Court denied a summary judgment motion by the Wren Control Group in the same case ("*Dubroff II*"),[197] addressing both (i) direct claims of equity dilution ("equity dilution claims") brought by minority stockholders whose equity had been diluted as the result of the recapitalization and (ii) fiduciary duty claims based on the allegedly insufficient disclosures in the DGCL § 228(e) notice. While acknowledging that a controlling stockholder is typically a single person or entity, the Chancery Court noted that under Delaware law a group of stockholders, each of whom cannot individually exert control over the corporation, can collectively form a "control group" when those stockholders work together toward a shared goal,[198] and members of a control group owe fiduciary duties to the minority stockholders of the corporation.[199] The Chancery Court applied this control group theory in finding that the Wren Control Group acted as a single group to establish the exact terms and timing of the recapitalization, and as a result had control group fiduciary obligations.

In *Dubroff II*, the Chancery Court followed *Gentile v. Rossette*[200] in holding that the plaintiffs could plead direct equity dilution claims because they alleged facts showing that: (1) the Wren Control Group was able to control the corporation and thus were controlling stockholders; (2) the Wren Control Group and the named director defendants were jointly responsible for causing the corporation to issue excessive shares to the Wren Control Group; and (3) the effect of the recapitalization was "an extraction from the corporation's public stockholders, and a redistribution to [the Wren Control Group], of a substantial portion of the economic portion of the economic value and voting power embodied in the minority interest."[201] The Chancery Court was also critical of earlier Delaware decisions that suggested that if anyone other than the controller benefits from the transaction, then the minority may not assert a direct equity dilution claim. The Court held that as long as the control group's holdings are not decreased, and the holdings of the minority stockholders are, the latter may have a direct equity dilution claim, even if someone other than the controller also benefits from the transaction.

Although the Chancery Court in *Dubroff II* did not further clarify the requirements of DGCL § 228(e) for a notice to stockholders of the taking of the corporate action without a meeting by less than unanimous consent, the Court did note that whatever the parameters of DGCL § 228(e) may be, the

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197 *Dubroff v. Wren Holdings, LLC*, C.A. No. 3940-VCN, 2011 WL 5137175, at *7, 2011 Del. Ch. LEXIS 164, at *24 (Del. Ch. Oct. 28, 2011) ("*Dubroff II*"). *Dubroff II* involved two sets of plaintiffs. One set of plaintiffs, organized by Sheldon Dubroff (the "Dubroff Plaintiffs"), first brought a class action in *Dubroff I* on behalf of the company's former stockholders. The Court in *Dubroff I* refused to certify the Dubroff Plaintiffs' class action, leaving the Dubroff Plaintiffs to pursue their claims individually. Shortly after the *Dubroff I* opinion was issued, Morris Fuchs and several others (the "Fuchs Plaintiffs"), who had acquired roughly 20% of the company's equity value from 1999 to 2002, filed a compliant similar to the one filed by the *Dubroff I* Plaintiffs. The Fuchs Plaintiffs moved for intervention and consolidation of their case with that of the Dubroff Plaintiffs. *Dubroff II* thus involved two sets of plaintiffs: the Dubroff Plaintiffs and the Fuchs Plaintiffs.

198 *Id.*

199 *In re PNB Holding Co. S'holders Litig.*, C.A. No. 28-N, 2006 WL 2403999, at *10, 2006 Del. Ch. LEXIS 158, at *32-*36 (Del. Ch. Aug. 18, 2006).

200 906 A.2d 91, 100 (Del. 2006). While under Delaware law equity dilution claims are typically viewed as derivative, not direct, the Delaware Supreme Court held that certain equity dilution claims may be pled both derivatively and directly in *Gentile v. Rossette*. *See Feldman v. Cutaia*, 951 A.2d 727 (Del. 2008), and *infra* notes 3 and related text.

201 *Dubroff II,* C.A. No. 3940-VCN, 2011 WL 5137175, at *7, 2011 Del. Ch. LEXIS 164, at *24.

plaintiffs pled sufficient facts for the Court to infer that the Board deliberately omitted material information with the goal of misleading stockholders. The Chancery Court noted that while the notice accurately stated the mechanics of the recapitalization plan, this disclosure alone was not enough because the beneficiaries of and benefits from the recapitalization were not disclosed to stockholders.

In *NACCO Industries, Inc. v. Applica Incorporated*,[202] NACCO (the acquirer under a merger agreement) brought claims against Applica (the target company) for breach of the merger agreement's "no-shop" and "prompt notice" provisions for assistance it gave to hedge funds managed by Herbert Management Corporation (collectively "Harbinger"), which made a topping bid after the merger agreement with NACCO was executed. NACCO also sued Harbinger for common law fraud and tortious interference with contract, alleging that while NACCO and Applica were negotiating a merger agreement, Applica insiders provided confidential information to principals at the Harbinger hedge funds, which were then considering their own bid for Applica. During this period, Harbinger amassed a substantial stake in Applica (which ultimately reached 40%), but reported on its Schedule 13D filings that its purchases were for "investment," thereby disclaiming any intent to control the company. After NACCO signed the merger agreement, communications between Harbinger and Applica management about a topping bid continued. Eventually, Harbinger amended its Schedule 13D disclosures and made a topping bid for Applica, which then terminated the NACCO merger agreement. After a bidding contest with NACCO, Harbinger succeeded in acquiring the company.

The Vice Chancellor also upheld NACCO's common law fraud claims against Harbinger based on the alleged inaccuracy of Harbinger's Schedule 13D disclosures about its plans regarding Applica. The Vice Chancellor dismissed Harbinger's contention that all claims related to Schedule 13D filings belong in federal court, holding instead that a "Delaware entity engaged in fraud"—even if in an SEC filing required by the 1934 Act—"should expect that it can be held to account in the Delaware courts." The Vice Chancellor noted that while the federal courts have exclusive jurisdiction over violations of the 1934 Act, the Delaware Supreme Court has held that statutory remedies under the 1934 Act are "intended to coexist with claims based on state law and not preempt them." The Vice Chancellor emphasized that NACCO was not seeking state law enforcement of federal disclosure requirements, but rather had alleged that Harbinger's statements in its Schedule 13D and 13G filings were fraudulent under state law without regard to whether those statements complied with federal law. The Court then ruled that NACCO had adequately pleaded that Harbinger's disclosure of a mere "investment" intent was false or misleading, squarely rejecting the argument that "one need not disclose any intent other than an investment intent until one actually makes a bid." In this respect, the *NACCO* decision highlights the importance of accurate Schedule 13D disclosures by greater-than-5% beneficial owners that are seeking or may seek to acquire a public company and raises the possibility of monetary liability to a competing bidder if faulty Schedule 13D disclosures are seen as providing an unfair advantage in the competition to acquire the company.

In *Sherwood v. Chan*,[203] the last minute removal of an incumbent director from the company slate shortly before an annual shareholders' meeting was found to create irreparable harm due to the threat of an uninformed shareholder vote that warranted temporarily enjoining holding the meeting. The Court explained that because considerations to which the business judgment rule applies are not present in the

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202 997 A.2d 1, 6 (Del. Ch. 2009).

203 C.A. No. 7106-VCP, 2011 Del. Ch. LEXIS 202, at *25 (Del. Ch. Dec. 20, 2011). *See supra* note 160 and related text.

shareholder voting context, the Court does not defer to the judgment of directors about what information is material, and determines materiality for itself from the record at the particular stage of the case when the issue arises. The Court explained the company's proxy materials may have been misleading in their explanation about the reasons they gave for the removal of the incumbent director from the company's slate and not nominating him for reelection to the Board. After holding that irreparable harm in the context of a shareholder vote can be established by a mere threat that a shareholder is uninformed, the Court emphasized that:

> The corporate election process, if it is to have any validity, must be conducted with scrupulous fairness and without any advantage being conferred or denied to any candidate or slate of candidates. In the interest of corporate democracy, those in charge of the election machinery of a corporation must be held to the highest standards in providing for and conducting corporate elections.[204]

(10) Special Facts Doctrine/Private Company Stock Purchases. *In re Wayport, Inc. Litigation*[205] involved duty of candor and common law fraud claims brought by the founder and former CEO/director of a closely held Delaware corporation headquartered in Austin, Texas against two venture capital funds that were holders of preferred stock of the company, had Board representation and were purchasers of stock from the founder in a privately negotiated transaction. The purchasers knew, but did not disclose, facts related to the company's sale of patents to Cisco for $7.6 million, an amount sufficient to cause the company's auditors to require disclosure in a note to the company's financial statements and to increase the company's year-end cash position by 22% and represent 77% of its operating income for the year. The patent sale was closed less than a month after a representative of one of the purchasers told the seller, who was concerned whether he was reviewing adequate information from the company and had refused to make a requested representation in the sale agreement that he had received adequate information, that the purchaser was not "aware of any bluebirds of happiness in the Wayport world." The Court interpreted this as a representation that the purchaser was not aware of any material undisclosed information that could affect the value of Wayport's stock. At the time of the "no bluebirds of happiness" statement, the company was in negotiations to sell the patents. After the Board and the purchaser learned of the sale, the "no bluebirds of happiness" statement was not updated.

In rejecting the founder's fiduciary duty claims but sustaining a common law fraud claim, Vice Chancellor Laster explained:

> The plaintiffs contended that the defendants owed them fiduciary duties that included a duty to disclose material information when they purchased the plaintiffs' shares. Directors of a Delaware corporation owe two fiduciary duties: care and loyalty. [Citing *Stone v. Ritter*]. The "duty of disclosure is not an independent duty, but derives from the duties of care and loyalty." [Citing *Pfeffer v. Redstone*]. The duty of disclosure arises because of "the application in a specific context of the board's fiduciary duties . . . ." * * *
>
> The first recurring scenario is classic common law ratification, in which directors seek approval for a transaction that does not otherwise require a stockholder vote under

[204] *Id.* at *53.

[205] 76 A.3d 296, 301 (Del. Ch. 2013).

the DGCL. [Citing *Gantler v. Stephens*]. If a director or officer has a personal interest in a transaction that conflicts with the interests of the corporation or its stockholders generally, and if the board of directors asks stockholders to ratify the transaction, then the directors have a duty "to disclose all facts that are material to the stockholders' consideration of the transaction and that are or can reasonably be obtained through their position as directors." . . . The failure to disclose material information in this context will eliminate any effect that a favorable stockholder vote otherwise might have for the validity of the transaction or for the applicable standard of review. * * *

A <u>second</u> and quite different scenario involves a <u>request for stockholder action</u>. When directors submit to the stockholders a transaction that requires stockholder approval (such as a merger, sale of assets, or charter amendment) or which requires a stockholder investment decision (such as tendering shares or making an appraisal election), but which is not otherwise an interested transaction, the directors have a duty to "exercise reasonable care to disclose all facts that are material to the stockholders' consideration of the transaction or matter and that are or can reasonably be obtained through their position as directors." * * * A failure to disclose material information in this context may warrant an injunction against, or rescission of, the transaction, but will not provide a basis for damages from defendant directors absent proof of (i) a culpable state of mind or nonexculpated gross negligence, (ii) reliance by the stockholders on the information that was not disclosed, and (iii) damages proximately caused by that failure. * * *

A <u>third</u> scenario involves a corporate <u>fiduciary who speaks outside of the context of soliciting or recommending stockholder action, such as through "public statements made to the market," "statements informing shareholders about the affairs of the corporation," or public filings required by the federal securities laws</u>. [Citing *Malone v. Brincat*, *supra* note. In that context, directors owe a duty to stockholders not to speak falsely:

> Whenever directors communicate publicly or directly with shareholders about the corporation's affairs, with or without a request for shareholder action, directors have a fiduciary duty to shareholders to exercise due care, good faith and loyalty. It follows a *fortiori* that when directors communicate publicly or directly with shareholders about corporate matters the *sine qua non* of directors' fiduciary duty to shareholders is honesty.

Id. at 10. "[D]irectors who knowingly disseminate false information that results in corporate injury or damage to an individual stockholder violate their fiduciary duty, and may be held accountable in a manner appropriate to the circumstances." *Id.* at 9; *see id.* at 14 ("When the directors are not seeking shareholder action, but are deliberately misinforming shareholders about the business of the corporation, either directly or by a public statement, there is a violation of fiduciary duty."). Breach "may result in a derivative claim on behalf of the corporation," "a cause of action for damages," or "equitable relief . . . ." *Id.*

The <u>fourth</u> scenario arises when a corporate <u>fiduciary buys shares directly from or sells shares directly to an existing outside stockholder</u>. * * * Under the "<u>special facts doctrine</u>" adopted by the Delaware Supreme Court in *Lank v. Steiner*, 224 A.2d 242 (Del.

1966), a director has a fiduciary duty to disclose information in the context of a private stock sale "only when a director is possessed of special knowledge of future plans or secret resources and deliberately misleads a stockholder who is ignorant of them." * * * If this standard is met, a duty to speak exists, and the director's failure to disclose material information is evaluated within the framework of common law fraud. If the standard is not met, then the director does not have a duty to speak and is liable only to the same degree as a non-fiduciary would be.[206]

(Emphasis added)

With the founder's claims under the first three Delaware duty of candor scenarios having been dismissed in prior proceedings,[207] the Court analyzed the founder's claim under the fiduciary duty of disclosure in the direct purchase by a fiduciary as follows:

> The legal principles that govern a direct purchase of shares by a corporate fiduciary from an existing stockholder have a venerable pedigree.
>
>> As almost anyone who has opened a corporation law casebook or treatise knows, there has been for over a century a conflict of authority as to whether in connection with a purchase of stock a director owes a fiduciary duty to disclose to the selling stockholder material facts which are not known or available to the selling stockholder but are known or available to the director by virtue of his position as a director.
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> *** Three rules were developed: a majority rule, a minority rule, and a compromise position known as the "special facts doctrine." * * *
>
> The "supposedly 'majority' rule disavows the existence of any general fiduciary duty in this context, and holds that directors have no special disclosure duties in the purchase and sale of the corporation's stock, and need only refrain from misrepresentation and intentional concealment of material facts." * * *
>
> "The ostensibly opposing 'minority' view broadly requires directors to disclose all material information bearing on the value of the stock when they buy it from or sell it to another stockholder." * * *
>
> The special facts doctrine attempts to strike a compromise position between "the extreme view that directors and officials are always under a full fiduciary duty to the shareholders to volunteer all their information and a rule that they are always free to take advantage of their official information." * * * Under this variant, a director has a duty of disclosure only

[206] *Id.* at 313-15.

[207] *Latesco, L.P. v. Wayport, Inc.*, C.A. No. 4167-VCL, 2009 WL 2246793, at *1, 2009 Del. Ch. LEXIS 145, at *5 (Del. Ch. July 24, 2009).

> in special circumstances . . . where otherwise there would be a great and unfair inequality of bargaining position by the use of inside information. Such special circumstances or developments have been held to include peculiar knowledge of directors as to important transactions, prospective mergers, probable sales of the entire assets or business, agreements with third parties to buy large blocks of stock at a high price and impending declarations of unusual dividends.

* * * Like the minority rule, the compromise position recognizes a duty of disclosure, but cuts back on its scope by limiting disclosure only to that subcategory of material information that qualifies as special facts or circumstances. * * *

After analyzing Delaware precedent, Vice Chancellor Laster concluded that the Delaware Supreme Court follows the "special facts" doctrine and proceeded to analyze the facts thereunder.

> Under the "special facts" doctrine, [the funds] were free to purchase shares from other Wayport stockholders, without any fiduciary duty to disclose information about the Company or its prospects, unless the information related to an event of sufficient magnitude to constitute a "special fact." If they knew of a "special fact," then they had a duty to speak and could be liable if they deliberately misled the plaintiffs by remaining silent.
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> To satisfy the "special facts" requirement, a plaintiff generally must point to knowledge of a substantial transaction, such as an offer for the whole company. * * *
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> Under Delaware law, "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important" such that "under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder." * * * The standard "does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote" or (in more generalized terms) act differently. The standard of materiality is thus lower than the standard for a "special fact."
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> * * *
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> For purposes of Delaware law, the existence of preliminary negotiations regarding a transaction generally becomes material once the parties "have agreed on the price and structure of the transaction." * * * Under these standards, the plaintiffs did not prove that [an undisclosed proposed licensing] deal ever became material. * * * No agreement on price and structure was reached, and [it] was not otherwise sufficiently firm to be material. It therefore could not rise to the level of a "special fact."
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> By contrast, plaintiffs proved at trial that the Cisco sale was material. Wayport and Cisco agreed on a total price of $9.5 million on June 29, 2007, and the patent sale agreement was signed that day. Wayport's net sale proceeds of $7.6 million increased the Company's year-end cash position by 22%, and the gain on sale represented 77% of the Company's year-end operating income. Wayport's auditors concluded that the transaction was material

to Wayport's financial statements and insisted that it be included over Williams's opposition because they "really didn't have an alternative . . . ."

The Cisco sale was a milestone in the Company's process of monetizing its patent portfolio, and it was sufficiently large to enter into the decision-making of a reasonable stockholder. But the plaintiffs did not prove at trial that the Cisco sale substantially affected the value of their stock to the extent necessary to trigger the special facts doctrine. * * *[208]

The Court, however, held that the founder had established a claim for fraud by proving (i) a false representation, (ii) a defendant's knowledge or belief of its falsity or his reckless indifference to its truth, (iii) a defendant's intention to induce action, (iv) reasonable reliance, and (v) causally related damages.

(b) Care.

(1) Business Judgment Rule; Informed Action; Gross Negligence. The duty of care in Delaware requires a director to perform his duties with such care as an ordinarily prudent man would use in similar circumstances. Subject to numerous limitations, Delaware has a business judgment rule "that a court will not substitute its judgment for that of the Board if the latter's decision can be 'attributed to any rational business purpose'."[209]

The availability of the business judgment rule does not mean, however, that directors can act on an uninformed basis. Directors have an obligation to inform themselves of all material information reasonably available to them before making a business decision and, having so informed themselves, to act with the requisite care in making such decision.[210] Directors are not required, however, "to read in haec verba every contract or legal document,"[211] or to "know all particulars of the legal documents [they] authorize[ ] for execution."[212]

Although a director must act diligently and with the level of due care appropriate to the particular situation, the Delaware courts have held that action (or inaction) will constitute a breach of a director's fiduciary duty of care only if the director's conduct rises to the level of gross negligence.[213] "Delaware's current understanding of gross negligence is conduct that constitutes reckless indifference or actions that are without the bounds of reason."[214]

Compliance with the duty of care requires active diligence. Accordingly, directors should attend board meetings regularly; they should take time to review, digest, and evaluate all materials and other information provided to them; they should take reasonable steps to assure that all material information

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208 *In re Wayport*, 76 A.3d at 316-22.

209 *Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946, 954 (Del. 1985) (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)). *See infra* notes and related text.

210 *See Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 367 (Del. 1993); *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

211 *Smith v. Van Gorkom*, 488 A.2d 858, 883 n.25 (Del. 1985), *overruled as to shareholder ratification extinguishing loyalty claim by Gantler v. Stephens*, 965 A.2d 695 (Del. 2009).

212 *Moran v. Household Int'l, Inc.,* 490 A.2d 1059, 1078 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985), disapproved of the use of the concept of "special injury" in *Moran* analysis in *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1035 (Del. 2004).

213 *See Van Gorkom*, 488 A.2d at 873.

214 *McPadden v. Sidhu*, 964 A.2d 1262, 1274 (Del. Ch. 2008).

bearing on a decision has been considered by the directors or by those upon whom the directors will rely; they should actively participate in board deliberations, ask appropriate questions, and discuss each proposal's strengths and weaknesses; they should seek out the advice of legal counsel, financial advisors, and other professionals, as needed; they should, where appropriate, reasonably rely upon information, reports, and opinions provided by officers, experts or board committees; and they should take sufficient time (as may be dictated by the circumstances) to reflect on decisions before making them. Action by unanimous written consent ordinarily does not provide any opportunity for, or record of, careful Board deliberations.[215]

(2) Business Judgment Rule Not Applicable When Board Conflicted. In *Gantler v. Stephens*, the Delaware Supreme Court held that the business judgment rule was not applicable to the Board's decision to approve a going private stock reclassification proposal in which by amendment to the certificate of incorporation common stock held by smaller stockholders was converted into non-voting preferred stock because the directors were conflicted.[216] The complaint (which the Court accepted as true because the decision was on defendants' motion to dismiss) alleged that the director defendants improperly rejected a value-maximizing merger bid and terminated the sales process to preserve personal benefits, including retaining their positions and pay as directors, as well as valuable outside business opportunities. The complaint further alleged that the Board failed to deliberate before deciding to reject the bid and to terminate the sales process, yet repeatedly disregarded its financial advisor's advice.

The Court noted that "[a] board's decision not to pursue a merger opportunity is normally reviewed within the traditional business judgment framework," but:

> [T]he business judgment presumption is two pronged. First, did the Board reach its decision in the good faith pursuit of a legitimate corporate interest? Second, did the Board do so advisedly? For the Board's decision here to be entitled to the business judgment presumption, both questions must be answered affirmatively.
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> * * *
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> Here, the plaintiffs allege that the Director Defendants had a disqualifying self-interest because they were financially motivated to maintain the status quo. A claim of this kind must be viewed with caution, because to argue that directors have an entrenchment motive solely because they could lose their positions following an acquisition is, to an extent, tautological. By its very nature, a board decision to reject a merger proposal could always enable a plaintiff to assert that a majority of the directors had an entrenchment motive. For that reason, the plaintiffs must plead, in addition to a motive to retain

215 *Official Comm. of Unsecured Creditors of Integrated Health Serv., Inc. v. Elkins*, C.A. No. 20228, 2004 WL 1949290 at *14, 2004 Del. Ch. LEXIS 122, at *20 (Del. Ch. Aug. 24, 2004) (discussing how Compensation Committee forgiveness of a loan to the CEO by written consent without any evidence of director deliberation or reliance upon a compensation expert raised a Vice Chancellor's "concern as to whether it acted with knowing or deliberate indifference.").

216 965 A.2d 695, 705 (Del. 2009).

corporate control, other facts sufficient to state a cognizable claim that the Director Defendants acted disloyally.[217]

The Delaware Supreme Court found that the plaintiffs had pled facts sufficient to establish disloyalty of at least three (*i.e.*, a majority) of the remaining directors, which sufficed to rebut the business judgment presumption. With respect to the CEO, the Court noted that in addition to losing his long held positions, the plaintiffs alleged a duty of loyalty violation when they pled that the CEO never responded to the due diligence request which had caused one bidder to withdraw its bid and that this bidder had explicitly stated in its bid letter that the incumbent Board would be terminated if it acquired the company. The Court held that it may be inferred that the CEO's unexplained failure to respond promptly to the due diligence request was motivated by his personal financial interest, as opposed to the interests of the shareholders, and that same inference can be drawn from his attempt to "sabotage" another bidder's due diligence request in a similar manner.

Another director was the president of a heating and air conditioning company that provided heating and air conditioning services to the bank; he may have feared that if the company were sold his firm would lose the bank as a client, which to him would be economically significant. A third director was a principal in a small law firm that frequently provided legal services to the company and was also the sole owner of a real estate title company that provided title services in nearly all of the Bank's real estate transactions. In summary, the Delaware Supreme Court concluded the plaintiffs had alleged facts sufficient to establish, for purposes of a motion to dismiss, that a majority of the Board acted disloyally and that a cognizable claim of disloyalty rebuts the business judgment presumption and is subject to entire fairness review.

The Delaware Supreme Court in *Gantler* set forth two reasons for rejecting the Chancery Court's dismissal of the case on the ground that a disinterested majority of the shareholders had "ratified" the reclassification by voting to approve it:

> First, because a shareholder vote was required to amend the certificate of incorporation, that approving vote could not also operate to "ratify" the challenged conduct of the interested directors. Second, the adjudicated cognizable claim that the Reclassification Proxy contained a material misrepresentation, eliminates an essential predicate for applying the doctrine, namely, that the shareholder vote was fully informed.
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> * * *
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> [T]he scope of the shareholder ratification doctrine must be limited to its so-called "classic" form; that is, to circumstances where a fully informed shareholder vote approves director action that does *not* legally require shareholder approval in order to become legally effective. Moreover, the only director action or conduct that can be ratified is that which the shareholders are specifically asked to approve. With one exception, the "cleansing" effect of such a ratifying shareholder vote is to subject the challenged director action to

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217 *Id.* at 706-07.

business judgment review, as opposed to "extinguishing" the claim altogether (*i.e.*, obviating all judicial review of the challenged action).[218]

(3) Inaction. In many cases, of course, the directors' decision may be not to take any action. To the extent that decision is challenged, the focus will be on the process by which the decision not to act was made. Where the failure to oversee or to act is so severe as to evidence a lack of good faith, the failure may be found to be a breach of the duty of loyalty.[219]

(4) Reliance on Reports and Records. The DGCL provides two important statutory protections to directors relating to the duty of care. The first statutory protection is DGCL § 141(e) which provides statutory protection to directors who rely in good faith upon corporate records or reports in connection with their efforts to be fully informed, and reads as follows:

> A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member's duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.[220]

Members of a Board's Audit and Risk Management Committee are entitled to rely in good faith on reports and statements and opinions, pursuant to DGCL § 141(e), from the corporation's officers and employees who are responsible for preparing the company's financial statements.[221] Significantly, as set forth above, DGCL § 141(e) provides protection to directors only if they acted in good faith.

(5) Limitation on Director Liability. The second statutory protection is DGCL § 102(b)(7),[222] which allows a Delaware corporation to provide in its certificate of incorporation limitations on (or partial elimination of) director liability for monetary damages in relation to the duty of care.[223] The liability of directors may not be so limited or eliminated, however, in connection with breaches of the duty of loyalty, the failure to act in good faith,[224] intentional misconduct, knowing violations of law, obtaining improper

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218 *Id.* at 712-13.

219 *See Stone v. Ritter,* 911 A.2d 362, 370 (Del. 2006) (holding that "the requirement to act in good faith is a subsidiary element, i.e., a condition, of the fundamental duty of loyalty."); *see supra* notes 120-135 and related text.

220 DGCL § 141(e).

221 *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 135 (Del. Ch. 2009).

222 *See infra* notes 244 and related text.

223 *See infra* notes -244 and related text.

224 *See In re Alloy, Inc. S'holder Litig.*, C.A. No. 5626-VCP, 2011 Del. Ch. LEXIS 159, at *22-23 (Del. Ch. Oct. 13, 2011) (In granting a motion to dismiss a class action challenging a going-private transaction, the Court explained that when a corporation has an exculpatory provision in its Charter pursuant to DGCL § 102(b)(7), barring claims for monetary liability against directors for breaches of their duty of care, the complaint must state a non-exculpated claim; that is, a claim predicated on a breach of the director's duty of loyalty or bad faith conduct.).

personal benefits, or paying dividends or approving stock repurchases in violation of DGCL § 174.[225] Officers do not have the benefit of the limitation of director liability authorized by DGCL § 102(b)(7).[226]

(c) Aiding and Abetting. A claim for aiding and abetting has four elements: (1) the existence of a fiduciary relationship; (2) a breach of the fiduciary's duty; (3) knowing participation in the breach by the non-fiduciary; and (4) damages proximately caused by the breach.[227] A buyer whose hard negotiations lead to the target's Board making concessions in violation of its fiduciary duties is ordinarily not subject to aider and abettor liability,[228] but cannot insist on and incorporate terms that take advantage of a conflict of interest that its fiduciary counterpart faces.[229]

In *RBC Capital Markets, LLC v. Joanna Jervis*,[230] the Delaware Supreme Court affirmed the Delaware Chancery Court's post-trial decision in *In re Rural/Metro Corp. S'holders Litig.*[231] that RBC Capital Markets, LLC ("RBC") was liable to a class of stockholders of Rural/Metro Corporation ("Rural") for aiding and abetting breaches of fiduciary duty by the Rural Board and its subsequent decision setting the amount of RBC's liability to the class at $75,798,550.33 (plus interest and after a credit for settlement payments made by two defendants).[232]

The Rural case arose out of a June 30, 2011 merger (the "Rural Merger") in which Rural was acquired by Warburg Pincus LLC ("Warburg") in a transaction that implied an equity value for Rural of $437.8 million. Lawsuits challenging the Rural Merger were filed shortly after the Rural Merger was announced.

The original complaint named as individual defendants Rural's Board, including Rural's CEO Michael DiMino, and contended that the individual defendants breached their fiduciary duties by (i) making decisions that fell outside the range of reasonableness during the process leading up to the Rural Merger and when approving the Rural Merger (the "Sale Process Claim"), and (ii) by failing to disclose material information in the definitive proxy statement (the "Proxy Statement") that the Company issued in connection with the Rural Merger (the "Disclosure Claim"). Later the plaintiffs filed a second amended complaint that added claims against RBC, which acted as Rural's lead financial advisor during the process that led to the Rural Merger, and Moelis & Company, LLC ("Moelis"), which served as Rural's secondary

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225 DGCL § 102(b)(7).

226 *See infra* notes 244 and related text.

227 *Malpiede v. Townson*, 780 A.2d 1075, 1096 (Del. 2001).

228 *In re Comverge, Inc. S'holders Litig.*, Consol. C.A. No. 7368-VCP, 2014 WL 6686570, at *19 (Del. Ch. Nov. 25, 2014) (Chancery Court in dismissing aiding and abetting claims against buyer observed that "arm's-length bargaining cannot give rise to aiding and abetting liability on the part of the acquirer."). *See also Lee v. Pincus*, C.A. No. 8458-CB (Del. Ch. Nov. 14, 2014 (Investment bankers were not held liable for aiding and abetting even though they provided their consent to a waiver that allowed certain directors to be given an early release from IPO stock lock-up provisions and thereby sell their shares earlier (and at higher prices) than other stockholders.).

229 *Pontiac Gen. Employees Ret. Sys. v. Ballantine*, C.A. No. 9789-VCL, 2014 WL 6388645 (Del. Ch. Oct. 14, 2014) (TRANSCRIPT)). *See infra* note and related text.

230 129 A.3d 816 (Del. 2015). *See* John Legaré Williams, *Delaware Insider: Rural Metro: Gulping Advisers and Practitioner Guidance*, BUS. L. TODAY (Jan. 2016).

231 88 A.3d 54 (Del. Ch. 2014).

232 *In re Rural/Metro Corp. S'holders Litig.*, 102 A.3d 205, 224 (Del. Ch. 2014).

financial advisor in a role junior to RBC, and contended that RBC and Moelis aided and abetted the individual defendants in breaching their fiduciary duties.

The events leading up to the Rural Merger began when RBC approached Rural's CEO proposing that Rural consider acquiring American Medical Response ("AMR"), a subsidiary of Emergency Medical Services Corporation ("EMS") and Rural's lone national competitor in the ambulance business. The Rural Board formed a three-person special committee to generate a recommendation regarding an acquisition of AMR, but at that point did not authorize the special committee to pursue a sale of Rural. The lead director on the special committee was a managing director of a hedge fund which had accumulated 12.43% of the company's stock which represented 22% of the hedge fund's portfolio and, as a successful and overweighted investment, was a position the fund wanted to liquidate. Another committee member needed to reduce the number of Boards on which he served to conform to ISS guidelines, which a sale of Rural could accomplish for him.

The special committee engaged RBC as its primary financial advisor and Moelis as its secondary financial advisor. Although the special committee was not authorized to pursue a sale of Rural at this point, RBC had heard rumors that EMS might be for sale, and believed that a private equity firm that acquired EMS might consider buying Rural rather than selling AMR to Rural. RBC sought to use its position as advisor to Rural to secure buy-side roles with the private equity firms bidding for EMS. Ultimately the special committee authorized RBC and Moelis to explore a sale of Rural contemporaneously with a possible sale of EMS. Although RBC disclosed to the Rural Board its intention to offer staple financing to potential Rural buyers, it did not disclose its plans to use its role as Rural's advisor to secure the financing for the EMS bidders.

After RBC was hired to sell Rural, it encountered problems trying to induce financial buyers to engage in parallel sales processes for Rural and EMS. RBC, Moelis and the special committee contacted twenty-eight private equity firms, but only six firms submitted preliminary bids. Only one submitted a final bid, and this bid did not utilize financing from RBC. The special committee directed RBC and Moelis to enter into final price negotiations with the bidder. RBC continued to seek a buy-side role providing financing to the bidder without disclosing its efforts to the special committee and lowered the valuations of Rural in its fairness presentation to the Rural Board, thereby making the bid look more attractive.

RBC formed an ad hoc fairness committee of two managing directors, which reviewed and approved RBC's fairness opinion. The fairness opinion was subsequently presented to the Rural Board. It was the first valuation information the board received as part of the sale process. The Board approved the Rural Merger. RBC was ultimately unsuccessful in trying to provide financing to the buyer.

The Rural Board and Moelis settled all claims against them for $6.6 million and $5 million, respectively. The case proceeded to trial against RBC.

On March 7, 2014, the Chancery Court issued its Liability Opinion which held, as to the Sale Process Claim, that the Rural directors breached their fiduciary duties by making decisions, taking actions, and allowing steps to be taken that fell outside the range of reasonableness (which the Chancery Court held was the applicable standard of review). Because the directors had settled their claims, the burden shifted to the plaintiffs to show that the directors' actions were unreasonable. The Chancery Court held that the provision in Rural's Charter exculpating directors for monetary damages arising from breaches of the duty of care did not cover aiders and abettors like RBC.

The Chancery Court next found that the Rural Board's decisions fell outside the range of reasonableness because (1) running a sales process in parallel with EMS fell outside the range of reasonableness because (i) the special committee had not been authorized to initiate a sale of the company and (ii) RBC did not disclose that proceeding in parallel with the EMS process served its interest in gaining a position in the financing for EMS bidders, and (2) approving the final bid "lacked a reasonable informational basis" because the Board failed (a) to become aware of RBC's last minute maneuvering to secure a role in the buy-side financing; (b) to consider RBC's potentially conflicting incentives; and (c) to receive valuation materials until hours before approving the deal. Next, the Chancery Court found that RBC knowingly participated in these breaches, by "act[ing] with the knowledge that the conduct advocated or assisted constitute[d] such a breach." The Chancery Court stated that as advisor to the Board, RBC had obligations to act as "gatekeeper" and to prevent the Board from breaching its fiduciary duty. The Chancery Court found that RBC had misled the Rural directors into breaching their fiduciary duties by:

(1) not disclosing its interest in using the Rural sales process to obtain a financing role in an acquisition of EMS;

(2) not providing any preliminary valuation analysis to the special committee; and

(3) never disclosing its plans to seek to provide buy-side financing at the end stages of the sales process.

RBC was not ultimately successful in securing a role in the buy-side financing, but this result did not change the Chancery Court's conclusion that RBC had breached its duties.

The Chancery Court further explained that RBC's conduct in deceiving the Board constituted a "fraud on the board" which rendered RBC equally culpable for the actions of the Board. Finally, the Chancery Court found that that RBC's actions proximately caused Rural to be sold at a price below its fair value.

As to the Disclosure Claim, the Chancery Court held that the individual defendants breached their fiduciary duties by providing materially misleading information in the Proxy Statement. The plaintiffs proved at trial that "[i]nformation that RBC provided to the Board in connection with its precedent transaction analyses was false, and that false information was repeated in the Proxy Statement." The Chancery Court found that information RBC provided about its conflicts of interest was false:

> The Proxy Statement stated that RBC received the right to offer staple financing because it "could provide a source for financing on terms that might not otherwise be available to potential buyers of the Company...." This statement was false. The Board never concluded that RBC could provide financing that might otherwise not be available, and no evidence to that effect was introduced at trial. In December 2010, RBC told the Special Committee that the credit markets were open and receptive to acquisition financing, and they remained so for the duration of the sale process.

The Chancery Court further found that this statement also constituted a partial disclosure which "imposed on the Rural directors a duty to speak completely on the subject of RBC's financing efforts." The Proxy Statement did not describe how RBC used the initiation of the Rural sale process to seek a role in the EMS acquisition financing, did not disclose RBC's receipt of more than $10 million for its part in financing the acquisition of EMS, and said nothing about RBC's lobbying of Warburg after the delivery of Warburg's fully financed bid while RBC was developing its fairness opinion.

For purposes of the plaintiffs' claim against RBC for aiding and abetting a breach of duty, the Liability Opinion only needed to determine that the directors' conduct fell outside the range of reasonableness. The plaintiffs did not ask the Chancery Court to go further and categorize the defendant directors' breaches as either breaches of the duty of loyalty or the duty of care.

In affirming the Chancery Court holding that the directors had violated their *Revlon* duties by engaging in a process for selling Rural that was outside of the range of reasonableness, the Supreme Court held that the Board's *Revlon* duties commenced when Rural's special committee instituted a process to sell Rural rather than, as RBC argued, three months later when the Board finally approved the sale. The Supreme Court explained:

> We agree with the Court of Chancery's principal conclusion that the Board's overall course of conduct fails *Revlon* scrutiny. *Revlon* permits a board to pursue the transaction it reasonably views as most valuable to the stockholders, provided "the transaction is subject to an effective market check under circumstances in which any bidder interested in paying more has a reasonable opportunity to do so." We stated in *C & J Energy* that "[s]uch a market check does not have to involve an active solicitation, so long as interested bidders have a fair opportunity to present a higher-value alternative, and the board has the flexibility to eschew the original transaction and accept the higher-value deal."
>
> Here, the evidence fully supports the trial court's findings that the solicitation process was structured and timed in a manner that impeded interested bidders from presenting potentially higher value alternatives. This aspect of the trial court's ruling relied, in part, upon findings that RBC designed the sale process to run in parallel with a process being conducted by EMS, and that "RBC did not disclose that proceeding in parallel with the EMS process served RBC's interest in gaining a role on the financing trees of bidders for EMS." We agree with the trial court's suggestion that the reasonableness of initiating a sale process to run in tandem with the EMS auction, absent conflicts of interest, "would be one of the many debatable choices that fiduciaries and their advisors must make . . . and it would fall within the range of reasonableness." But where undisclosed conflicts of interest exist, such decisions must be viewed more skeptically.
>
> The record indicates that Rural's Board was unaware of the implications of the dual-track structure of the bidding process and that the design was driven by RBC's motivation to obtain financing fees in another transaction with Rural's competitor. There is ample evidence that there were material barriers, including confidentiality restrictions, that would have impeded or prevented a bidder from making an offer. For example, the record supports the trial court's findings that a bidder for EMS would need a separate team of advisors to participate in the Rural process, and that these individuals could not share

confidential information with advisors working on a potential EMS acquisition. RBC also did not explain that a successful bidder for EMS would own a Rural competitor, making it difficult for the Company to provide due diligence freely to such bidder. The trial court found that "[t]here is no contemporaneous evidence that [these problems] were identified and considered." These findings are sufficiently supported by the record evidence.

The Board, as a result, took no steps to address or mitigate RBC's conflicts. Directors frequently rely on expert opinions concerning the fairness of proposed transactions, and the Delaware General Corporation Law recognizes that directors may rely upon such expert opinions. In *Citron v. Fairchild Camera & Instrument Corp.*, this Court observed:

> [W]e are, of course, ever mindful of the realities of corporate directorship. We recognize that management is often the catalyst in the decision-making process. We further recognize that a board will receive substantial information from third-party sources. As we have noted on various occasions, however, in change of control situations, sole reliance on hired experts and management can "taint[] the design and execution of the transaction." Thus, we look particularly for evidence of a board's active and direct role in the sale process.

While a board may be free to consent to certain conflicts, and has the protections of 8 *Del. C.* § 141(e), directors need to be active and reasonably informed when overseeing the sale process, including identifying and responding to actual or potential conflicts of interest. But, at the same time, a board is not required to perform searching and ongoing due diligence on its retained advisors in order to ensure that the advisors are not acting in contravention of the company's interests, thereby undermining the very process for which they have been retained. A board's consent to a conflict does not give the advisor a "free pass" to act in its own self-interest and to the detriment of its client. Because the conflicted advisor may, alone, possess information relating to a conflict, the board should require disclosure of, on an ongoing basis, material information that might impact the board's process.[233]

The Supreme Court rejected RBC's contention that the Chancery Court erred by finding a due care violation without finding gross negligence, explaining:

> When disinterested directors themselves face liability, the law, for policy reasons, requires that they be deemed to have acted with gross negligence in order to sustain a monetary judgment against them. That does not mean, however, that if they were subject to *Revlon* duties, and their conduct was unreasonable, that there was not a breach of fiduciary duty. The Board violated its situational duty by failing to take reasonable steps to attain the best value reasonably available to the stockholders. We agree with the trial court that the individual defendants breached their fiduciary duties by engaging in conduct that fell

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233 129 A.3d at 854-56.

> outside the range of reasonableness, and that this was a sufficient predicate for its finding of aiding and abetting liability against RBC.[234]

Turning to RBC's liability as an aider and abettor, the Supreme Court affirmed the Chancery Court holding that if a "[i]f the third party knows that the board is breaching its duty of care and participates in the breach by misleading the board or creating the informational vacuum, then the third party can be liable for aiding and abetting." The Supreme Court explained:

> It is the aider and abettor that must act with *scienter*. The aider and abettor must act "knowingly, intentionally, or with reckless indifference . . .[;]" that is, with an "illicit state of mind." To establish *scienter*, the plaintiff must demonstrate that the aider and abettor had "actual or constructive knowledge that their conduct was legally improper." Accordingly, the question of whether a defendant acted with *scienter* is a factual determination. The trial court found that, "[o]n the facts of this case, RBC acted with the necessary degree of *scienter* and can be held liable for aiding and abetting." The evidence supports this finding.
>
> RBC knowingly induced the breach by exploiting its own conflicted interests to the detriment of Rural and by creating an informational vacuum. RBC's knowing participation included its failure to disclose its interest in obtaining a financing role in the EMS transaction and how it planned to use its engagement as Rural's advisor to capture buy-side financing work from bidders for EMS; its knowledge that the Board and Special Committee were uninformed about Rural's value; and its failure to disclose to the Board its interest in providing the winning bidder in the Rural process with buy-side financing and its eleventh-hour attempts to secure that role while simultaneously leading the negotiations on price. RBC's desire for Warburg's business also manifested itself in its financial analysis, provided by RBC the day the Board approved the merger. RBC's illicit manipulation of the Board's deliberative processes for self-interested purposes was enabled, in part, by the Board's own lack of oversight, affording RBC "the opportunity to indulge in the misconduct which occurred." The Board was unaware of RBC's modifications to the valuation analysis, back-channel communications with Warburg, and eleventh-hour attempt to capture at least a portion of the acquirer's buy-side financing business. RBC made no effort to advise the Rural directors about these contextually shaping points. The result was a poorly-timed sale at a price that was not the product of appropriate efforts to obtain the best value reasonably available and, as the trial court found, a failure to recognize that Rural's stand-alone value exceeded the sale price.
>
> RBC's failure to fully disclose its conflicts and ulterior motives to the Board, in turn, led to a lack of disclosure in the Proxy Statement. The Proxy Statement included materially misleading information that RBC presented to the Board in its financial presentation and omitted information about RBC's conflicts.
>
> The manifest intentionality of RBC's conduct—as evidenced by the bankers' own internal communications—is demonstrative of the advisor's knowledge of the reality that the Board was proceeding on the basis of fragmentary and misleading information.

[234] *Id.* at 857.

> Propelled by its own improper motives, RBC misled the Rural directors into breaching their duty of care, thereby aiding and abetting the Board's breach of its fiduciary obligations.[235]

The Supreme Court, however, rejected the Chancery Court's view that an investment banker generally has an obligation to act as a "gatekeeper" to prevent the Board from breaching its fiduciary duty. Rather, the Supreme Court focused on RBC's *scienter* by failing to disclose its conflicts and furnishing incomplete and misleading information to the Board.

In re Zale Corporation Stockholders Litigation[236] involved claims against the Board of Zale Corporation for approving a merger with Signet Jewelers Limited with an inadequate price, unreasonable deal protection provisions and other failings, and a claim against Merrill Lynch as financial adviser to Zale for aiding and abetting the alleged fiduciary duty violations by the Zale Board. As Zale's Charter contained a DGCL § 102(b)(7) exculpation provision,[237] the directors were dismissed as no duty of loyalty claims were credibly alleged. The crux of the aiding abetting claim was that Merrill Lynch, as it was being engaged, told the Board that it had limited prior relationships and no conflicts with Signet when in fact it had received more than $2 million in fees from Signet during the prior two years and had very recently proposed to Signet that it acquire Zale. Merrill later disclosed these facts after the merger agreement was signed but before the merger proxy statement was distributed to stockholders. The Board's failure to more thoroughly scrutinize Merrill Lynch's relationships was alleged as the predicate Board duty of care breach for Merrill's aiding and abetting liability. Based on the Delaware Supreme Court's decision in *Corwin v. KKR Financial Holdings LLC*,[238] the Chancery Court concluded "that when reviewing a board of directors' actions during a merger process after the merger has been approved by a majority of disinterested stockholders in a fully informed vote, the standard for finding a breach of the duty of care under BLR [the business judgment rule] is gross negligence." In this context the Chancery Court wrote that "the core inquiry . . . is whether there was a real effort to be informed and exercise judgment." The Court was troubled by the conduct of Merrill, but held that it was not "reasonably conceivable that the [Board] conduct amounted to 'reckless indifference or a gross abuse of discretions'" or that "the facts 'suggest a *wide* disparity between the process the directors used and [a process] which would have been rational.'" Because there were not sufficient allegations of a predicate fiduciary duty breach by the Board, the aiding and abetting claims against Merrill Lynch were dismissed.[239]

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235 *Id.* at 862-63.

236 Consol. C.A. No. 9388-VCP, 2015 WL 6551418, 2015 Del. Ch. LEXIS 249 (Del. Ch. Oct. 29, 2015).

237 *See supra* notes 222-225.

238 *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015), *affirming In re KKR Financial Holdings LLC Shareholder Litigation*, 101 A.3d 980 (Del. Ch. 2014); *see infra* note and related text.

239 In so holding, the Court in *Zale* distinguished the Chancery Court decision in *In re TIBCO Software, Inc. Stockholders Litigation*, Consol. C.A. No. 10319-CB, 2015 WL 6155894, 2015 Del. Ch. LEXIS 265 (Del. Ch. Oct. 20, 2015) (emphasis in original) (quoting *Guttman v. Huang*, 823 A.2d 492, 508 n.39 (Del. Ch. 2003)) as follows:

> Although the board in *TIBCO* was exculpated from monetary liability for a breach of the duty of care due to the 102(b)(7) provision in its charter, the Court found it reasonably conceivable that the financial advisor aided and abetted the board's duty of care breach by withholding the acquirer's reliance on the erroneous share count [the number of outstanding shares set forth in the merger agreement] in order to increase the odds of the merger being consummated, thereby earning a significantly larger fee for its services. * * * Whereas in *TIBCO* the Court focused on the board's duty to investigate and inquire further

2.2.5. Governing Authority and Document Limitations of Fiduciary Duties. Unlike the statutes governing partnerships and LLCs, neither the Tex. Corp. Stats. nor the DGCL include provisions generally recognizing the principle of freedom of contract for corporations.[240] The Tex. Corp. Stats. and the DGCL do, however, allow fiduciary duties or the consequences thereof to be modified by Charter provision or contract in some limited circumstances.

(a) Limitation of Director Liability. Both the DGCL and the Tex. Corp. Stats. allow corporations to provide limitations on (or partial elimination of) director liability in relation to the duty of care in their certificates of incorporation, but none of them authorizes the limitation of liability of officers. DGCL § 102(b)(7) reads as follows: DGCL § 102(b)(7) in effect permits a corporation to include a provision in its certificate of incorporation limiting or eliminating a director's personal liability for

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after the disclosure of the share count error, the focus of the inquiry in this case was on whether the Director Defendants discharged their duty of care when they first engaged Merrill Lynch.

240 *See* Edward P. Welch & Robert S. Saunders, *Freedom and its Limits in the Delaware General Corporation Law*, 33 Del. J. Corp. L. 845 (2008); DLLCA § 18-1101(a)-(f) (2017); E. Norman Veasey & Christine T. Di Guglielmo, *How Many Masters Can a Director Serve? A Look at the Tensions Facing Constituency Directors*, 63 Bus. Law. 761 (May 2008). The DLLCA aggressively adopts a "contracterian approach" (i.e., the bargains of the parties manifested in LLC Agreements are to be respected and rarely trumped by statute or common law) and does not have any provision which itself creates or negates Member or Manager fiduciary duties, but instead allows modification of fiduciary duties by an LLC Agreement as follows:

> **18-1101 CONSTRUCTION AND APPLICATION OF CHAPTER AND LIMITED LIABILITY COMPANY AGREEMENT.**
>
> (a) The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter.
>
> (b) It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.
>
> (c) To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.
>
> (d) Unless otherwise provided in a limited liability company agreement, a member or manager or other person shall not be liable to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement for breach of fiduciary duty for the member's or manager's or other person's good faith reliance on the provisions of the limited liability company agreement.
>
> (e) A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.
>
> (f) Unless the context otherwise requires, as used herein, the singular shall include the plural and the plural may refer to only the singular. The use of any gender shall be applicable to all genders. The captions contained herein are for purposes of convenience only and shall not control or affect the construction of this chapter.
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> * * *

DLLCA §§ 18-1101(a)-(f) are counterparts of, and virtually identical to, §§ 17-1101(a)-(f) of the Delaware Revised Limited Partnership Act ("DRLPA"). Thus, Delaware cases regarding partner fiduciary duties should be helpful in the LLC context.

monetary damages for breaches of the duty of care.[241] DGCL § 102(b)(7) does not authorize the liability of directors to be so limited or eliminated for breaches of the duty of loyalty, the failure to act in good faith, intentional misconduct, knowing violations of law, obtaining improper personal benefits, or paying dividends or approving stock repurchases in violation of DGCL § 174.[242] Delaware courts have routinely enforced DGCL § 102(b)(7) provisions and held that, pursuant to such provisions, directors cannot be held monetarily liable for damages caused by alleged breaches of the fiduciary duty of care.[243]

The Tex. Corp. Stats. contain provisions which are comparable to DGCL § 102(b)(7) and permit a corporation to include a provision in its Charter limiting or eliminating a director's personal liability for monetary damages for breaches of the duty of care.[244]

(b) <u>Renunciation of Corporate Opportunities</u>. Both Texas and Delaware law permit a corporation to renounce any interest in business opportunities presented to the corporation or one or more of its officers, directors or shareholders in its certificate of formation or by action of its board of

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241 *Id.*

242 *Id. See also Zirn v. VLI Corp.*, 621 A.2d 773, 783 (Del. 1993) (holding DGCL § 102(b)(7) provision in corporation's certificate did not shield directors from liability where disclosure claims involving breach of the duty of loyalty were asserted).

243 A DGCL § 102(b)(7) provision does not operate to defeat the validity of a plaintiff's claim on the merits, rather it operates to defeat a plaintiff's ability to recover monetary damages. *Emerald Partners v. Berlin*, 787 A.2d 85, 92 (Del. 2001). In determining when a DGCL § 102(b)(7) provision should be evaluated by the Court of Chancery to determine whether it exculpates defendant directors, the Delaware Supreme Court recently distinguished between cases invoking the business judgment presumption and those invoking entire fairness review (these standards of review are discussed below). *Id.* at 92-93. The Court determined that if a stockholder complaint unambiguously asserts solely a claim for breach of the duty of care, then the complaint may be dismissed by invocation of a DGCL § 102(b)(7) provision. *Id.* at 92. The Court held, however, that "when entire fairness is the applicable standard of judicial review, a determination that the director defendants are exculpated from paying monetary damages can be made only *after the basis* for their liability has been decided." *Id.* at 94. In such a circumstance, defendant directors can avoid personal liability for paying monetary damages only if they establish that their failure to withstand an entire fairness analysis was exclusively attributable to a violation of the duty of care. *Id.* at 98.

244 The Texas analogue to DGCL § 102(b)(7) is TBOC § 7.001, which provides in relevant part:

> (b) The certificate of formation or similar instrument of an organization to which this section applies [generally, corporations] may provide that a governing person of the organization is not liable, or is liable only to the extent provided by the certificate of formation or similar instrument, to the organization or its owners or members for monetary damages for an act or omission by the person in the person's capacity as a governing person.
>
> (c) Subsection (b) does not authorize the elimination or limitation of the liability of a governing person to the extent the person is found liable under applicable law for:
>
> > (1) a breach of the person's duty of loyalty, if any, to the organization or its owners or members;
> >
> > (2) an act or omission not in good faith that:
> >
> > (A) constitutes a breach of duty of the person to the organization; or
> >
> > (B) involves intentional misconduct or a knowing violation of law;
> >
> > (3) a transaction from which the person received an improper benefit, regardless of whether the benefit resulted from an action taken within the scope of the person's duties; or
> >
> > (4) an act or omission for which the liability of a governing person is expressly provided by an applicable statute.

TMCLA art. 1302-7.06 provides substantially the same.

directors.[245] While this allows a corporation to specifically forgo individual corporate opportunities or classes of opportunities, the type of judicial scrutiny applied to the decision to make any such renunciation of corporate opportunities will generally be governed by a traditional common law fiduciary duty analysis.[246]

(c) Interested Director Transactions. Both Texas and Delaware have embraced the principle that a transaction or contract between a director or officer and the corporation served is presumed to be valid and will not be void or voidable solely by reason of the interest of the director or officer as long as certain conditions are met.

DGCL § 144 provides that a contract between a director or officer and the corporation served will not be voidable due to the interest of the director or officer if (i) the transaction or contract is approved in good faith by a majority of the disinterested directors after the material facts as to the relationship or interest and as to the transaction or contract are disclosed or known to the directors, (ii) the transaction or contract is approved in good faith by shareholders after the material facts as to the relationship or interest and as to the transaction or contract is disclosed or known to the shareholders, or (iii) the transaction or contract is fair to the corporation as of the time it is authorized, approved, or ratified by the directors or shareholders of the corporation.[247] In *Fliegler v. Lawrence*, however, the Delaware Supreme Court held that where the votes of directors, qua stockholders, were necessary to garner stockholder approval of a transaction in which the directors were interested, the taint of director self-interest was not removed, and the transaction or contract may still be set aside and liability imposed on a director if the transaction is not fair to the corporation.[248] The question remains, however, whether approval by a

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245 TBOC § 2.101(21), TBCA art. 2.02(20); DGCL § 122(17).

246 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 2.1 (2d ed. 1997); *see generally id.* at § 4.36.

247 DGCL § 144 provides as follows:

> (a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because any such director's or officer's votes are counted for such purpose, if:
>
> (1) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or
>
> (2) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or
>
> (3) the contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.
>
> (b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction.

248 *Fliegler v. Lawrence*, 361 A.2d 218, 222 (Del. 1976). In *Sutherland v. Sutherland*, C.A. No. 2399-VCL, 2009 WL 857468, at *3, 2009 Del. Ch. LEXIS 46, at *9 (Del. Ch. March 23, 2009), *clarified by* No. 2399-VCL, 2009 Del. Ch. LEXIS 52 (Del. Ch. Apr. 22, 2009), the Court of Chancery held that an exculpatory provision in a corporation's certificate of incorporation purporting to immunize interested transactions from entire fairness review would effectively eviscerate the duty of loyalty

majority of disinterested stockholders will, pursuant to DGCL § 144(a)(2), cure any invalidity of director actions <u>and</u>, by virtue of the stockholder ratification, eliminate any director liability for losses from such actions.[249]

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for corporate directors and would, therefore, be void as contrary to the laws of Delaware and against public policy. The provision at issue in *Sutherland* read in pertinent part:

> Any director individually . . . may be a party to or may be pecuniarily or otherwise interested in any contract or transaction of the corporation, provided that the fact that he . . . is so interested shall be disclosed or shall have been known to the board of directors, or a majority thereof; and any director of the corporation, who is . . . so interested, may be counted in determining the existence of a quorum at any meeting of the board of directors of the corporation which shall authorize such contract or transaction, and may vote thereat to authorize any such contract or transaction, with like force and effect, as if he were not . . . so interested.

The Court construed the provision at issue to simply mean that interested directors may be counted toward a quorum; since the provision did not sanitize disloyal transactions, it was valid. The Court then proceeded to explain that if the provision would transmogrify an interested director into a disinterested one for the purposes of approving a transaction, it would be void:

> However, if, *arguendo*, the meaning of the provision is as the defendants suggest, interested directors would be treated as disinterested for the purposes of approving corporate transactions. Because approval by a majority of disinterested directors affords a transaction the presumptions of the business judgment rule, all interested transactions would be immunized from entire fairness analysis under this scheme. Thus, the only basis that would remain to attack a self-dealing transaction would be waste.
>
> The question that remains then is whether such a far-reaching provision would be enforceable under Delaware law. It would not. If the meaning of the above provision were as the defendants suggest, it would effectively eviscerate the duty of loyalty for corporate directors as it is generally understood under Delaware law. While such a provision is permissible under the Delaware Limited Liability Company Act and the Delaware Revised Uniform Limited Partnership Act, where freedom of contract is the guiding and overriding principle, it is expressly forbidden by the DGCL. Section 102(b)(7) of the DGCL provides that a corporate charter may contain a provision eliminating or limiting personal liability of a director for money damages in a suit for breach of fiduciary duty, so long as such provision does not affect director liability for "any breach of the director's duty of loyalty to the corporation or its stockholders. . . ."
>
> The effect of the provision at issue would be to do exactly what is forbidden. It would render any breach of the duty of loyalty relating to a self-dealing transaction beyond the reach of a court to remedy by way of damages. The exculpatory charter provision, if construed in the manner suggested by the defendants, would therefore be void as "contrary to the laws of this State" and against public policy. As such, it could not form the basis for a dismissal of claims of self-dealing.
>
> Thus, the charter provision, under either interpretation, provides no protection for the defendants beyond that afforded by Sections 144 of the DGCL. Because none of the safe-harbor provisions of Section 144(a)(1) or (a)(2) apply, the challenged interested transactions are not insulated on grounds of unfairness. 2009 WL 857468, at *4; 2009 Del. Ch. LEXIS 46, at *13-*15.

249 *See Michelson v. Duncan*, 407 A.2d 211, 219 (Del. 1979). In *Gantler v. Stephens*, 965 A.2d 695, 712 (Del. 2009), the Delaware Supreme Court found that stockholder approval of a going private stock reclassification proposal did not effectively ratify or cleanse the transaction for two reasons:

> First, because a shareholder vote was required to amend the certificate of incorporation, that approving vote could not also operate to "ratify" the challenged conduct of the interested directors. Second, the adjudicated cognizable claim that the Reclassification Proxy contained a material misrepresentation, eliminates an essential predicate for applying the doctrine, namely, that the shareholder vote was fully informed.

* * *

In 1985, Texas followed Delaware's lead in the area of interested director transactions and adopted TBCA article 2.35-1,[250] the predecessor to TBOC § 21.418. In general, these Tex. Corp. Stats. provide that a transaction between a corporation and one or more of its directors or officers will not be voidable solely by reason of that relationship if the transaction is approved by shareholders or disinterested directors after disclosure of the interest, or if the transaction is otherwise fair.[251] Because TBCA art. 2.35-1, as initially enacted, was essentially identical to DGCL § 144, some uncertainty on the scope of TBCA art. 2.35-1 arose because of *Fliegler*'s interpretation of DGCL § 144. This imposition of a fairness gloss on the Texas statute rendered the effect of the safe harbor provisions in TBCA article 2.35-1 uncertain.

In 1997, TBCA article 2.35-1 was amended to address the ambiguity created by *Fliegler* and to clarify that contracts and transactions between a corporation and its directors and officers or in which a director or officer has a financial interest are valid notwithstanding that interest as long as any one of the following are met: (i) the disinterested directors of the corporation approve the transaction after disclosure of the interest, (ii) the shareholders of the corporation approve the transaction after disclosure of the interest or (iii) the transaction is fair.[252] TBOC § 21.418 mirrors these clarifications. Under the Tex. Corp. Stats., if any one of these conditions is met, the contract will be considered valid notwithstanding the fact that the director or officer has an interest in the transaction.[253] These provisions rely heavily on the statutory definitions of "disinterested" contained in TBOC § 1.003 and TBCA art. 1.02. Under these definitions, a director will be considered "disinterested" if the director is not a party to the contract or transaction or does not otherwise have a material financial interest in the outcome of the contract.[254]

TBCA Article 2.35-1 also changed the general approach of the statute from a mere presumption that a contract is not voidable by reason of the existence of an affiliated relationship if certain conditions are met to an absolute safe harbor that provides that an otherwise valid contract will be valid if the specified conditions are met, a change retained by TBOC § 21.418 which was amended in the 2011 Texas Legislature Session.[255] Although the difference between the Texas and Delaware constructions is subtle, the

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> [T]he scope of the shareholder ratification doctrine must be limited to its so-called "classic" form; that is, to circumstances where a fully informed shareholder vote approves director action that does not legally require shareholder approval in order to become legally effective. Moreover, the only director action or conduct that can be ratified is that which the shareholders are specifically asked to approve. With one exception, the "cleansing" effect of such a ratifying shareholder vote is to subject the challenged director action to business judgment review, as opposed to "extinguishing" the claim altogether (i.e., obviating all judicial review of the challenged action).

250 TBOC § 21.418; TBCA art. 2.35-1.

251 TBOC § 21.418; TBCA art. 2.35-1; *see Landon v. S & H Marketing Group, Inc.*, 82 S.W.3d 666, 671 (Tex. App.—Eastland 2002, no pet.).

252 TBCA art. 2.35-1.

253 *Id.* art. 2.35-1(A); TBOC § 21.418(b).

254 TBOC § 21.418(b); TBCA art. 2.35-1(A).

255 TBOC § 21.418 (Contracts or Transactions Involving Interested Directors and Officers) was restructured in the 2011 Texas Legislature Session by S.B. 748 § 28 to make more clear its intent. TBOC § 21.418(a) was amended to clarify that it also applies to affiliates or associates of directors or officers that have the conflicting relationship or interest. TBOC § 21.418(b) was further amended to clarify that the contract or transaction is not void or voidable, and is valid and enforceable, notwithstanding the conflicting relationship or interest if the requirements of the Section are satisfied. Provisions formerly located in TBOC § 21.418(b) permitting the execution of a consent of directors, or the presence, participation or voting in the meeting of the board of directors, by the director or officer having the conflicting relationship or interest were moved to a new TBOC § 21.418(d). Finally, a new TBOC § 21.418(e) was added specifying that neither the corporation nor any

distinction is significant and provides more certainty as transactions are structured. However, these Tex. Corp. Stats. do not eliminate a director's or officer's fiduciary duty to the corporation.

of its shareholders have any cause of action against any of the conflicted officers or directors for breach of duty in respect of the contract or transaction because of such relationship or interest or the taking of any actions described by TBOC § 21.418(d). S.B. 748 § 28 reads as follows:

SECTION 28. Section 21.418, Business Organizations Code, is amended by amending Subsections (a) and (b) and adding Subsections (d) and (e) to read as follows:

(a) This section applies [only] to a contract or transaction between a corporation and:

(1) one or more [of the corporation's] directors or officers, or one or more affiliates or associates of one or more directors or officers, of the corporation; or

(2) an entity or other organization in which one or more [of the corporation's] directors or officers, or one or more affiliates or associates of one or more directors or officers, of the corporation:

(A) is a managerial official; or

(B) has a financial interest.

(b) An otherwise valid and enforceable contract or transaction described by Subsection (a) is valid and enforceable, and is not void or voidable, notwithstanding any relationship or interest described by Subsection (a), if any one of the following conditions is satisfied [~~notwithstanding that the director or officer having the relationship or interest described by Subsection (a) is present at or participates in the meeting of the board of directors, or of a committee of the board that authorizes the contract or transaction, or votes or signs, in the person's capacity as a director or committee member, a unanimous written consent of directors or committee members to authorize the contract or transaction, if~~]:

(1) the material facts as to the relationship or interest described by Subsection (a) 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

(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.

(c) Common or interested directors may be included in determining the presence of a quorum at a meeting of the corporation's board of directors or a committee of the board of directors that authorizes the contract or transaction.

(d) A person who has the relationship or interest described by Subsection (a) may:

(1) be present at or participate in and, if the person is a director or committee member, may vote at a meeting of the board of directors or of a committee of the board that authorizes the contract or transaction; or

(2) sign, in the person's capacity as a director or committee member, a unanimous written consent of the directors or committee members to authorize the contract or transaction.

(e) If at least one of the conditions of Subsection (b) is satisfied, neither the corporation nor any of the corporation's shareholders will have a cause of action against any of the persons described by Subsection (a) for breach of duty with respect to the making, authorization, or performance of the contract or transaction because the person had the relationship or interest described by Subsection (a) or took any of the actions authorized by Subsection (d).

Cf. Val D. Ricks, *Texas' So-Called "Interested Director" Statute*, 50 S. TEX. L. REV. 129 (Winter 2008).

CHAPTER 3. LIMITED PARTNERSHIPS.

3.1. General. A "limited partnership" is a partnership formed by two or more persons, with one or more general partners and one or more limited partners.[256] Delaware and most other states have adopted some form of the Uniform Limited Partnership Act or the Revised Uniform Limited Partnership Act to govern the rights, duties and liabilities of limited partnerships organized under such statutes. Delaware limited partnerships are governed by the Delaware Revised Limited Partnership Act ("DRLPA").[257] In Texas, all domestic limited partnerships are now governed by the TBOC.[258]

3.2. Fiduciary Duties.

3.2.1. Texas. Case law has adopted fiduciary standards for general partners of limited partnerships mirroring the unbending fiduciary standards espoused in general partnership cases.[259] Because of their control over partnership affairs, general partners may be subjected to an even higher fiduciary standard with respect to limited partners.[260] Those in control of the general partner have been held to the same high standards.[261]

Since a general partner in a limited partnership has the powers, duties and liabilities of a partner in a general partnership unless applicable law or the partnership agreement provides otherwise, a general

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256 TBOC § 1.002(50); TRLPA § 1.02(6).

257 DEL. CODE ANN. tit. 6, §§ 17-101 *et seq.* (Supp. 2017).

258 The TBOC provisions relating to limited partnerships are Title 1 and Chapters 151, 153, and 154, as well as certain provisions of Chapter 152. Such provisions may officially and collectively be referred to as "Texas Limited Partnership Law." TBOC § 1.008(g). Like other entities formed under Texas law, limited partnerships formed on or after January 1, 2006 are governed by the TBOC,[258] and those formed prior to January 1, 2006 which did not voluntarily opt into the TBOC continued to be governed by the TRLPA until January 1, 2010.[258] Because from January 1, 2006 until January 1, 2010 some limited partnerships were governed by the TRLPA and others by the TBOC and because the substantive principles under both statutes are generally the same, the term "Tex. LP Stats." is used herein to refer to the TBOC and the TRPA collectively, and the particular differences between the TRLPA and the TBOC are referenced as appropriate.

259 *See Hughes v. St. David's Support Corp.*, 944 S.W.2d 423, 425–26 (Tex. App.—Austin 1997, writ denied) (holding that "in a limited partnership, the general partner stands in the same fiduciary capacity to the limited partners as a trustee stands to the beneficiaries of a trust."); *McLendon v. McLendon*, 862 S.W.2d 662, 676 (Tex. App.—Dallas 1993, writ denied), *disapproved of by Tex. Commerce Bank, N.A. v. Grizzle*, 96 S.W.3d 240 (Tex. 2002) (holding that "in a limited partnership, the general partner acting in complete control stands in the same fiduciary capacity to the limited partners as a trustee stands to the beneficiaries of a trust."); *Crenshaw v. Swenson*, 611 S.W.2d 886, 890 (Tex. Civ. App.—Austin 1980, writ ref'd n.r.e.); *Watson v. Ltd. Partners of WCKT, Ltd.*, 570 S.W.2d 179, 182 (Tex. Civ. App.—Austin 1978, writ ref'd n.r.e.); Robert W. Hamilton, *Corporate General Partners of Limited Partnerships*, 1 J. SMALL & EMERGING BUS. L. 73, 73 (1997) (stating that "[g]eneral partners are personally liable for all partnership obligations, including breaches of fiduciary duties owed to the limited partners."); *see also Huffington v. Upchurch*, 532 S.W.2d 576 (Tex. 1976); *Johnson v. Peckham*, 120 S.W.2d 786 (Tex. 1938); *Kunz v. Huddleston*, 546 S.W.2d 685 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.).

260 In *Palmer v. Fuqua*, 641 F.2d 1146, 1155 (5th Cir. 1981), the Fifth Circuit noted that under Texas law a general partner having exclusive power and authority to control and manage the limited partnership "owe[s] the limited partners an even greater duty than is normally imposed [upon general partners]."

261 *See In re Bennett*, 989 F.2d 779, 790 (5th Cir. 1993), *opinion amended on reh'ing*, No. 91-1059, 1993 WL 268299 (5th Cir. July 15, 1993) (explaining that when a partner is in complete control of the partnership, the partner owes the highest level of fiduciary duty); *In re USA Cafes, L.P. Litig.*, 600 A.2d 43 (Del. Ch. 1991) (in holding that directors of corporate general partner of limited partnership owe fiduciary duties to the partnership and its limited partners, the court wrote: "those affiliates of a general partner who exercise control over the partnership's property may find themselves owing fiduciary duties to both the partnership and its limited partners").

partner in a limited partnership has the duties of care and loyalty set forth in TBOC §152.204 and TRPA § 4.04,[262] which basically codify those duties without giving them the "fiduciary" appellation.[263] Since Tex. LP Stats. provide that a general partner's conduct is not to be measured by trustee standards, it may no longer be appropriate to measure general partner conduct in terms of trustee fiduciary standards.[264] Courts, however, continue to refer to the trustee standard.[265]

A general partner in a limited partnership owes the duties of care and loyalty to the partnership and the other partners.[266] The Tex. LP Stats. define the duty of care as requiring a partner to act in the conduct and winding up of the partnership business with the care of an ordinarily prudent person under similar circumstances.[267] An error in judgment does not by itself constitute a breach of the duty of care.[268] Further, a general partner is presumed to satisfy the duty of care if the partner acts on an informed basis, in good faith and in a manner the partner reasonably believes to be in the best interest of the partnership.[269]

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262 TBOC § 152.204 provides as follows:

> Sec. 152.204. GENERAL STANDARDS OF PARTNER'S CONDUCT. (a) A partner owes to the partnership, the other partners, and a transferee of a deceased partner's partnership interest as designated in Section 152.406(a)(2):
>
> (1) a duty of loyalty; and
>
> (2) a duty of care.
>
> (b) A partner shall discharge the partner's duties to the partnership and the other partners under this code or under the partnership agreement and exercise any rights and powers in the conduct or winding up of the partnership business:
>
> (1) in good faith; and
>
> (2) in a manner the partner reasonably believes to be in the best interest of the partnership.
>
> (c) A partner does not violate a duty or obligation under this chapter or under the partnership agreement merely because the partner's conduct furthers the partner's own interest.
>
> (d) A partner, in the partner's capacity as partner, is not a trustee and is not held to the standards of a trustee.

263 TBOC §§ 153.003, 153.152; TRLPA §§ 4.03(b), 13.03. TBOC § 153.152 provides:

> Sec. 153.152. GENERAL POWERS AND LIABILITIES OF GENERAL PARTNER. (a) Except as provided by this chapter, the other limited partnership provisions, or a partnership agreement, a general partner of a limited partnership:
>
> (1) has the rights and powers and is subject to the restrictions of a partner in a partnership without limited partners; and
>
> (2) has the liabilities of a partner in a partnership without limited partners to the partnership and to the other partners.
>
> (b) Except as provided by this chapter or the other limited partnership provisions, a general partner of a limited partnership has the liabilities of a partner in a partnership without limited partners to a person other than the partnership and the other partners.

See Erin Larkin, *What's in a Word? The Effect on Partners' Duties after Removal of the Term "Fiduciary" in the Texas Revised Partnership Act*, 59 BAYLOR L. REV. 895 (2007).

264 TBOC § 152.204(d); TRPA § 4.04(f).

265 *See McBeth v. Carpenter*, 565 F.3d 171 (5th Cir. 2009); *Hughes v. St. David's Support Corp.,* 944 S.W.2d 423, 425-26 (Tex. App.—Austin 1997, writ denied).

266 TBOC § 152.204(a); TRPA § 4.04(a).

267 TBOC § 152.206(a); TRPA § 4.04(c).

268 TBOC § 152.206(a); TRPA § 4.04(c).

269 TBOC §§ 152.204(b), 152.206; TRPA § 4.04(c)-(d).

These provisions draw on the corporate business judgment rule in articulating the duty of care. Nevertheless, Texas law does not specify whether the standard of care is one of simple or gross negligence. The sparse case law in this area (pre-dating the TRPA) indicates that a general partner will not be held liable for mere negligent mismanagement.[270]

In Texas, the duty of loyalty is defined as including:[271]

1. accounting to the partnership and holding for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business or from use by the partner of partnership property;

2. refraining from dealing with the partnership on behalf of a party having an interest adverse to the partnership; and

3. refraining from competing with the partnership or dealing with the partnership in a manner adverse to the partnership.

These provisions in the Tex. LP Stats. mirror the common areas traditionally encompassed by the duty of loyalty (e.g., self-dealing, conflicts of interest and usurpation of partnership opportunity).[272] To temper some of the broader expressions of partner duties in older Texas case law and permit a balancing analysis as in the corporate cases, Texas law specifically states that a partner does not breach a duty merely because his conduct furthers his own interest and that the trustee standard should not be used to test general partner conduct.[273] It does, however, impose on a general partner in a limited partnership the obligation to discharge any duty, and exercise any rights or powers, in conducting or winding up partnership business in good faith and in a manner that the partner reasonably believes to be in the best interest of the partnership.[274]

Under the TBOC limited partners, as limited partners, generally do not owe fiduciary duties to the partnership or to other partners.[275] Previously, a literal reading of the TRPA and TRLPA suggested that limited partners owed such duties by virtue of the linkage of TRPA to TRLPA under TRLPA section 13.03(a).[276] That literal interpretation of the statutes, however, was contrary to the general concept that

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270 *See Ferguson v. Williams*, 670 S.W.2d 327, 331 (Tex. App.—Austin 1984, writ ref'd n.r.e.).

271 TBOC § 152.205; TRPA § 4.04(b).

272 Under Texas law, persons engaged in a partnership owe to one another one of the highest duties recognized in law—the duty to deal with one another with the utmost good faith and most scrupulous honesty. *See Huffington v. Upchurch*, 532 S.W.2d 576, 579 (Tex. 1976); *Smith v. Bolin*, 271 S.W.2d 93, 96 (Tex. 1954); *Johnson v. J. Hiram Moore, Ltd.*, 763 S.W.2d 496, 497 (Tex. App.—Austin 1988, writ denied); *see also Brazosport Bank of Tex. v. Oak Park Townhouses*, 837 S.W.2d 652, 659 (Tex. App.—Houston [14th Dist.] 1992, writ granted), *rev'd on other grounds*, 851 S.W.2d 189 (Tex. 1993); *Crenshaw v. Swenson*, 611 S.W.2d 886, 890 (Tex. Civ. App.—Austin 1980, writ ref'd n.r.e.).

273 TBOC § 152.204(c)-(d); TRPA § 4.04(e)-(f).

274 TBOC § 152.204(b); TRPA § 4.04(d).

275 TBOC §§ 153.003(b) ("The powers and duties of a limited partner shall not be governed by a provision of Chapter 152 [the TBOC Chapter dealing with general partnerships] that would be inconsistent with the nature and role of a limited partner as contemplated by this chapter [153]") and 153.003(c) ("A limited partner shall not have any obligation or duty of a general partner solely by reason of being a limited partner").

276 TRLPA § 13.03(a) provides: "In any case not provided by [TRLPA], the applicable statute governing partnerships that are not limited partnerships [TRPA] and the rules of law and equity, including the law merchant, govern."

limited partners are merely passive investors and thus should not be subjected to liability for their actions as limited partners. Further, even before the TBOC was enacted there was some case law to the effect that limited partners do not have fiduciary duties.[277] Pre TBOC, an exception was made to this general rule in the case where a limited partner actually had or exercised control in management matters (e.g., because of control of the general partner, contractual veto powers over partnership actions or service as an agent of the partnership).[278] In such situations, the limited partner's conduct could be judged by fiduciary principles.[279]

The Tex. LP Stats. state in part that except as provided in various statutory provisions or the partnership agreement, a general partner of a limited partnership "has the liabilities of a partner in a partnership without limited partners to the partnership and to the other partners."[280] This language

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277 *See, e.g., Strebel v. Wimberly II*, 371 S.W.3d 267 (Tex. App.—Houston [1st Dist.] 2012, pet. denied); *In re Villa West Assocs.*, 146 F.3d 798, 806 (10th Cir. 1998); *In re Kids Creek Partners, L.P.*, 212 B.R. 898, 937 (Bankr. N.D. Ill. 1997).

278 *McBeth v. Carpenter*, 565 F.3d 171 (5th Cir. 2009) (limited partnerships controlled by the same individual who controlled the general partner, and whose individual conduct was held to violate his fiduciary duties to the limited partners, were held to have fiduciary duties to the other limited partners).

279 *See RJ Assocs., Inc. v. Health Payors' Org. Ltd. P'ship, HPA, Inc.*, No. 16873, 1999 WL 550350, at *10, 1999 Del. Ch. LEXIS 161, at *34-*35 (Del. Ch. July 16, 1999) (suggesting that, unless a partnership agreement provides to the contrary, any limited partner owes fiduciary duties to the partnership); *KE Prop. Mgmt. Inc. v. 275 Madison Mgmt. Inc.*, Civ. A. No. 12683, 1993 WL 285900, at *4, 1993 Del. Ch. LEXIS 147, at *12-*13 (Del. Ch. July 27, 1993). Limited partners who function as officers or managers of a limited partnership are typically considered agents of the limited partnership, and as agents to owe fiduciary duties, including the duty of loyalty, to the limited partnership and its other partners. *See* RESTATEMENT (SECOND) OF THE LAW OF AGENCY (1958) §§ 13 ("An agent is a fiduciary with respect to matters within the scope of his agency"), 387 ("Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency"), 393 ("Unless otherwise agreed, an agent is subject to a duty not to compete with the principal concerning the subject matter of his agency"), 394 ("Unless otherwise agreed, an agent is subject to a duty not to act or to agree to act during the period of his agency for persons whose interests conflict with those of the principal in matters in which the agent is employed"), and 395 ("Unless otherwise agreed, an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of his duties as agent, in competition with or to the injury of the principal, on his own account or on behalf of another, although such information does not relate to the transaction in which he is then employed, unless the information is a matter of general knowledge"); *see also Daniel v. Falcon Interest Realty Corp.*, 190 S.W.3d 177, 180 (Tex. App.—Houston [1st Dist.] 2005, no pet.).

280 TBOC § 153.152(a); TRLPA § 4.03(b). This language should *not* be mistaken as an authorization for partnership agreements to alter partner liabilities to third parties. *See infra* notes and related text regarding the LLP provisions in the TBOC and TRPA which permit a general partnership to significantly limit the individual liability of its partners for certain acts of other partners by the partnership making a specified LLP filing with the Secretary of State and complying with the other requirements of the Tex. LLP Stats.

The implied contractual duty of good faith and fair dealing is a duty of a general partner, in addition to the general partner's fiduciary duties. *See Johnson v. Peckham*, 132 Tex. 148, 120 S.W.2d 786, (1938) (partner purchasing other's partnership owes "the highest duty of honesty and fair dealing in making the trade"); *Cole v. Hall*, 864 S.W.2d 563 (Tex. App.—Dallas 1993, writ dism'd w.o.j.) ("A claim for breach of duty of good faith and fair dealing is a tort action that arises from an underlying contract…Texas does not recognize an implied duty of good faith and fair dealing in every contract or business transaction…Texas courts have carved out exceptions for certain 'special relationships', such as those between insurers and insured, principal and agent, joint venturers, and partners"); *see also English v. Fischer*, 660 S.W.2d 521, 524 (Tex. 1983) (implied covenant of good faith and fair dealing exists in partnerships, particularly when purchasing another partnership interest), *Swanson v. Schlumberger*, 895 S.W.2d 719, 736 (Tex. App.—Texarkana 1994, no writ), *Morgan v. Arnold*, 441 S.W.2d 897 (Tex.Civ.App.—Dallas 1969, writ ref'd n.r.e.), *Inman v. Parr*, 311 S.W.2d 658 (Tex.Civ.App.—Beaumont 1958, writ ref'd n.r.e.); *Fitz-Gerald v. Hull*, 150 Tex. 39, 237 S.W.2d 256 (1951) (joint adventurers owe one another an obligation of utmost good faith). *See Dunnagan v. Watson*, 204 S.W.3d 30 (Tex. App.—Ft. Worth 2006, *pet. denied*); RESTATEMENT (SECOND) OF CONTRACTS § 205 ("every contract imposes upon each party a duty of good faith and fair dealing in its performance and indicates that the partnership agreement may modify the internal liabilities of a general partner. Although there are questions whether it is an authorization without express limits or whether it would link to Texas general partnership statutes that prohibit elimination of duties and set a "manifestly unreasonable" floor for contractual variation,[281] in *Strebel v. Wimberly II*[282] the Court denied a limited partner's claims for general partner breach of fiduciary duty on the basis of a limited partnership agreement provision that "the General Partner shall have no duties (including fiduciary duties) except as expressly set forth in this Agreement." In the 2013 Legislative Session, TBOC § 7.001(d)(2) was amended to provide that the liability of a general partner may be limited or eliminated "in a limited partnership by its partnership agreement to the same extent [TBOC § 7.001] Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections apply [a for-profit corporation] and to the additional extent permitted under Chapter 153 and, to the extent applicable to limited partnerships, Chapter 152."

Under the Tex. LP Stats., the duties of care and loyalty and the obligation of good faith may not be eliminated by the partnership agreement, but the statute leaves room for some modification by contract.[283] For example, the partnership agreement may not eliminate the duty of care, but may determine the standards by which the performance of the obligation is to be measured, if the standards are not "manifestly unreasonable."[284] In one case decided prior to the passage of the TRPA or the TBOC, the Court stated that, when the parties bargain on equal terms, a fiduciary may contract for the limitation of liability, though public policy would preclude limitation of liability for self-dealing, bad faith, intentional adverse acts, and reckless indifference with respect to the interest of the beneficiary.[285]

With respect to a partner's duty of loyalty, Tex. LP Stats. provide that the partnership agreement may not eliminate the duty of loyalty, but may identify specific types or categories of activities that do not violate the duty of loyalty, again if not "manifestly unreasonable."[286] The level of specificity required of provisions in the partnership agreement limiting duties pursuant to Tex. LP Stats. is unknown. In fact, it may depend upon the circumstances, such as the sophistication and relative bargaining power of the parties, the scope of the activities of the partnership, etc.

Tex. LP Stats. provide that the obligation of good faith may not be eliminated by the partnership agreement, but the agreement may determine the standards by which the performance is to be measured

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its enforcement"). This contractual duty of good faith and fair dealing is to be contrasted with the fiduciary duty of good faith, which is a component of the common law fiduciary duty of loyalty. *See also infra* note 352.

281 *See* TBOC § 152.002(b); TRPA § 1.03(b). "Partnership agreement" is defined to be either a written *or oral* agreement of the partners concerning the affairs of the partnership and the conduct of its business. *See* TBOC § 151.001(5); TRLPA § 1.02(10) (emphasis added).

Some TRLPA provisions permit modification by either a written or oral partnership agreement, while others require the modification to be in the form of a written partnership agreement. *Compare* TBOC § 153.152 and TRLPA § 4.03(a) concerning restrictions on a general partner *with* TRLPA § 11.02 and TBOC § 8.103(c) concerning indemnification of a general partner.

282 371 S.W.3d 267 (Tex. App.—Houston [1st Dist.] 2012, pet. denied).

283 TBOC §§ 152.002(b); 153.003(a); TRLPA §§ 4.03(b), 13.03(a); TRPA §§ 1.03(b), 4.04.

284 TBOC § 152.002(b)(3); TRLPA §§ 4.03(b), 13.03(a); TRPA §§ 1.03(b)(3), 4.04.

285 *Grider v. Boston Co., Inc.*, 773 S.W.2d 338, 343 (Tex. App.—Dallas 1989, writ denied), *disapproved by Tex. Commerce Bank, N.A. v. Grizzle*, 96 S.W.3d 240, 250-51 n.42 (Tex. 2002).

286 TBOC §§ 152.002(b)(2), 153.003(a); TRLPA §§ 4.03(b), 13.03(a); TRPA §§ 1.03(b)(2), 4.04.

if not "manifestly unreasonable."[287] Again the parameters of this provision are not readily apparent and probably will depend, at least in part, on the circumstances of any particular case.

Texas law requires a limited partnership to keep in its registered office, and make available to the partners for copying and inspection, certain minimum books and records of the partnership.[288] This mandate provides a statutory mechanism by which a partner may obtain the documents specified therein, but should not be viewed as in any way limiting a general partner's broader fiduciary duty of candor regarding partnership affairs as developed in case law and as provided in Tex. LP Stats.[289]

3.2.2. Delaware. Delaware concepts of general partner fiduciary duties generally parallel Texas law, and are framed in the Delaware statutes.[290] Delaware, however, expressly allows the limitation or elimination of partner fiduciary duties in the partnership agreement, but expressly does not allow the elimination of the implied contractual covenant of good faith and fair dealing which Delaware recognizes in all partnership agreements.[291] Although limitations on fiduciary duty in a partnership agreement may be

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287 TBOC §§ 152.002(b)(4), 153.003(a); TRLPA §§ 4.03(b), 13.03(a); TRPA §§ 1.03(b)(4), 4.04.

288 TBOC §§ 153.551, 153.552; TRLPA § 1.07.

289 *See* TBOC §§ 153.551, 153.552; TRPA § 4.03.

290 The duties of a partner in a Delaware general partnership are set forth in Section 15-404 of the Delaware Revised Uniform Partnership Act ("DRPA"), DEL. CODE ANN. tit. 6, §§ 15-101 *et seq.* (Supp. 2017). Section 15-404(a)-(d) of DRPA provides, in part, as follows:

> **§ 15-404. General standards of partner's conduct.**
>
> (a) The only fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care set forth in subsections (b) and (c) of this section.
>
> (b) A partner's duty of loyalty to the partnership and the other partners is limited to the following:
>
> (1) To account to the partnership and hold as trustee for it any property, profit or benefit derived by the partner in the conduct or winding up of the partnership business or affairs or derived from a use by the partner of partnership property, including the appropriation of a partnership opportunity;
>
> (2) To refrain from dealing with the partnership in the conduct or winding up of the partnership business or affairs as or on behalf of a party having an interest adverse to the partnership; and
>
> (3) To refrain from competing with the partnership in the conduct of the partnership business or affairs before the dissolution of the partnership.
>
> (c) A partner's duty of care to the partnership and the other partners in the conduct and winding up of the partnership business or affairs is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.
>
> (d) A partner does not violate a duty or obligation under this chapter or under the partnership agreement solely because the partner's conduct furthers the partner's own interest.

Section 17-403(a) of the Delaware Revised Limited Partnership Act ("DRLPA), DEL. CODE ANN. tit. 6, §§ 17-101 *et seq.* (Supp. 2017), makes the DRPA § 15-404 fiduciary duties applicable to the general partner of a limited partnership as follows:

> **§ 17-403. General powers and liabilities.**
>
> (a) Except as provided in this chapter or in the partnership agreement, a general partner of a limited partnership has the rights and powers and is subject to the restrictions of a partner in a partnership that is governed by the Delaware Uniform Partnership Law in effect on July 11, 1999 (6 Del. C. § 1501 et seq.).

291 Section 17-1101(b)-(f) of DRLPA provides as follows:

> (b) The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter.
>
> (c) It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements.

respected by courts when they are expressly set forth in the four corners of the partnership agreement, "a topic as important as this should not be addressed coyly."[292]

> (d) To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, the partner's or other person's duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.
>
> (e) Unless otherwise provided in a partnership agreement, a partner or other person shall not be liable to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement for breach of fiduciary duty for the partner's or other person's good faith reliance on the provisions of the partnership agreement.
>
> (f) A partnership agreement may provide for the limitation of elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a partner or other person to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement; provided, that a partnership agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

See RESTATEMENT (SECOND) OF CONTRACTS § 205 ("every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement"). This contractual duty of good faith and fair dealing is to be contrasted with the fiduciary duty of good faith, which is a component of the common law fiduciary duty of loyalty. *See Stone v. Ritter*, 911 A.2d 362 (Del. 2006); Byron F. Egan, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations* at 13-15 and 435-443, University of Texas School of Law 36th Annual Conference on Securities Regulation and Business Law (Feb. 14, 2014), *available at* http://www.jw.com/publications/article/1945.

See Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 25 (2007), in which Delaware Supreme Court Chief Justice Steele argues that parties forming limited partnerships and companies should be free to adopt or reject some or all of the fiduciary duties recognized at common law in the context of corporations, that courts should look to the parties' agreement and apply a contractual analysis, rather than analogizing to traditional notions of corporate governance, in limited partnership and LLC fiduciary duty cases, and that Delaware courts should analyze limited partnership fiduciary duty cases as follows:

> The courts' approach should be, first, to examine the agreement to determine if the act complained of is legally authorized by statute or by the terms of the agreement itself. If so, a court should then proceed to inquire whether the implementation of the lawful act requires equity to intervene and craft a remedy? At this point, the court should look to the agreement to determine the extent to which it establishes the duties and liabilities of the parties, i.e., their bargained for, negotiated, contractual relationship. Is the agreement silent about traditional fiduciary duties, but creates a fiduciary relationship consistent with those duties thus allowing the court to imply them by default? Does the agreement expand, restrict, or eliminate one or more of the traditional fiduciary duties? Is the contract language creating those duties and liabilities so inconsistent with common law fiduciary duty principles that it can be concluded that the parties consciously modified them in a discernible way? If so, which duties and in what respect were they modified? Finally, without regard to traditional overlays of scrutiny under the common law of corporate governance, has a party breached its implied covenant of good faith and fair dealing?

See infra note 371 regarding former Chief Justice Steele's views in respect of fiduciary duties in the LLC context.

292 *Miller v. Am. Real Estate Partners, L.P.*, C.A. No. 16788, 2001 WL 1045643, 2001 Del. Ch. LEXIS 116 (Del. Ch. Sept. 6, 2001). In *Miller*, the general partner contended that the partnership agreement eliminated any default fiduciary duty of loyalty owed by the general partner to the limited partners in section 6.13(d) of the partnership agreement, which read as follows:

> Whenever in this Agreement the General Partner is permitted or required to make a decision (i) in its "sole discretion" or "discretion", with "absolute discretion" or under a grant of similar authority or latitude, the General Partner shall be entitled to consider only such interests and factors as it desires and shall have no duty or obligation to give any consideration to any interest of or factors affecting the Partnership, the Operating Partnership or the Record Holders, or (ii) in its "good faith" or under another express standard, the General

> Partner shall act under such express standard and shall not be subject to any other or different standards imposed by this Agreement or any other agreement contemplated herein.

2001 WL 1045643, at *6, 2001 Del. Ch. LEXIS 116, at *19-*20

In finding that the foregoing provision was not adequate to eliminate the general partner's fiduciary duty of loyalty, then Vice Chancellor and now Chief Justice Strine wrote:

> This is yet another case in which a general partner of a limited partnership contends that the partnership agreement eliminates the applicability of default principles of fiduciary duty, and in which this court finds that the drafters of the agreement did not make their intent to eliminate such duties sufficiently clear to bar a fiduciary duty claim. Here, the drafters of the American Real Estate Partners, L.P. partnership agreement did not clearly restrict the fiduciary duties owed to the partnership by its general partner, a defendant entity wholly owned by defendant Carl Icahn. Indeed, the agreement seems to contemplate that the general partner and its directors could be liable for breach of fiduciary duty to the partnership if they acted in bad faith to advantage themselves at the expense of the partnership.
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> * * *
>
> Once again, therefore, this court faces a situation where an agreement which does not expressly preclude the application of default principles of fiduciary is argued to do so by implication. Indeed, this case presents the court with an opportunity to address a contractual provision similar to the one it interpreted on two occasions in *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, and contemporaneously with this case in *Gelfman v. Weeden Investors, L.P.* In each of those cases, this court held that the traditional fiduciary entire fairness standard could not be applied because it was inconsistent with a contractual provision providing a general partner with sole and complete discretion to effect certain actions subject solely to a contract-specific liability standard. The court's decision was based on two factors. First, the court noted the difference between the sole and complete discretion standard articulated in the agreements, which explicitly stated that the general partner had no duty to consider the interests of the partnership or the limited partner in making its decisions, and the traditional notion that a fiduciary acting in a conflict situation has a duty to prove that it acted in a procedurally and substantively fair manner. Second, and even more critically, however, each of the agreements indicated that when the sole and complete discretion standard applied, any other conflicting standards in the agreements, other contracts, or under law (including the DRULPA) were to give way if it would interfere with the general partners' freedom of action under the sole and complete discretion standard. That is, in each case, the agreement expressly stated that default principles of fiduciary duty would be supplanted if they conflicted with the operation of the sole and complete discretion standard.
>
> This case presents a twist on *Gotham Partners* and *Gelfman*. Like the provisions in *Gotham Partners* and *Gelfman*, § 6.13(d) sets forth a sole discretion standard that appears to be quite different from the duty of a fiduciary to act with procedural and substantive fairness in a conflict situation. What is different about § 6.13(d), however, is that it does not expressly state that default provisions of law must give way if they hinder the General Partner's ability to act under the sole discretion standard. Rather, § 6.13(d) merely states that other standards in the Agreement or agreements contemplated by the agreement give way to the sole discretion standard. By its own terms, § 6.13(d) says nothing about default principles of law being subordinated when the sole discretion standard applies.
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> * * *
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> This court has made clear that it will not be tempted by the piteous pleas of limited partners who are seeking to escape the consequences of their own decisions to become investors in a partnership whose general partner has clearly exempted itself from traditional fiduciary duties. The DRULPA puts investors on notice that fiduciary duties may be altered by partnership agreements, and therefore that investors should be careful to read partnership agreements before buying units. In large measure, the DRULPA reflects the doctrine of *caveat emptor*, as is fitting given that investors in limited partnerships have countless other investment opportunities available to them that involve less risk and/or more legal protection. For example, any investor who wishes to retain the protection of traditional fiduciary duties can always invest in corporate stock.
>
> But just as investors must use due care, so must the drafter of a partnership agreement who wishes to supplant the operation of traditional fiduciary duties. In view of the great freedom afforded to such drafters and the reality that most publicly traded limited partnerships are governed by agreements drafted exclusively by

A series of Delaware Supreme Court decisions issued between 2013 and 2017 involving transactions by a publicly traded master limited partnership ("MLP")[293] with a related party address the effectiveness of contractual provisions in a limited partnership agreement ("LPA") that modify or eliminate default fiduciary duties and substitute therefor contractual "safe harbors" to cleanse conflicted transactions.[294] These opinions can be viewed as a roadmap to the wording, pitfalls and alternatives to be considered when structuring M&A transactions involving alternative entities.[295]

Four of these recent decisions reaffirm the effectiveness of LPA provisions that modify or eliminate default fiduciary duties of the MLP's general partner and substitute therefor contractual "safe harbors" to cleanse conflicted transactions. Other decisions illustrate that the express terms of the LPA or the implied contractual covenant of good faith and fair dealing (which parties may not contractually eliminate) can provide the basis for challenging an unfair M&A transaction even where default fiduciary duties have been clearly eliminated in the MLP's LPA.[296]

In *Allen v. Encore Energy Partners, L.P.*,[297] a case involving a merger of an MLP with its general partner's ultimate parent (its "controller"), a limited partner alleged that the general partner, its controller and its directors breached the contractual duties imposed by the LPA in connection with the merger. The

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> the original general partner, it is fair to expect that restrictions on fiduciary duties be set forth clearly and unambiguously. A topic as important as this should not be addressed coyly.

2001 WL 1045643, at *1-*8, 2001 Del. Ch. LEXIS 116, at *1-*28.

293 In *Brinckerhoff v. Enbridge Energy Company, Inc.*, 159 A.3d 242, 245 (Del. 2017) ("*Brinckerhoff IV*"), the Delaware Supreme Court explained MLPs as follows:

> As followers of this investment space know, MLPs are set up in the petroleum transportation business to allow sponsors and public investors to take advantage of favorable tax laws. Another benefit under Delaware law is the ability to eliminate common law duties in favor of contractual ones, thereby restricting disputes to the four corners of the limited partnership agreement ("LPA").
>
> MLPs are typically families of entities that often engage in internal business transactions, referred to as dropdowns, rollups, insider financings, incentive distribution rights, and equity investments. Because the entities proposing transactions often have representatives seated at both sides of the negotiating table, the LPAs typically attempt to address conflicts using various contractual tools. Even so, disputes still arise over whether the conflicted parties have complied with the letter and spirit of the LPA.

MLPs have also been used for other assets, including amusement parks, mineral interests, real estate and timber.

294 Examples of these decisions were listed in *Brinckerhoff IV*, 159 A.3d at 245 n.1, as follows:

> *E.g.*, *Dieckman v. Regency GP LP*, 155 A.3d 358, 2017 WL 243361, (Del. 2017); *El Paso Pipeline GP Co., L.L.C. v. Brinckerhoff*, 152 A.3d 1248 (Del. 2016); *Employees Ret. Sys. of the City of St. Louis v. TC Pipelines GP, Inc.*, 2016 WL 7338592, 152 A.3d 1248 (Del. Dec. 19, 2016) (TABLE); *Haynes Family Trust v. Kinder Morgan G.P., Inc.*, 2016 WL 912184, 135 A.3d 76 (Del. March 10, 2016) (TABLE); *Allen v. El Paso Pipeline GP Co., L.L.C.*, 2015 WL 803053 (Del. Feb. 26, 2015) (TABLE); *Allen v. Encore Energy Partners, L.P.*, 72 A.3d 93 (Del. 2013); *Gerber v. Enter. Prods. Holdings, LLC*, 67 A.3d 400 (Del. 2013) *overruled on other grounds by Winshall v. Viacom Intern., Inc.*, 76 A.3d 808 (Del. 2013); *Norton v. K–Sea Transp. Partners L.P.*, 67 A.3d 354 (Del. 2013); *Brinckerhoff v. Enbridge Energy Co.*, 67 A.3d 369 (Del. 2013).

295 "Alternative entities" are unincorporated entities, including general and limited partnerships and limited liability companies, in which the relationships among the key players can be defined by contract under the applicable Delaware statutes, which provide that common law fiduciary duties may be limited or eliminated in a partnership or limited liability company agreement.

296 *Gerber v. Enter. Prods. Hldgs., LLC*, 67 A.3d 400, 404 (Del. 2013), *overruled in part on other grounds by Winshall v. Viacom Int'l, Inc.*, 76 A.3d 808, 815 n.13 (Del. 2013).

297 72 A.3d 93, 95 (Del. 2013).

Supreme Court confirmed the enforceability of clear, express and unambiguous language in an LPA replacing default fiduciary duties with a contractual duty that would be satisfied if the transaction at issue was approved in "good faith" (as defined by the LPA) by the Conflicts Committee of independent directors on the general partner's Board. The LPA replaced common law fiduciary duties with a contractually adopted duty of "subjective good faith" and deemed this contractual duty to be satisfied if a Committee of independent directors of the general partner's Board grants "Special Approval" to a transaction, so long as the independent directors themselves act with subjective good faith.[298] The Court concluded that the contractual "good faith" standard under the LPA required only a subjective belief that the determination or other action is in the best interests of the limited partnership:

> The LPA's contractual duty require[d] a "belie[f] that the determination or other action is in the best interests of the Partnership." *Black's Law Dictionary* defines *believe* as "[t]o feel certain about the truth of; to accept as true," whereas it defines *reasonably believe* as "[t]o believe (a given fact or combination of facts) under circumstances in which a reasonable person would believe." Some LPA provisions use "reasonably believes," while others use "believes," indicating that the parties intentionally distinguished between those two standards. Therefore, we conclude that the Vice Chancellor correctly defined this LPA's contractual duty of good faith when he stated that "an act is in good faith if the actor *subjectively believes* that it is in the best interests of the Partnership." This definition distinguishes between "reasonably believes" and "believes" and eschews an objective standard when interpreting the unqualified term "believes."[299]

Thus, to avoid the granting of defendants' motion to dismiss, the plaintiff would have to adequately plead either that (i) the Conflicts Committee of the general partner's Board believed it was acting against the limited partnership's best interests when approving the merger or (ii) the Conflicts Committee consciously disregarded its duty to form a subjective belief that the merger was in the limited partnership's best interests. The Supreme Court observed that it would likely take an extraordinary set of facts to meet such a pleading burden and that plaintiff had failed to do so, but noted that plaintiff had not pled that defendant's conduct did not conform to the implied contractual duty of good faith and fair dealing.

Norton v. K-Sea Transportation Partners L.P.,[300] involved another MLP in which the LPA replaced common law fiduciary duties with a contractual process for approving related party transactions. The plaintiffs alleged that the general partner obtained excessive consideration for its incentive distribution

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298 Taking advantage of DRULPA's flexibility, the LPA provided:

> Except as expressly set forth in [the LPA], *neither [general partner] nor any other Indemnitee [an affiliate of the general partner] shall have any duties or liabilities, including fiduciary duties, to the Partnership or any Limited Partner* . . . and the provisions of [the LPA], to the extent that they restrict, eliminate or otherwise modify the duties and liabilities, including fiduciary duties, of [general partner] or any other Indemnitee otherwise existing at law or in equity, are agreed by the Partners to replace such other duties and liabilities of [general partner] or such other Indemnitee.

Id. at 100.

Additional relevant provisions from the LPA involved in *Allen v. Encore Energy Partners, L.P.* are quoted in note 1492 on pages 439-440 of Byron F. Egan, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations*, University of Texas School of Law 36th Annual Conference on Securities Regulation and Business Law (Feb. 14, 2014), *available at* http://www.jw.com/publications/article/1945.

299 *Id.* at 104.

300 67 A.3d 354 (Del. 2013).

rights ("IDRs") when an unaffiliated third party purchased the limited partnership. The Supreme Court held that the general partner needed only to exercise its discretion in good faith, as the parties intended that term to be construed, to satisfy its duties under the LPA. Noting that the general partner obtained an appropriate fairness opinion, which under the LPA created a conclusive presumption that the general partner made its decision in good faith, the Supreme Court affirmed the Chancery Court's dismissal of the complaint. In rejecting plaintiff's argument that the general partner is not entitled to a conclusive presumption of good faith because the fairness opinion did not specifically address the IDR payment's fairness, the Supreme Court wrote that the LPA does not require the general partner to evaluate the IDR payment's reasonableness separately from the remaining consideration, and explicitly states that nothing in the LPA shall be construed to require the general partner to consider the interests of any person other than the limited partnership. The general partner was not required to consider whether the IDR payment was fair, but only whether the merger as a whole was in the best interests of the limited partnership (which included the general partner and the limited partnership). Because of those clear provisions, the Supreme Court held that plaintiff had no reasonable contractual expectation that the general partner or the Conflict Committee's investment banker would specifically consider the IDR payment's fairness. Because the fairness opinion satisfied the LPA's requirements, the Court held that the general partner was conclusively presumed to have acted in good faith when it approved the merger and submitted it to the unitholders for a vote, commenting that plaintiff willingly invested in a limited partnership that provided fewer protections to limited partners than those provided under corporate fiduciary duty principles and is bound by his investment decision.

Earlier in 2013 in *Brinckerhoff v. Enbridge Energy Company, Inc. ("Brinckerhoff III")*,[301] the Supreme Court affirmed the dismissal of derivative claims brought by an LP challenging the fairness of a joint venture ("JV") entered into between the MLP and its controller. The plaintiff alleged that the controller purchased its stake in the JV from the MLP for substantially less than its fair value. In affirming the dismissal of plaintiff's complaint, the Supreme Court commented that, in order for the plaintiff to succeed, the decision to enter into the JV must have been so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.[302] In a 2017 decision also styled *Brinckerhoff v. Enbridge Energy Company, Inc.* ("*Brinckerhoff IV*")[303] involving the same parties, MLP and pipeline, but a different transaction in which the controller was purchasing the same asset it had sold six years earlier, the Delaware Supreme Court reversed course and found that Brinckerhoff had sufficiently alleged bad faith to survive Enbridge's motion to dismiss. In so holding, the Supreme Court in *Brinckerhoff IV* explained its change of course as follows:

> Brinckerhoff filed suit and alleged that the defendants breached the LPA by (a) agreeing to repurchase the same asset—the Alberta Clipper Interest—EEP sold to Enbridge six years earlier, on terms Brinckerhoff claims were not "fair and reasonable" as required by Section 6.6(e) of the LPA * * *

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301 67 A.3d 369 (Del. 2013), *abrogated by* 159 A.3d 242 (Del. 2017).

302 The Supreme Court followed *Brinckerhoff III* in *DV Realty Advisors LLC v. Policemen's Annuity and Benefit Fund of Chicago*, 75 A.3d 101 (Del. 2013), and held that the removal of a general partner met the contractual subjective good faith standard in the LPA because the action was not "so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith."

303 159 A.3d 242 (Del. 2017)

EEP GP and its Affiliates moved to dismiss, claiming that, regardless of any breach of the LPA's specific affirmative requirements, before Brinckerhoff could pursue his claims, he first had to plead facts leading to an inference that the defendants acted in bad faith. In other words, EEP GP and its affiliates were free to breach any of the LPA's specific requirements, so long as they did so in good faith. The defendants also argued that to allege bad faith, Brinckerhoff had to plead facts that ruled out all legitimate explanations for the defendants' actions except for bad faith—a pleading hurdle borrowed from one of the most demanding corporate law standards, that of "waste."

The Court of Chancery did its best to reconcile earlier decisions interpreting the same or a similar LPA, and ended up dismissing the complaint. Though the court believed that in the corporate context Brinckerhoff's allegations would have stated a claim, it concluded that so long as EEP GP acted in good faith, it was free to breach any of the LPA's specific requirements. Once that standard applied, the court found that Brinckerhoff had failed to allege bad faith conduct by EEP GP, which required dismissal of the complaint.

On appeal, Brinckerhoff has challenged the reasonableness of the Court of Chancery's interpretation of the LPA. He also argues that this Court in *Brinckerhoff III* improperly defined what was needed to plead bad faith. * * *

We agree with Brinckerhoff in part and reverse the decision of the Court of Chancery. We * * *find that the Court of Chancery erred when it held that other "good faith" provisions of the LPA "modified" Section 6.6(e)'s specific requirement that the Alberta Clipper transaction be "fair and reasonable to the Partnership." The provisions of the LPA relied on by the Court of Chancery—Sections 6.8(a), 6.9(a), and 6.10(d)—exculpate EEP GP and others from monetary damages if they act in good faith, apply a good faith standard to EEP GP's resolution of conflicts of interest, and replace default fiduciary duties with a contractual good faith standard. They do not, however, alter the specific affirmative obligations of the LPA. The Court of Chancery's interpretation of the LPA leads to an unreasonable result no public investor would have considered possible when reviewing the LPA—that EEP GP is free to violate any specific LPA requirement so long as the breach is in good faith. In fact, precisely because the Delaware Revised Uniform Limited Partnership Act ("DRULPA") allows LPAs—like that of the Enbridge LPA—to eliminate fiduciary duties, it is essential that unitholders be able to hold the GP accountable for not complying with the terms of the LPA.

We also find that the Court of Chancery erred when it determined that EEP GP and its Affiliates were exculpated under Section 6.8(a) from any liability for breaching the LPA. The Court of Chancery cannot be faulted for faithfully applying our earlier decision in *Brinckerhoff III*, and its rigorous pleading standard for bad faith. But we now change course from our earlier decision and adhere to the more traditional definition of bad faith utilized in Delaware entity law. *We hold that bad faith is sufficiently alleged under the Enbridge LPA if the plaintiff pleads facts supporting an inference that EEP GP did not reasonably believe it was acting* *in the best interest of the partnership.* Accepting the facts as pled, as we must on an appeal from a motion to dismiss, Brinckerhoff has met this standard. (emphasis added)[304]

In the foregoing 2013 cases, claims based on implied covenant of good faith and fair dealing were not pursued by the plaintiffs, but in *Gerber v. Enter. Prods. Hldgs., LLC*,[305] breach of the implied covenant of good faith and fair dealing was pled and was outcome determinative in the Supreme Court. *Gerber* involved allegations by a limited partnership that the limited partnership's purchase of interests in an entity controlled by its controller was unfair to the limited partnership, in violation of its LPA and in breach of the duty of good faith owed to the limited partners. Its LPA substituted a subjective good faith standard and Conflicts Committee process for common law fiduciary duties. The challenged transaction was, in fact, approved by the Conflicts Committee as in the Committee's subjective belief in the best interest of the limited partnership. The plaintiff pleaded a claim for breach of the implied contractual covenant of good faith and fair dealing, alleging that the fairness opinion relied upon by the Conflicts Committee did not value separately the consideration the limited partnership actually received and did not address the value of the limited partnership's claims against the general partner, the elimination of which was a disclosed purpose of the transaction. The Supreme Court explained its holding on the basis of the implied contractual covenant of good faith and fair dealing in temporal conceptual terms. Adopting the reasoning in *ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC*,[306] the Supreme Court explained the implied covenant seeks to enforce the parties' contractual bargain by implying only those terms that the parties would have agreed to during their original negotiations if they had thought to address them and "a court confronting an implied covenant claim asks whether it is clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach of the implied covenant of good faith—had they thought to negotiate with respect to that matter." In contrast under a common law fiduciary duty or tort analysis, a court examines the parties as situated at the time of the wrong, determining whether the defendant owed the plaintiff a duty which was breached.

Focusing on the alleged unfairness of the challenged transaction in which the limited partnership sold the interests to the controller for only 9% of limited partnership's original purchase price and that the fairness opinion did *not* address whether holders of the limited partnership units received fair consideration for the limited partnership's interest (it only addressed the total consideration paid to all parties in two related transactions), the Court held that when plaintiff agreed in the LPA to be bound by the LPA's conclusive presumption the general's contractual fiduciary duty to be satisfied if the general partner relied upon the opinion of a qualified expert, plaintiff could hardly have anticipated that the general partner would rely upon a fairness opinion that did not fulfill its basic function—evaluating the consideration the limited partnership unitholders received for purposes of opining whether the transaction was financially fair. It held this is the type of arbitrary, unreasonable conduct that the implied covenant prohibits.

Applying a similar analysis, the Court concluded "that the parties would certainly have agreed, at the time of contracting, that any fairness opinion contemplated by that provision would address the value of derivative claims where (as here) terminating those claims was a principal purpose of a merger." In

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304 *Brinckerhoff IV*, 159 A.2d at 246-47.

305 67 A.3d 400 (Del. 2013), *overruled in part on other grounds by Winshall v. Viacom Int'l, Inc.*, 76 A.3d 808 (Del. 2013).

306 50 A.3d 434, 440-42 (Del. Ch. 2012), *aff'd in part, rev'd in part on other grounds by Scion Breckenridge Managing Member LLC v. ASB Allegiance Real Estate*, 68 A.3d 665 (Del. 2013).

addition to clarifying that an LPA definition of good faith cannot restrict the implied contractual covenant of good faith and fair dealing, *Gerber* teaches that fairness opinions in M&A transactions involving Delaware alternative entities should (i) address the fairness of the consideration to be received by the limited partners (separately from the general partner) in each transaction on which it will be relied to satisfy the implied contractual covenant of good faith and fair dealing requirements under Delaware law and (ii) take into account the value of derivative claims being eliminated by a merger to which it relates.

Further, where fiduciary duties have been eliminated by an LPA provision and replaced by a contractual process for approving conflict of interest transactions, the general partner may be held liable if the process was not followed or, in the court's judgment, followed in form but not in substance. *Dieckman v. Regency GP LP*,[307] involved the merger of a Delaware limited partnership with affiliate of the general partner. The limited partnership agreement contractually eliminated fiduciary duties as permitted by DRLPA and replaced them with two alternative contractual mechanisms for approving affiliate transactions: (i) approval by disinterested special committee of independent directors of general partner <u>or</u> (ii) approval by majority of the unaffiliated limited partners. Both mechanisms were used in the approval of the affiliate transaction. The plaintiff alleged that the contractual special committee mechanism was not effective because one of the two members of the special committee was not independent at all relevant times because he served on the special committee for four days before resigning as a director of an affiliated company and thus becoming temporarily independent. The special committee process only lasted few days and then, immediately after the merger closed, the director was again elected to the affiliate Board. The second special committee member became a director of another affiliate of the general partner after the merger was closed. During its brief existence, the special committee negotiated to improve the price for limited partners, but was unsuccessful and ended up recommending that the Board approve the transaction terms initially proposed. The Delaware Supreme Court held that plaintiff had pled sufficient facts under its implied covenant of good faith and fair dealing claim to survive a motion to dismiss. Although *Regency* looks like a fiduciary duty of candor case and Regency's LPA eliminated all fiduciary duties (including the duty of candor), the Supreme Court found that the facts surrounding the director's appointment to and service on the special committee demonstrated a lack of respect for the director

[307] 155 A.3d 358 (Del. 2017).

independence requirement of the partnership agreement[308] and the failure to disclose the director conflict was such a fundamental disclosure failure as to negate the approval by the unaffiliated limited partners.[309]

Similarly, *In re El Paso Pipeline Partners, L.P. Derivative Litigation*[310] was an MLP case in which the LPA eliminated default fiduciary duties and replaced them with a contractual standard requiring that the persons approving a conflicted transaction on behalf of the partnership subjectively believe that the transaction was in the best interests of the partnership. In *El Paso*, the conflicts committee responsible for approving the dropdown transaction from the general partner's parent to the MLP was composed solely of independent directors, had engaged its own independent legal and financial advisors, had received from its financial advisor an opinion that the challenged transaction was fair from a financial point of view to the unaffiliated unitholders of the MLP, and ultimately approved the transaction. Vice Chancellor Laster ruled that under the MLP's LPA each conflicts committee member had an affirmative duty to conclude in good faith that the challenged transaction was in the best interests of the partnership, but that the conflicts committee members did not actually conclude that the challenged transaction was in the best interests of the partnership. The Vice Chancellor found that the conflicts committee had focused extensively on the expected accretion from the challenged transaction—i.e., the amount by which the cash distributions for common unitholders of the partnership could be expected to increase—but failed to take sufficiently into account the valuation of the assets being acquired under traditional valuation analyses. Although the committee members and their financial adviser testified that they in good faith believed that the transaction was in the best interests of the partnership, the Vice Chancellor found that their testimony was not credible in the face of objective evidence that the committee and its financial adviser did not have adequate information to justify the partnership paying more for the assets than the assets were objectively worth and that they were merely going through the motions in approving a transaction which they knew the general partner wanted (and who they wanted to accommodate). Emails and other evidence showed the committee had reservations about the dropdown. The Vice Chancellor awarded damages against the general partner of $171 million, which the Vice Chancellor determined to be the difference between what the partnership actually paid for the assets acquired in the challenged transaction and the fair value of the

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308 The Supreme Court explained:

> As with the contract language regarding Unaffiliated Unitholder Approval, this language is reasonably read by unitholders to imply a condition that a Committee has been established whose members genuinely qualified as unaffiliated with the General Partner and independent at all relevant <u>times</u>. Implicit in the express terms is that the Special Committee membership be genuinely comprised of qualified members and that deceptive conduct not be used to create the false appearance of an unaffiliated, independent Special Committee. *** Instead of staffing the Conflicts Committee with independent members, the plaintiff alleges that the chair of the two-person Committee started reviewing the transaction while *still* a member of an Affiliate board.

Id. at 369.

Plaintiff also alleged that in the proxy statement used to solicit limited partner approval of the merger transaction, the general partner materially misled the limited partners about the independence of the special committee members. The Supreme Court held that in deciding to approve the merger, a reasonable limited partner would have assumed based on the disclosures that the transaction was negotiated and approved by a special committee composed of persons who were not "affiliates" of the general partner and who had the independent status dictated by the limited partnership agreement. This assurance was one a reasonable investor may have considered a material fact weighing in favor of the transaction's fairness.

309 *Cf. Gerber v. Enter. Prods. Hldgs., LLC*, 67 A.3d 400, 404 (Del. 2013), *overruled in part on other grounds by Winshall v. Viacom Int'l, Inc.*, 76 A.3d 808 (Del. 2013), *supra* note 305.

310 C.A. No. 7141-VCL, 2015 WL 1815846, 2015 Del. Ch. LEXIS 116 (Del. Ch. Apr. 20, 2015).

assets. On appeal, the Supreme Court of Delaware[311] respected the Vice Chancellor's findings of fact, but reversed because it concluded that the plaintiffs did not have standing as its claims were derivative and were extinguished by the merger of the MLP into an unaffiliated entity while the lawsuit was pending.[312]

The foregoing cases illustrate that Delaware courts will generally respect the DRLPA statutory authority to eliminate common law fiduciary duties in an LPA if the LPA clearly does so.[313] The *Gerber*, *Regency* and *El Paso* cases notwithstanding, where they have found that parties have expressly limited fiduciary duties in LPAs, Delaware courts have been reluctant to use the implied covenant of good faith and fair dealing, viewing this concept instead as more of a gap-filler where the parties had not contemplated the particular circumstance. After *Gerber*, *Regency* and *El Paso*, however, it is likely that claims based on the implied covenant will be pursued more vigorously.

A corporation that controls the general partner may owe a duty of loyalty to the limited partnership.[314] Directors of a corporate general partner who dominate and control the underlying limited partnership can be liable for the corporate general partner's breach of fiduciary duty to the limited partners.[315] Similarly, the parent and grandparent entities of the managing owner of a Delaware statutory business trust may be liable, directly or indirectly, for exercising control over or aiding and abetting the managing owner's actions to serve its own self-interest in violation of its fiduciary duties to the Delaware statutory business trust, which suffered significant losses as a result of a transfer of certain of its assets to a third party shortly before the transferee's collapse.[316]

CHAPTER 4. LIMITED LIABILITY COMPANIES

4.1. Texas. LLCs formed under Texas law are now governed by Title 3 and pertinent provisions of Title 1 of the TBOC.[317] Because until January 1, 2010 some LLCs were governed by the LLC Act[318] and

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311 152 A.3d 1248 (Del. 2016).

312 The court reasoned that plaintiffs' claims were assets of the partnership and in the merger were acquired by the surviving entity of the merger, thereby extinguishing plaintiffs' standing to assert the claims.

313 *Norton v. K-Sea Trans. Partners L.P.*, 67 A.3d 354 (Del. 2013); *see Miller v. Am. Real Estate Partners, L.P.*, C.A. No. 16788, 2001 WL 1045643, at *8, 2001 Del. Ch. LEXIS 116, at *28 (Del. Ch. Sept. 6, 2001) ("A topic as important as [limitation or elimination of common law fiduciary duties] should not be addressed coyly.").

314 *James River-Pennington, Inc. v. CRSS Capital, Inc.*, C.A. No. 13870, 1995 WL 106554, at *11, 1995 Del. Ch. LEXIS 22, at *32 (Del. Ch. Mar. 6, 1995), *overruled on other grounds by Scion Breckenridge Managing Member, LLC v. ASB Allegiance Real Estate Fund* , 68 A.3d 665, 679 n.57 (Del. 2013) (also recognizing also that the general partner's fiduciary duties might be modified by the limited partnership agreement); *Bigelow/Diversified Secondary P'ship Fund 1990 v. Damson/Birtcher Partners*, C.A. No. 16630-NC, 2001 WL 1641239, at *1-2, *8-9, 2001 Del. Ch. LEXIS 152, at *3-*6, *31 (Del. Ch. Dec. 4, 2001) (holding that various "upstream" entities controlling general partners could owe fiduciary duties to either the partnership or the limited partners, the Court explained: "While mere ownership—either direct or indirect—of the general partner does not result in the establishment of a fiduciary relationship, those affiliates of a general partner who exercise control over the partnership's property may find themselves owing fiduciary duties to both the partnership and its limited partners.").

315 *In re USACafes, L.P. Litig.*, 600 A.2d 43, 48 (Del. Ch. 1991); *see also Bigelow/Diversified Secondary Partnership Fund 1990 v. Damson/Birtcher Partners*, C.A. No. 16630-NC, 2001 WL 1641239, 2001 Del. Ch. LEXIS 152 (Del. Ch. Dec. 4, 2001).

316 *Cargill, Inc. v. JWH Special Circumstance LLC*, 959 A.2d 1096 (Del. Ch. 2008).

317 TBOC §§ 401.001, 402.003. The TBOC provisions applicable to LLCs may be officially and collectively referred to as "Texas Limited Liability Company Law." TBOC § 1.008(e).

318 The Texas Limited Liability Company Act, as amended, is found at TEX. REV. CIV. STAT. ANN. art. 1528n (Vernon Supp. 2017) (hereinafter "LLC Act"). The operational provisions of the LLC Act are modeled after the TBCA, the TMCLA, and TRLPA. *Summary of Business Organizations Bill (HB 278)*, 28 BULL. OF BUS. L. SEC. OF THE ST. B. OF TEX. 2, 31-41 (June 1991)

others by the TBOC and because the substantive principles under both statutes are generally the same, the term "Tex. LLC Stats." is used herein to refer to the TBOC and the LLC Act collectively, and the particular differences between the LLC Act and the TBOC are referenced as appropriate. Texas was the fourth state to adopt an LLC statute and now every state has adopted an LLC statute.[319]

"The allure of the [LLC] is its unique ability to bring together in a single business organization the best features of all other business forms - properly structured, its owners obtain both a corporate-styled liability shield and the pass-through tax benefits of a partnership."[320] All equity holders of an LLC have the limited liability of corporate shareholders even if they participate in the business of the LLC. Thus the Tex. LLC Stats. contemplate that LLCs will be organized with features that resemble corresponding features of corporations.

The owners of a Texas LLC are called "Members,"[321] and are analogous to shareholders in a corporation or limited partners of a limited partnership.[322] The "Managers" of an LLC are generally analogous to directors of a corporation and are elected by the Members in the same manner as corporate directors are elected by shareholders.[323] Under the Tex. LLC Stats., however, an LLC may be structured so that management shall be by the Members as in the case of a close corporation or a general partnership,[324] and in that case the Members would be analogous to general partners in a general or limited partnership but without personal liability for the LLC's obligations.[325] Under the Tex. LLC Stats., any "person" may become a Member or Manager.[326] Because of the broad definition given to "person" by the Tex. LLC Stats., any individual, corporation, partnership, LLC or other person may become a Member or Manager.[327] Thus, it is possible to have an LLC with a corporation as the sole Manager just as it is possible to have a limited partnership with a sole corporate general partner.

An underlying premise of the Tex. LLC Stats. is that the LLC is based in large part upon a contract between its Members, similar to a partnership agreement. As a result, fundamental principles of freedom

[hereinafter "1991 Bill Analysis Summary"]; TEX. REV. CIV. STAT. ANN. art. 1302 (Vernon Supp. 2017); TEX. REV. CIV. STAT. ANN. art. 1302 (Vernon 2003 & Supp. 2004); TEX. REV. CIV. STAT. ANN. art. 6132a-1, arts. 1-13 (Vernon Supp. 2017).

319 *See* Charles W. Murdock, *Limited Liability Companies in the Decade of the 1990s: Legislative and Case Law Developments and Their Implications for the Future*, 56 BUS. LAW 499, 502 (2001).

320 *PB Real Estate, Inc. v. DEM Properties II*, 719 A.2d 73, 74 (Conn. App., 1998); *see* Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004-2007 and How LLCs Were Taxed for Tax Years 2002-2006*, XV FORDHAM J. CORP. & FIN. L. 459 (2010)

321 TBOC §§ 1.002(53), 101.101, 101.102; LLC Act § 4.01.

322 1991 Bill Analysis Summary at 41.

323 *See* TBOC § 101.302; LLC Act § 2.13; 1991 Bill Analysis Summary at 41.

324 TBOC §§ 1.002(35), 101.251; LLC Act § 2.12.

325 1991 Bill Analysis Summary at 41.

326 TBOC § 101.102(a); LLC Act § 4.01C.

327 "Person" is defined in TBOC § 1.002(69-b) as follows:

> (69-b) "Person" means an individual or a corporation, partnership, limited liability company, business trust, trust, association, or other organization, estate, government or governmental subdivision or agency, or other legal entity, or a series of domestic limited liability company or foreign entity.

"Person" was similarly defined in LLC Act § 1.02(4).

of contract imply that the owners of an LLC have maximum freedom to determine the internal structure and operation of the LLC.

4.2. Delaware. LLCs formed under Delaware law are governed by the Delaware Limited Liability Company Act (the "DLLCA").[328] As in Texas, the owners of a Delaware LLC are called Members[329] and are analogous to stockholders of a Delaware corporation or limited partners of a Delaware limited partnership. The Managers of a Delaware LLC are called Managers and are typically selected by the Members in accordance with its LLC Agreement.[330]

4.3. Formation and Governing Documents.

4.3.1. Certificate of Formation.

(a) Texas. A Texas LLC is formed when one or more persons file a certificate of formation with the Texas Secretary of State along with a filing fee.[331] [332]

(b) Delaware. In Delaware an LLC is formed by the filing of an executed certificate of formation with the Secretary of State of Delaware.[333]

4.3.2. Company Agreement.

(a) Texas. Most of the provisions relating to the organization and management of a Texas LLC and the terms governing its securities are to be contained in the LLC's company agreement ("Company Agreement"), which will typically contain provisions similar to those in limited partnership agreements and corporate bylaws.[334] A Company Agreement is the same as the document referred to as (i) the "Regulations" for LLCs governed by the LLC Act and (ii) a limited liability company agreement for

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328 DEL. CODE ANN. tit. 6 § 18-101 *et. seq.* (West 2011 & Supp. 2017); *see* ROBERT L. SYMONDS, JR. & MATTHEW J. O'TOOLE, SYMONDS & O'TOOLE ON DELAWARE LIMITED LIABILITY COMPANIES § 5.01.

329 DLLCA § 18-101(11) provides:

> "Member" means a person who is admitted to a limited liability company as a member as provided in § 18-301 of this title.

330 ROBERT L. SYMONDS, JR. & MATTHEW J. O'TOOLE, SYMONDS & O'TOOLE ON DELAWARE LIMITED LIABILITY COMPANIES § 9.02.

331 TBOC §§ 3.001, 4.152(1), 4.154. Prior to January 1, 2006, an LLC was formed by filing articles of organization with the Secretary of State, which were similar to a certificate of limited partnership under TRLPA and articles of incorporation under the TBCA. *See* LLC Act §§ 3.01, 9.01.

332 TBOC § 3.006(b).

333 DLLCA § 18-201(a).

334 TBOC § 101.052; LLC Act § 2.09A; Joint Task Force of the Committee on LLCs, Partnerships and Unincorporated Entities and the Committee on Taxation, ABA Section of Business Law, *Model Real Estate Development Operating Agreement with Commentary*, 63 BUS. LAW. 385 (February 2008).

LLCs governed by the DLLCA.[335] A Company Agreement may be oral or in writing,[336] but an oral Company Agreement is subject to the statute of frauds.[337]

Under the TBOC, the Company Agreement controls the majority of LLC governance matters and generally trumps the default TBOC provisions relating to LLCs, but certain provisions of the Tex. LLC Stats. may not be waived or modified by Regulations or Company Agreement.[338]

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335 DLLCA § 18-101(7); *see* ROBERT L. SYMONDS, JR. & MATTHEW J. O'TOOLE, SYMONDS & O'TOOLE ON DELAWARE LIMITED LIABILITY COMPANIES §4.01 *et seq.*

336 TBOC § 101.001(1); DLLCA § 18-101(7).

337 An oral agreement which is not to be performed within one year from the date of making of the agreement is barred by the statute of frauds. TBOC § 26.01(b)(6). To be enforceable, an agreement to make contributions of cash or property to an LLC must be in writing and signed by the person making the promise. TBOC § 101.151. Likewise, profits and losses are to be allocated, and distributions made, according to the written agreed value of contributions found in the LLC's company records. TBOC §§ 101.501, 101.201, 101.203. *See Olson v. Halvorsen*, 982 A.2d 286 (Del. Ch. 2008), *aff'd*, 986 A.2d 1150 (Del. 2009) (Delaware statute of frauds, which provides "an agreement 'that is not to be performed within the space of one year from the making thereof' must be reduced to writing and signed by the party against which the agreement is to be enforced," applies to a Delaware LLC Agreement; noting that "the statute of frauds does not apply to any contract which may, by any possibility, be performed within a year," the court observed that few oral LLC Agreements would contain terms that could not possibly be performed within one year and thus ordinarily the statute of frauds would not limit the enforcement of oral LLC Agreements; nevertheless, in the case before it, the court held that the earnout provision at issue violated the statute of frauds because it could not be performed within a year and none of the exceptions to the statute of frauds was applicable).

338 TBOC §§ 101.052 and 101.054 provide as follows:

> Sec. 101.052. COMPANY AGREEMENT. (a) Except as provided by Section 101.054, the company agreement of a limited liability company governs:
>
> (1) the relations among members, managers, and officers of the company, assignees of membership interests in the company, and the company itself; and
>
> (2) other internal affairs of the company.
>
> (b) To the extent that the company agreement of a limited liability company does not otherwise provide, this title and the provisions of Title 1 applicable to a limited liability company govern the internal affairs of the company.
>
> (c) Except as provided by Section 101.054, a provision of this title or Title 1 that is applicable to a limited liability company may be waived or modified in the company agreement of a limited liability company.
>
> (d) The company agreement may contain any provisions for the regulation and management of the affairs of the limited liability company not inconsistent with law or the certificate of formation.
>
> (e) A company agreement may provide rights to any person, including a person who is not a party to the company agreement, to the extent provided by the company agreement.
>
> (f) A company agreement is enforceable by or against the limited liability company regardless of whether the company has signed or otherwise expressly adopted the agreement.
>
> Sec. 101.054. WAIVER OR MODIFICATION OF CERTAIN STATUTORY PROVISIONS PROHIBITED; EXCEPTIONS. (a) Except as provided by this section, the following provisions may not be waived or modified in the company agreement of a limited liability company:
>
> (1) this section;
>
> (2) Section 101.101(b)[Members Required], 101.151 [Requirements for Enforceable Promise [to make contribution]], 101.206 [Prohibited Distribution; Duty to Return], 101.501 [Supplemental Records Required for Limited Liability Companies], or 101.502 [Right to Examine Records and Certain Other Information];
>
> (3) Chapter 1 [Definitions and Other General Provisions], if the provision is used to interpret a provision or define a word or phrase contained in a section listed in this subsection;

(b) Delaware. In Delaware and some other states, the agreement which is referred to in Texas as the Company Agreement is referred to as the LLC agreement ("LLC Agreement").[339] The term "limited liability company agreement" is broadly defined in the DLLCA to be the principal governing document of a Delaware LLC[340] and to mean and encompass "any agreement … written, oral or implied, of the

> (4) Chapter 2 [Purposes and Power of Domestic Entity], except that Section 2.104(c)(2) [Power to Make Guaranties], 2.104(c)(3) [Power to Make Guaranties], or 2.113 [Limitation on Powers] may be waived or modified in the company agreement;
>
> (5) Chapter 3 [Formation and Governance], except that Subchapters C [Governing Persons and Officers] and E [Certificates Representing Ownership Interest] may be waived or modified in the company agreement; or
>
> (6) Chapter 4 [Filings], 5 [Names of Entities; Registered Agents and Registered Offices], 7 [Liability], 10 [Mergers, Interest Exchanges, Conversions, and Sales of Assets], 11 [Winding Up and Termination of Domestic Entity], or 12 [Administrative Powers], other than Section 11.056 [Supplemental Provisions for Limited Liability Company].
>
> (b) A provision listed in Subsection (a) may be waived or modified in the company agreement if the provision that is waived or modified authorizes the limited liability company to waive or modify the provision in the company's governing documents.
>
> (c) A provision listed in Subsection (a) may be modified in the company agreement if the provision that is modified specifies:
>
> (1) the person or group of persons entitled to approve a modification; or
>
> (2) the vote or other method by which a modification is required to be approved.
>
> (d) A provision in this title or in that part of Title 1 [General Provisions] applicable to a limited liability company that grants a right to a person, other than a member, manager, officer, or assignee of a membership interest in a limited liability company, may be waived or modified in the company agreement of the company only if the person consents to the waiver or modification
>
> (e) The company agreement may not unreasonably restrict a person's right of access to records and information under Section 101.502.

Although TBOC § 101.054 expressly states which provisions *cannot* be modified, its predecessor, the LLC Act, only expressly states which provisions *can* be modified. As the Revisor's Note to TBOC § 101.052 explains:

> Because of the reversal of the prior assumption that each provision of the [LLC Act] was mandatory (unless expressly qualified) to the new assumption in Sections 101.052 and 101.054 [of the TBOC] that most provisions of the code governing limited liability companies may be waived or modified, a number of the provisions of Title 3 are now stated in such a way that the new provision appears to be the converse of the corresponding provision under the Texas Limited Liability Company Act.

339 DLLCA § 18-101(7) (2017) ("limited liability company agreement"); *cf. see, e.g.*, OHIO REV. CODE ANN. § 1705.01(J) (West 2009 & Supp. 2012) ("operating agreement").

340 *See* ROBERT L. SYMONDS, JR. & MATTHEW J. O'TOOLE, SYMONDS & O'TOOLE ON DELAWARE LIMITED LIABILITY COMPANIES § 4.01.

member or members as to the affairs of a limited liability company or its business."[341] Oral LLC Agreements, while expressly recognized by the DLLCA, are subject to the Delaware statute of frauds.[342]

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[341] DLLCA § 18-101(7) defines LLC Agreement as follows:

> (7) Limited liability company agreement" means any agreement (whether referred to as a limited liability company agreement, operating agreement or otherwise), written, oral or implied, of the member or members as to the affairs of a limited liability company and the conduct of its business. A member or manager of a limited liability company or an assignee of a limited liability company interest is bound by the limited liability company agreement whether or not the member or manager or assignee executes the limited liability company agreement. A limited liability company is not required to execute its limited liability company agreement. A limited liability company is bound by its limited liability company agreement whether or not the limited liability company executes the limited liability company agreement. A limited liability company agreement of a limited liability company having only 1 member shall not be unenforceable by reason of there being only 1 person who is a party to the limited liability company agreement. A limited liability company agreement is not subject to any statute of frauds (including § 2714 of this title). A limited liability company agreement may provide rights to any person, including a person who is not a party to the limited liability company agreement, to the extent set forth therein. A written limited liability company agreement or another written agreement or writing:
>
> a. May provide that a person shall be admitted as a member of a limited liability company, or shall become an assignee of a limited liability company interest or other rights or powers of a member to the extent assigned:
>
> 1. If such person (or a representative authorized by such person orally, in writing or by other action such as payment for a limited liability company interest) executes the limited liability company agreement or any other writing evidencing the intent of such person to become a member or assignee; or
>
> 2. Without such execution, if such person (or a representative authorized by such person orally, in writing or by other action such as payment for a limited liability company interest) complies with the conditions for becoming a member or assignee as set forth in the limited liability company agreement or any other writing; and
>
> b. Shall not be unenforceable by reason of its not having been signed by a person being admitted as a member or becoming an assignee as provided in paragraph (7)a. of this section, or by reason of its having been signed by a representative as provided in this chapter.

[342] In *Olson v. Halvorsen*, 986 A.2d 1150 (Del. 2009), a withdrawing founder of a Delaware LLC sued to collect a multi-year earnout he claimed that the LLC owed him under an unsigned LLC agreement, and the Chancery Court held that an alleged oral amendment to the LLC agreement requiring the earnout payments was unenforceable under the Delaware statute of frauds (Del. Code Ann. tit. 6, § 2714(a)) because it required more than one year to complete. In affirming the Chancery Court decision, Chief Justice Myron Steele explained:

> Under Section 18-604 of the Delaware LLC Act, a resigning member of an LLC "is entitled to receive . . . the fair value of such member's limited liability company interest," unless the LLC agreement provides otherwise. Under 6 *Del. C.* § 17-604, a withdrawing partner of a limited partnership "is entitled to receive…the fair value of such partner's partnership interest," unless the partnership agreement provides otherwise. Olson [the resigning member] admits that the founders originally agreed that a departing member would only receive his "cap and comp" [his capital account and accrued compensation]. Thus, for Olson to succeed on his fair-value claim, he had to prove that the founders amended their original "cap and comp" agreement.
>
> * * *
>
> The Delaware statute of frauds, which the General Assembly enacted over a century ago, bars the enforcement of an agreement "that is not to be performed within the space of one year from the making thereof," unless it is (1) written and (2) signed by the party against whom the agreement is to be enforced. Only if the parties cannot possibly perform the agreement within one year does the statute of frauds apply and require a writing, signed by the charged party.
>
> The Delaware LLC Act seeks "to give maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements." * * * Thus, the Delaware LLC Act generally allows parties to enforce unwritten, unsigned LLC agreements.
>
> * * *
>
> The Delaware LLC Act does not address the relationship between LLC agreements and the statute of frauds.

A member, manager or assignee of a Delaware LLC is bound by the LLC Agreement whether or not a signatory thereto.[343] Single member LLCs are expressly authorized.[344] An LLC Agreement may be amended as provided therein or, if the LLC Agreement does not provide for its amendment, an amendment requires approval of all of the members[345] unless (in the case of a Delaware LLC formed after 2011) otherwise provided in a merger agreement.[346]

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* * *

> The statute of frauds does not conflict with the LLC Act any more than the statute of frauds generally conflicts with contracts. The LLC Act does not guarantee enforcement of all oral or implied LLC agreements. Rather, the LLC Act, like many other contracts, treats LLC agreements by permitting oral, written, or implied agreements. The LLC Act's explicit recognition of oral and implied LLC agreements does not preclude the statute of frauds.

* * *

> The statute of frauds does not contravene the legislative policy of giving "maximum effect" to LLC agreements. The LLC Act cannot -- and has not -- rendered LLC agreements impervious to all other rules and laws relating to contract law.

* * *

> We hold that the Vice Chancellor did not clearly erroneously conclude that the Viking founders never departed from the original "cap and comp" agreement, and that they were not obligated to pay Olson an earnout or the fair value of his interest in Viking. We further hold that the Delaware LLC Act does not explicitly remove LLC agreements from the application of the statute of frauds. Therefore, the statute of frauds applies to LLC agreements.

343 *Id.*

344 *Id.*

345 DLLCA § 18-302(f) provides:

> (f) If a limited liability company agreement does not provide for the manner in which it may be amended, the limited liability company agreement may be amended with the approval of all of the members or as otherwise permitted by law, including as permitted by § 18-209(f) of this title. This subsection shall only apply to a limited liability company whose original certificate of formation was filed with the Secretary of State on or after January 1, 2012.

346 DLLCA § 18-209(f) provides:

> (f) An agreement of merger or consolidation or a plan of merger approved in accordance with subsection (b) of this section may:
>
> (1) Effect any amendment to the limited liability company agreement; or
>
> (2) Effect the adoption of a new limited liability company agreement, for a limited liability company if it is the surviving or resulting limited liability company in the merger or consolidation.
>
> Any amendment to a limited liability company agreement or adoption of a new limited liability company agreement made pursuant to the foregoing sentence shall be effective at the effective time or date of the merger or consolidation and shall be effective notwithstanding any provision of the limited liability company agreement relating to amendment or adoption of a new limited liability company agreement, other than a provision that by its terms applies to an amendment to the limited liability company agreement or the adoption of a new limited liability company agreement, in either case, in connection with a merger or consolidation. The provisions of this subsection shall not be construed to limit the accomplishment of a merger or of any of the matters referred to herein by any other means provided for in a limited liability company agreement or other agreement or as otherwise permitted by law, including that the limited liability company agreement of any constituent limited liability company to the merger or consolidation (including a limited liability company formed for the purpose of consummating a merger or consolidation) shall be the limited liability company agreement of the surviving or resulting limited liability company.

4.4. Fiduciary Duties.

4.4.1. Texas. The Tex. LLC Stats. do not address specifically whether Manager or Member fiduciary or other duties exist or attempt to define them,[347] but they implicitly recognize that these duties may exist in statutory provisions which permit them to be expanded or restricted, and liabilities for the breach thereof to be limited or eliminated, in the Company Agreement.[348] The duty of Managers in a Manager-managed

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347 *See* Elizabeth M. McGeever, *Hazardous Duty? The Role of the Fiduciary in Noncorporate Structures*, 4 BUS. L. TODAY 51, 53 (Mar.–Apr.1995); Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 401 (1992) (noting that LLC statutes usually do not specify fiduciary duties of Members or Managers).

348 TBOC § 101.401 provides that a Company Agreement may expand or reduce (but not eliminate) fiduciary duties as follows:

> The company agreement of a limited liability company may expand or restrict any duties, including fiduciary duties, and related liabilities that a member, manager, officer, or other person has to the company or to a member or manager of the company.

Similarly, LLC Act § 2.20B provides that the Regulations may expand or reduce fiduciary duties as follows:

> To the extent that at law or in equity, a member, manager, officer, or other person has duties (including fiduciary duties) and liabilities relating thereto to a limited liability company or to another member or manager, such duties and liabilities may be expanded or restricted by provisions in the regulations.

TBOC § 7.001, as amended in 2013 by S.B. 847 § 2, does allow for the limitation or elimination of liabilities for breach of fiduciary duties as follows:

> Sec. 7.001. LIMITATION OF LIABILITY OF GOVERNING PERSON.
>
> (a) Subsections (b) and (c) apply to:
>
> (1) a domestic entity other than a partnership or limited liability company;
>
> (2) another organization incorporated or organized under another law of this state; and
>
> (3) to the extent permitted by federal law, a federally chartered bank, savings and loan association, or credit union.
>
> (b) The certificate of formation or similar instrument of an organization to which this section applies may provide that a governing person of the organization is not liable, or is liable only to the extent provided by the certificate of formation or similar instrument, to the organization or its owners or members for monetary damages for an act or omission by the person in the person's capacity as a governing person.
>
> (c) Subsection (b) does not authorize the elimination or limitation of the liability of a governing person to the extent the person is found liable under applicable law for:
>
> (1) a breach of the person's duty of loyalty, if any, to the organization or its owners or members;
>
> (2) an act or omission not in good faith that:
>
> (A) constitutes a breach of duty of the person to the organization; or
>
> (B) involves intentional misconduct or a knowing violation of law;
>
> (3) a transaction from which the person received an improper benefit, regardless of whether the benefit resulted from an action taken within the scope of the person's duties; or
>
> (4) an act or omission for which the liability of a governing person is expressly provided by an applicable statute.
>
> (d) The liability of a governing person may be limited or eliminated [~~restricted~~]:
>
> (1) in a general partnership by its partnership agreement to the same extent Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections apply and to the additional extent permitted under Chapter 152;
>
> (2) in a limited partnership by its partnership agreement to the same extent Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections apply and to the additional extent permitted under Chapter 153 and, to the extent applicable to limited partnerships, Chapter 152; and

LLC and Members in a Member-managed LLC to the LLC is generally assumed to be fiduciary in nature, measured by reference to the fiduciary duties of corporate directors in the absence of modification in the Company Agreement. The fiduciary duties of Managers could also be measured by reference to partnership law or the law of agency.[349]

By analogy to corporate directors, Managers would have the duties of obedience, care and loyalty and should have the benefit of the business judgment rule. Much like a corporate director who, in theory, represents all of the shareholders of the corporation rather than those who are responsible for his being a director, a Manager should be deemed to have a fiduciary duty to all of the Members. Whether Members owe a fiduciary duty to the other Members or the LLC will likely be determined by reference to corporate principles in the absence of controlling provisions in the certificate of formation or Company Agreement.[350]

> (3) in a limited liability company <u>by its certificate of formation or company agreement</u> to the <u>same</u> extent <u>Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections apply and to the additional extent</u> permitted under Section 101.401.

Thus, the TBOC now <u>allows</u> the <u>elimination of liabilities</u> – to a specified and limited extent – but does <u>not allow</u> the <u>elimination</u> of <u>fiduciary duties</u>, although fiduciary duties may be <u>expanded</u> or <u>reduced</u> in a company agreement. Thus, in theory, equitable remedies may exist to address acts for which any monetary liability has been eliminated by a company agreement.

349 *See* American Law Institute, RESTATEMENT (SECOND) OF AGENCY § 13 (1958) ("An agent is a fiduciary with respect to matters within the scope of his agency"), 387 ("Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency"), 393 ("Unless otherwise agreed, an agent is subject to a duty not to compete with the principal concerning the subject matter of his agency"), 394 ("Unless otherwise agreed, an agent is subject to a duty not to act or to agree to act during the period of his agency for persons whose interests conflict with those of the principal in matters in which the agent is employed"), and 395 ("Unless otherwise agreed, an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of his duties as agent, in competition with or to the injury of the principal, on his own account or on behalf of another, although such information does not relate to the transaction in which he is then employed, unless the information is a matter of general knowledge"). *See also* Elizabeth S. Miller, *Practical Pitfalls in Drafting Texas Limited Liability Company Agreements*, 45:1 TEX. J. BUS. L. 27 (2012) ("Absent provisions in the company agreement otherwise, managers and managing members would seemingly owe the common law fiduciary duties of an agent to the LLC as principal, even without resort to analogies to corporate or partnership law.").

350 *See Allen v. Devon Energy Holdings, L.L.C.*, 367 S.W.3d 355, 391-97 (Tex. App.—Houston [1st Dist.] 2012, pet. granted, *judgment set aside and remanded by agreement by* 2013 Tex. LEXIS 20 (Tex. Jan. 11, 2013) (case settled in 2013 while writ of error pending) (Court declined to recognize a fiduciary duty of a majority member to a minority member generally since Texas does not recognize such a relationship between majority and minority shareholders in closely held corporations, but concluded that the majority member's position as the controlling member and sole manager was sufficient to create a fiduciary duty to the minority member in a transaction in which the minority member's interest was being redeemed; the Court also concluded that an exculpation provision in the LLC's articles of organization referring to the manager's "duty of loyalty to [the LLC] or its members" could be read to create a fiduciary duty to the members individually which would include a duty of candor to disclose material facts relating to the value of the interest to be redeemed) (*Allen* was distinguished by *Fazio v. Cypress*, 2012 Tex. App. LEXIS 6837, on disclaimer of reliance issue); *Suntech Processing Sys., L.L.C. v. Sun Communications, Inc.*, No. 05-99-00213-CV, 2000 WL 1780236, at *6, 2000 Tex. App. LEXIS 8094, at *15-*19 (Tex. App.—Dallas Dec. 5, 2000, pet. denied) (minority Member of a Texas LLC claimed that the controlling Member owed a fiduciary duty as a matter of law in connection with the winding up of operations and distribution of assets; the Court pointed out that the Regulations expressly provided for a duty of loyalty to the LLC rather than between the Members, and, noting the absence of Texas case law on fiduciary duties of LLC Members and looking to case law regarding fiduciary duties of shareholders of a closely held corporation, held that there was no fiduciary relationship between the Members as a matter

The Tex. LLC Stats. allow LLC Company Agreements to expand or restrict the duties (including fiduciary duties) and liabilities of Members, Managers, officers and other persons to the LLC or to Members or Managers of the LLC.[351] This provision of Texas law was designed, in the same vein as the DLLCA from which it drew inspiration, to allow LLCs the flexibility to address fiduciary duties through contract principles.[352] Unlike the DLLCA which allows an LLC Agreement to eliminate fiduciary duties (but not the contractual duty of good faith and fair dealing),[353] the TBOC only permits an LLC Company Agreement to "restrict" duties, but allows the elimination of liability for breach of fiduciary duties (other than the duty of loyalty).[354]

The contractual elimination or restriction of fiduciary duties is an important developing issue in the context of fiduciary duties for Texas LLCs. The Texas Legislature in 2013 amended TBOC § 7.001(d)(3) to expand the permitted contractual limitation or elimination of liabilities for monetary damages for breach of fiduciary duties by Members and Managers of Texas LLCs, but does not allow the elimination of liabilities for breaches of the duty of loyalty or acts or omissions not in good faith.[355]

A Company Agreement provision restricting fiduciary duties and limiting liability for breaches thereof as permitted by TBOC §§ 7.001 and 101.401 could read as follows:

> This Agreement is not intended to, and does not, create or impose any fiduciary duty on any Member or Manager. Furthermore, each of the Members, the Managers and the Company hereby, to the fullest extent permitted by Applicable Law [defined to mean the TBOC and other applicable Texas and federal statutes and regulations thereunder], restricts, limits, waives and eliminates any and all duties, including fiduciary duties, that otherwise may be implied by Applicable Law and, in doing so, acknowledges and agrees that the duties and obligations of each Member or Manager to each other and to the

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of law). *See* Elizabeth S. Miller, *Practical Pitfalls in Drafting Texas Limited Liability Company Agreements*, 45:1 TEX. J. BUS. L. 27, 46 (2012).

351 *See* TBOC § 101.401; LLC Act § 2.20B. Prior to the effectiveness of 1997 S.B. 555 on September 1, 1997 ("1997 S.B. 555"), LLC Act § 8.12 had incorporated by reference the limitation of liability afforded to corporate directors under TMCLA 1302-7.06 and thereby allowed the limitation of Manager liability by a provision in the Articles (now, the Certificate of Formation) to the extent permitted for a director under TMCLA 1302-7.06. 1997 S.B. 555 deleted such incorporation by reference of TMCLA 1302-7.06 in favor of the broader authorization now in LLC Act § 2.20B, but a comparable provision was added back in TBOC § 7.001 as amended in 2013 by S.B. 847 § 2 as quoted *supra* in note 348.

352 DLLCA §§ 18-1101(a)-(f).

353 In Texas a common-law duty of good faith and fair dealing does not exist in all contractual relationships. *Blackmon-Dunda v. Mary Kay, Inc.*, No. 05-08-00192-CV, 2009 WL 866214, 2009 Tex. App. LEXIS 2512 (Tex. App.—Dallas April 1, 2009, pet. denied). Rather, the duty arises only when a contract creates or governs a special relationship between the parties. *Subaru of Am. v. David McDavid Nissan*, 84 S.W.3d 212, 225 (Tex. 2002). A "special relationship" has been recognized where there is unequal bargaining power between the parties and a risk exists that one of the parties may take advantage of the other based upon the imbalance of power, e.g., insurer-insured (*see Arnold v. Nat'l County Mut. Fire Ins. Co.*, 725 S.W.2d 165, 167 (Tex. 1987). The elements which make a relationship special are absent in the relationship between an employer and an employee. *See City of Midland v. O'Bryant*, 18 S.W.3d 209, 215 (Tex. 2000). While there are no reported Texas cases as to whether a contractual duty of good faith and fair dealing exists between Members in an LLC, or between Managers and Members in a Texas LLC, it is likely that the duty of good faith and fair dealing exists in those LLC relationships, just as fiduciary duties likely exist, except in each case to the extent that the duty has been restricted by contract as permitted by the Tex. LLC Stats. *See supra* note 348 and related text.

354 *See supra* note 348 and related text.

355 *See supra* note 348 and related text.

Company are only as expressly set forth in this Agreement and that no Member or Manager shall have any liability to the Company or any other Member or Manager for any act or omission except as specifically provided by Applicable Law or in this Agreement or another written agreement to which the Member or Manager is a party. The provisions of this Agreement, to the extent that they restrict, limit, waive and eliminate the duties and liabilities of a Member or Manager otherwise existing at law or in equity, are agreed by the Members to replace such other duties and liabilities of such Members or Managers.

Notwithstanding anything to the contrary contained in this Agreement,

(1) the Managers shall not permit or cause the Company to engage in, take or cause any of the following actions except with the prior approval of a majority of the outstanding Units voting: [*list specific actions*]:

(2) the Members and Managers and each of their respective Affiliates are permitted to have, and may presently or in the future have, investments or other business relationships, ventures, agreements or arrangements (i) with entities engaged in the business of the Company, other than through the Company (an "Other Business") and (ii) with [*additional entity specifics*]; [*provided*, that any transactions between the Company and an Other Business will be on terms no less favorable to the Company than would be obtainable in a comparable arm's-length transaction];[356] and

(3) there shall be a presumption by the Company that any actions taken in good faith by the Manager on behalf of the Company shall not violate any fiduciary or other duties owed by the Managers to the Company or the Members.[357]

Provisions such as the foregoing are often subject to intense negotiations and some investors may not agree to the limitations on duties and liabilities that those in control propose.

Although the Tex. LLC Stats., unlike their Delaware counterpart, do not include provisions that expressly emphasize the principles of freedom of contract and enforceability of LLC Company Agreements that expand, restrict or eliminate liability for breach of fiduciary duties, the legislative history and scope of LLC Act § 2.20B, the precursor to TBOC § 101.401, indicate that even before the 2013 Legislative Session there was more latitude to exculpate Managers and Members for conduct that would

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356 *See infra* notes 363-368 and related text for cases holding that wording such as this provision may contractually import the common law fiduciary duty of loyalty in Delaware

357 S.B. 847 in the 2013 Legislative Session amended TBOC § 7.001(d)(3) to read as follows:

> (d) The liability of a governing person may be limited or <u>eliminated</u> [~~restricted~~]:
>
> * * *
>
> (3) in a limited liability company <u>by its certificate of formation or company agreement</u> to the <u>same</u> extent <u>Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections apply and to the additional extent</u> permitted under Section 101.401 [The company agreement of a limited liability company may expand or restrict any duties, including fiduciary duties, and related liabilities that a member, manager, officer, or other person has to the company or to a member or manager of the company.].

See supra note 348.

otherwise breach a fiduciary duty under the Tex. LLC Stats. than under provisions of the TBOC and the TBCA relating specifically to corporations.[358]

The Tex. LLC Stats., which are based on TBCA article 2.35-1, provide that, unless the articles of organization, certificate of formation, Regulations or Company Agreement provide otherwise, a transaction between an LLC and one or more of its Managers or officers, or between an LLC and any other LLC or other entity in which one or more of its Managers or officers are Managers, directors or officers or have a financial interest, shall be valid notwithstanding the fact that the Manager or officer is present or participates in the meeting of Managers, or signs a written consent, which authorizes the transaction or the Manager's votes are counted for such purpose, <u>if</u> any of the following is satisfied:

> (i) The material facts as to the transaction and interest are disclosed or known to the governing authority, and the governing authority in good faith authorizes the transaction by the approval of a majority of the disinterested Managers or Members (as appropriate) even though the disinterested Managers or Members are less than a quorum; <u>or</u>
>
> (ii) The material facts as to the transaction and interest are disclosed or known to the Members, and the transaction is approved in good faith by a vote of the Members; <u>or</u>
>
> (iii) The transaction is fair to the LLC as of the time it is authorized, approved or ratified by the Managers or Members.[359]

In a joint venture, the duty of a Manager to all Members could be an issue since the Managers would often have been selected to represent the interests of particular Members. The issue could be addressed by structuring the LLC to be managed by Members who would then appoint representatives to act for them on an operating committee which would run the business in the name of the Members. In such a situation, the Members would likely have fiduciary duties analogous to partners in a general partnership.[360]

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358 In Texas a common-law duty of good faith and fair dealing does not exist in all contractual relationships. *Blackmon-Dunda v. Mary Kay, Inc.*, No. 05-08-00192-CV, 2009 WL 866214, at*1, 2009 Tex. App. LEXIS 2512, at *1 (Tex. App.—Dallas April 1, 2009, pet. denied). Rather, the duty arises only when a contract creates or governs a special relationship between the parties. *Subaru of Am. v. David McDavid Nissan*, 84 S.W.3d 212, 225 (Tex. 2002). A "special relationship" has been recognized where there is unequal bargaining power between the parties and a risk exists that one of the parties may take advantage of the other based upon the imbalance of power, e.g., insurer-insured (*see Arnold v. Nat'l County Mut. Fire Ins. Co.*, 725 S.W.2d 165, 167 (Tex. 1987). The elements which make a relationship special are absent in the relationship between an employer and an employee. *See City of Midland v. O'Bryant*, 18 S.W.3d 209, 215 (Tex. 2000). While there are no reported Texas cases as to whether a contractual duty of good faith and fair dealing exists between Members in an LLC, or between Managers and Members in a Texas LLC, it is likely that the duty of good faith and fair dealing exists in those LLC relationships, just as fiduciary duties likely exist, except in each case to the extent that the duty has been restricted by contract as permitted by the Tex. LLC Stats.

359 TBOC § 101.255 as amended in the 2009 Legislative Session by 2009 S.B. 1442 § 44 and in the 2011 Legislative Session by 2011 S.B. 748 § 38; LLC Act § 2.17.

360 *Id.*; *see* TBOC § 152.204; *see also* TRPA § 4.04.

4.4.2. Delaware. The DLLCA does not codify Manager or Member fiduciary duties, but expressly permits the elimination of fiduciary duties in an LLC,[361] although not all Delaware LLC Agreements

[361] DLLCA § 18-1101(b), (c), (d) and (e) provides:

> (b) It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.
>
> (c) To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.
>
> (d) Unless otherwise provided in a limited liability company agreement, a member or manager or other person shall not be liable to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement for breach of fiduciary duty for the member's or manager's or other person's good faith reliance on the provisions of the limited liability company agreement.
>
> (e) A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

effectively do so.[362] In *Auriga Capital Corp. v. Gatz Properties, LLC*,[363] Delaware Chancellor (now Chief Justice) Strine, in finding for the minority investors who had challenged the merger of the LLC into an entity controlled by the Manager, held that the LLC Agreement contractually incorporated a core element of the traditional common law fiduciary duty of loyalty by providing that the Manager could enter into a self-dealing transaction (such as its purchase of the LLC) only if it proved that the terms were fair. The LLC Agreement provided that, without the consent of the holders of two-thirds of the interests not held by the Manager or its affiliates, the Manager would not be entitled to cause the LLC to enter into any transaction with an affiliate that is less favorable to the LLC than that which could be entered into with an unaffiliated third party. The LLC Agreement's exculpation provision provided that the Manager would not be liable to the LLC for actions taken or omitted by the Manager in good faith and without gross negligence or willful misconduct. As the LLC Agreement's exculpatory provision expressly did not excuse bad faith action, willful misconduct, or even grossly negligent action, by the LLC Manager, the Manager was liable for the losses caused by its flawed merger. The Chancellor mused that under traditional principles of equity applicable to an LLC and in the absence of a contrary LLC Agreement provision, a

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362 *In re Atlas Energy Resources LLC*, C.A. No. 4589-VCN, 2010 WL 4273122, 2010 Del. Ch. LEXIS 216 (Del. Ch. Oct. 28, 2010), involved breach of fiduciary duty claims arising from a merger between a publicly traded LLC and its controlling unitholder. In *In re Atlas*, the Chancery Court held that an LLC Agreement eliminated the traditional fiduciary duties of the LLC's directors and officers, replacing them with a contractually-defined duty of good faith, which was not breached, but did not address the duties of the controlling unitholder, which were held to be equivalent to those of a controlling shareholder of a Delaware corporation. The Court commented that LLCs are creatures of contract designed to afford the maximum amount of freedom of contract, private ordering, and flexibility to the parties involved. One aspect of this flexibility, the Court wrote, is that parties to an LLC Agreement can contractually expand, restrict, modify or fully eliminate the fiduciary duties owed by its members, subject to certain limitations, but in the absence of explicit provisions in the LLC Agreement to the contrary, the traditional fiduciary duties owed by corporate directors and controlling shareholders apply in the LLC context. Because this LLC Agreement did not eliminate the fiduciary duties of the controlling unitholder, it owed directly to the LLC's minority unitholders the traditional fiduciary duties that controlling shareholders owe minority shareholders. Since the merger created a conflict between the controlling unitholder's interest in acquiring the balance of the LLC for the lowest possible price and the minority unitholders' interest in obtaining a high price for their units and the LLC Agreement did not address this conflict of interest, the Court evaluated the merger under the entire fairness standard of review in order to assure that the controlling unitholder "has been assiduous in fulfilling those duties," held that "plaintiffs' allegations as to price and process, adequately suggest that the merger was not entirely fair to the public unitholders," and denied defendants' motion to dismiss the claim for breach of fiduciary duty by the controlling unitholder.

DLLCA § 18-1101(e) was followed in *In re Heritage Org., LLC*, No. 04-35574-BJH-11, 2008 WL 5215688, at *16, 2008 Bankr. LEXIS 3230, at *53 (Bankr. N.D. Tex. Dec. 12, 2008), which involved a bankruptcy trustee's breach of fiduciary duty claims against former officers of a bankrupt Delaware LLC which had an LLC Agreement that eliminated fiduciary duties in the following sweeping language:

> The Manager shall not be required to exercise any particular standard of care, nor shall he owe any fiduciary duties to the Company or the other Members. Such excluded duties include, by way of example, not limitation, any duty of care, duty of loyalty, duty of reasonableness, duty to exercise proper business judgment, duty to make business opportunities available to the company, and any other duty which is typically imposed upon corporate officers and directors, general partners or trustees. The Manager shall not be held personally liable for any harm to the Company or the other Members resulting from any acts or omissions attributed to him. Such acts or omissions may include, by way of example but not limitation, any act of negligence, gross negligence, recklessness, or intentional misconduct.

Id.

Faced with this broad clause, the bankruptcy court in *Heritage* held that the defendants had no fiduciary duties to breach, and thus rejected the trustee's breach of fiduciary duty claim. *Cf. Kahn v. Portnoy*, C.A. No. 3515-CC, 2008 WL 5197164, 2008 Del. Ch. LEXIS 184 (Del. Ch. Dec. 11, 2008) (under freedom of contract principles, fiduciary duties held to be defined, but not eliminated, by LLC Agreement).

363 40 A.3d 839 (Del. Ch. 2012), *aff'd*, 59 A.3d 1206 (Del. 2012).

Manager of an LLC would owe to the LLC and its members the common law fiduciary duties of care and loyalty.

The Delaware Supreme Court affirmed *Auriga* in *Gatz Properties, LLC v. Auriga Capital Corp.*,[364] holding that although the LLC Agreement did not use words such as "entire fairness" or "fiduciary duties," there was nonetheless an explicit contractual assumption by the parties of an obligation on the part of the Manager and Members of the LLC to obtain a fair price for the LLC in transactions between the LLC and affiliates, but the Supreme Court expressly rejected the Chancellor's conclusion that the fiduciary duties were "default" fiduciary duties:

> The pivotal legal issue presented on this appeal is whether Gatz owed contractually-agreed-to fiduciary duties to Peconic Bay [the LLC] and its minority investors. Resolving that issue requires us to interpret Section 15 of the LLC Agreement, which both sides agree is controlling. Section 15 pertinently provides that:
>
>> Neither the Manager nor any other Member shall be entitled to cause the Company to enter into any amendment of any of the Initial Affiliate Agreements which would increase the amounts paid by the Company pursuant thereto, or enter into any additional agreements with affiliates on terms and conditions which are less favorable to the Company than the terms and conditions of similar agreements which could then be entered into with arms-length third parties, without the consent of a majority of the non-affiliated Members (such majority to be deemed to be the holders of 66-2/3% of all Interests which are not held by affiliates of the person or entity that would be a party to the proposed agreement).
>
> The Court of Chancery determined that Section 15 imposed fiduciary duties in transactions between the LLC and affiliated persons. We agree. To impose fiduciary standards of conduct as a contractual matter, there is no requirement in Delaware that an LLC agreement use magic words, such as "entire fairness" or "fiduciary duties." Indeed, Section 15 nowhere expressly uses either of those terms. Even so, we construe its operative language as an explicit contractual assumption by the contracting parties of an obligation subjecting the manager and other members to obtain a fair price for the LLC in transactions between the LLC and affiliated persons. Viewed functionally, the quoted language is the contractual equivalent of the entire fairness equitable standard of conduct and judicial review.
>
> We conclude that Section 15 of the LLC Agreement, by its plain language, contractually adopts the fiduciary duty standard of entire fairness, and the "fair price" obligation which inheres in that standard. Section 15 imposes that standard in cases where

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364 59 A.3d 1206 (Del. 2012), *aff'g* 40 A.3d 839; *see* Jessica Liou, *Fiduciary Duty Bound (Part 1): "Default" Fiduciary Duties Apply in Delaware LLC's…Or Maybe They Don't*, Weil Bankruptcy Blog, Mar. 8, 2013, http://business-finance-restructuring.weil.com/fiduciary-duties/fiduciary-duty-bound-part-1-default-fiduciary-duties-apply-in-delaware-llcsor-maybe-they-dont/.

an LLC manager causes the LLC to engage in a conflicted transaction with an affiliate without the approval of a majority of the minority members. There having been no majority-of-the-minority approving vote in this case, the burden of establishing the fairness of the transaction fell upon Gatz. That burden Gatz could easily have avoided. If (counterfactually) Gatz had conditioned the transaction upon the approval of an informed majority of the nonaffiliated members, the sale of Peconic Bay would not have been subject to, or reviewed under, the contracted-for entire fairness standard.

* * *

Entire fairness review normally encompasses two prongs, fair dealing and fair price. "However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness." In this case, given the language of Section 15 which speaks only in terms of fair price, the Court of Chancery formally applied only the fair price prong. But, in doing so that court also properly considered the "fairness" of how Gatz dealt with the minority "because the extent to which the process leading to the self-dealing either replicated or deviated from the behavior one would expect in an arms-length deal bears importantly on the price determination." The court further held that "in order to take cover under the contractual safe harbor of Section 15, Gatz bears the burden to show that he paid a fair price to acquire [the LLC]."

* * *

Although the trial court's adjudication subjects Gatz to liability under Section 15 of the LLC Agreement, another provision, Section 16, permits both exculpation and indemnification of Peconic Bay's manager in specified circumstances. Gatz, however, did not cause those circumstances to come about. Having failed to satisfy the criteria of Section 16, Gatz was not eligible for exculpation or indemnification, and the Court of Chancery properly so held.

Section 16 of the LLC Agreement pertinently provides:

> No Covered Person [defined to include, among others, the members, manager, and officers and the employees] shall be liable to the Company, [or] any other Covered Person or any other person or entity who has an interest in the Company for any loss, damage or claim incurred by reason of any act or omission performed or omitted by such Covered Person in good faith in connection with the formation of the Company or on behalf of the Company and in a manner reasonably believed to be within the scope of the authority conferred on such Covered Person by this Agreement, except that a Covered Person shall be liable for any such loss, damage or claim incurred by reason of such Covered Person's gross negligence, willful misconduct or willful misrepresentation.

Gatz was not entitled to exculpation because the Court of Chancery properly found that he had acted in bad faith and had made willful misrepresentations in the course of breaching his contracted-for fiduciary duty. Consequently, Section 16 of the LLC Agreement provides no safe harbor.

* * *

At this point, we pause to comment on one issue that the trial court should not have reached or decided. We refer to the court's pronouncement that the Delaware Limited Liability Company Act imposes "default" fiduciary duties upon LLC managers and controllers unless the parties to the LLC Agreement contract that such duties shall not apply. Where, as here, the dispute over whether fiduciary standards apply could be decided solely by reference to the LLC Agreement, it was improvident and unnecessary for the trial court to reach out and decide, *sua sponte*, the default fiduciary duty issue as a matter of statutory construction. The trial court did so despite expressly acknowledging that the existence of fiduciary duties under the LLC Agreement was "no longer contested by the parties." For the reasons next discussed, that court's statutory pronouncements must be regarded as dictum without any precedential value.

First, the Peconic Bay LLC Agreement explicitly and specifically addressed the "fiduciary duty issue" in Section 15, which controls this dispute. Second, no litigant asked the Court of Chancery or this Court to decide the default fiduciary duty issue as a matter of statutory law. In these circumstances we decline to express any view regarding whether default fiduciary duties apply as a matter of statutory construction. The Court of Chancery likewise should have so refrained.[365]

While the Supreme Court opinion in *Gatz* did not resolve the issue of whether fiduciary duties would be implied in the absence of the contractual elimination or modification of fiduciary duties in the LLC Agreement,[366] the Delaware Court of Chancery subsequently "considered the issue of default fiduciary duties and held that, subject to clarification from the Supreme Court, managers and managing members of an LLC <u>do</u> owe fiduciary duties as a default matter."[367] Further, the DLLCA has been

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365 59 A.3d at 1212-18.

366 *See infra* note 364 and related text.

367 *Zimmerman v. Adhezion Biomedical LLC*, 62 A.3d 676, 702 n.145 (Del. Ch. 2013) (*emphasis added*, referencing *Feeley v. NHAOCG, LLC*, 62 A.3d 649 (Del. Ch. Nov. 28, 2012)). In *Zimmerman*, Robert Zimmerman, co-founder and former CEO of Adhezion, sued the current majority owners, alleging breach of the LLC Agreement (failure to obtain consent of the common members) and fiduciary duties (self-dealing transactions) when such majority owners caused Adhezion to enter into certain financing transactions. The majority owners denied any fundamental breach of fiduciary duty, and argued, in any event, that the LLC Agreement proscribed an applicable standard of review (the business judgment rule), which they contend they did not breach.

The Court of Chancery found that the majority owners did breach the LLC Agreement in issuing units without written consent, involving a detailed analysis of the LLC Agreement, which the Court found to be an unusually ambiguous contract. It also noted that the LLC Agreement imposed duties of good faith (to act with an objective standard of reasonableness) and enumerated specific safe harbors for intercompany dealings; and accordingly, because the Court found that (i) Zimmerman failed to show that the financing transactions were unfair to Adhezion and (ii) the financing transactions were approved in compliance with the requisite safe harbor, the Court held that the majority owners had not breached their contracted-for fiduciary duties to the company. With respect to this latter finding, the Court of Chancery specifically distinguished *Auriga*, which placed the burden of proving the fairness of the self-dealing transaction on the LLC manager (because of language in the LLC Agreement prohibited such a manager from entering into self-dealing transaction without the consent of the other managers), as opposed to the LLC Agreement in *Zimmerman*, which gave members, directors, or officers the affirmative right to engage in transactions with the company, so long as such a transaction was comparable to a third-party one. Ultimately, the Court awarded Zimmerman $1 for his successful breach of contract claim with respect to the majority owners' failure to obtain written consent and otherwise found that the majority owners were protected by the indemnification provisions of the LLC Agreement with respect to Zimmerman's requests for attorneys' fees advanced by Adhezion on behalf of the majority owners.

See also Kelly v. Blum, No. 4516-VCP, 2010 WL 629850 at *9-*13, 2010 Del. Ch. LEXIS 31, at *34-*50 (Del. Ch. Feb. 24, 2010), the Chancery Court denied motions for summary judgment, dealing with (among other things) fiduciary duties in a merger challenged by a minority Member/Manager of an LLC who was squeezed out in a merger into a sister company of the majority Member. The Court held that: (i) the claims of the minority were direct rather than derivative, (ii) the Managers and majority Members owed traditional fiduciary duties to the minority Member in the absence of any express provisions in the operating agreement to limit fiduciary duties, and (iii) the corporate parent of the majority Member and the surviving Member could be liable for aiding and abetting breaches of fiduciary duty. In so holding, the Court explained:

> Though few Delaware cases deal specifically with the distinction between derivative and direct claims in the LLC context, Sections 18-1001 to 18-1004 of the Delaware Limited Liability Company Act ("LLC Act") were modeled, in significant part, on the corporate derivative suit. Consequently, "case law governing corporate derivative suits is equally applicable to suits on behalf of an LLC," and I look to corporate case law to determine the proper method for distinguishing between derivative actions brought on behalf of Marconi and Kelly's direct claims.
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> The distinction between the rights of an LLC and the individual rights of its members is often quite narrow. Though several early Delaware cases addressing this distinction relied largely on the "amorphous and confusing concept of 'special injury,'" the Delaware Supreme Court expressly disavowed use of that concept in *Tooley*. In *Tooley*, the Court stated that determining whether a claim is derivative or direct depends solely upon two questions: First, "who suffered the alleged harm," the LLC or its members, and second, "who would receive the benefit of any recovery or other remedy," the LLC or its members, individually. In answering these questions, the Court looks to the nature of the wrong alleged, not merely at the form of words used in the complaint.
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> In the second count of the Complaint, Kelly claims that, by virtue of their status as Members or Managers of Marconi, Defendants Blum, Breen, Kestenbaum, MBC Investment, and MBC Lender each "owed various fiduciary duties to Kelly as the minority equity owner." Kelly further avers that these Defendants violated their duties of loyalty and care to him by entering into a self-interested Merger on terms that were unfair to Kelly.
>
> The basic approach of the LLC Act is to "provide members with broad discretion in drafting the [LLC] Agreement and to furnish default provisions when the members' agreement is silent." In the case of fiduciary duties, the LLC Act permits LLC contracting parties to expand, restrict, or eliminate duties, including fiduciary duties, owed by members and managers to each other and to the LLC. Section 18-1101(c) does not specify a statutory default provision as do other sections of the LLC Act; rather, it implies that some default fiduciary duties may exist "at law or in equity," inviting Delaware courts to make an important policy decision and determine the default level of those duties.
>
> Accepting that invitation, Delaware cases interpreting Section 18-1101(c) have concluded that, despite the wide latitude of freedom of contract afforded to contracting parties in the LLC context, "in the absence of a contrary provision in the LLC agreement," LLC managers and members owe "traditional fiduciary duties of loyalty and care" to each other and to the company. Thus, unless the LLC agreement in a manager-managed LLC explicitly expands, restricts, or eliminates traditional fiduciary duties, managers owe those duties to the LLC and its members and controlling members owe those duties to minority members. Therefore, I must determine whether the 2008 LLC Agreement expanded, restricted, or eliminated the default fiduciary duties the Managers (Blum, Breen, and Kestenbaum) and controlling Members (MBC Investment and MBC Lender) owed to Kelly, and whether a breach of any existing duty would support a direct, as opposed to a derivative, claim.
>
> In large measure, the 2008 LLC Agreement is silent on the issue of duties owed by Managers to the LLC and its Members, with the exception of Sections 7.5 and 7.9. In its entirety, Section 7.5, entitled "Duties," states that
>
>> [t]he Board of Managers shall manage the affairs of the Company in a prudent and business-like manner and shall devote such time to the Company affairs as they shall, in their discretion exercised in good faith, determine is reasonably necessary for the conduct of such affairs.

In relevant part, Section 7.9, which limits the monetary liability of Managers, states that

> [i]n carrying out their duties hereunder, the Managers shall not be liable for money damages **for breach of fiduciary duty to the Company nor to any Member** for their good faith actions or failure to act ... but only for their own willful or fraudulent misconduct or willful breach of their contractual or **fiduciary duties** under this Agreement.

(Emphasis added).

I do not read these clauses, individually or collectively, as "explicitly disclaim[ing or limiting] the applicability of default principles of fiduciary duty." Indeed, far from limiting such duties, Section 7.9 suggests that the parties intended traditional fiduciary duties to apply. Additionally, Section 7.5 does not limit the Managers' duties so much as place control of Marconi's affairs in the board of Managers, rather than the Members, allowing each Manager the discretion to determine the amount of time she must devote to running Marconi.

Because no clause in the 2008 LLC Agreement explicitly restricts or eliminates the default applicability of fiduciary duties, I find that Blum, Breen, and Kestenbaum, as Managers of Marconi, were required to treat Kelly in accordance with such traditional fiduciary duties. Furthermore, if the allegations in Kelly's Complaint are true, then Blum, Breen, and Kestenbaum entered the Merger largely intending to profit from a "premeditated scheme to squeeze Kelly out of Marconi and seize control of the FCC license" held by Marconi-actions that support a claim for breach of the duty of loyalty. Thus, drawing reasonable inferences in Kelly's favor, I find that his Complaint alleges sufficient facts to support his claim that the Managers breached these duties by entering into a Merger designed solely to eliminate Kelly's interest in Marconi.

Even though Kelly alleged facts that, if true, are sufficient to show that Blum, Breen, and Kestenbaum may have breached their fiduciary duties, those Defendants still might avoid liability because the 2008 LLC Agreement contains an exculpatory provision limiting the monetary liability of Managers. Section 18-1101(e) of the LLC Act permits members, in their LLC agreement, to limit or eliminate a manager's or member's liability for "breach of contract and breach of duties (including fiduciary duties)," except for liability arising from a "bad faith violation of the implied contractual covenant of good faith and fair dealing." While somewhat analogous to 8 *Del. C.* § 102(b)(7), which authorizes a corporation to adopt provisions limiting liability for a director's breach of the duty of care, Section 18-1101(e) goes further by allowing broad exculpation of *all* liabilities for breach of fiduciary duties-including the duty of loyalty.

Here, Section 7.9 of the 2008 LLC Agreement eliminates the Managers' monetary liability for all conduct except "willful or fraudulent misconduct or willful breach of ... contractual or fiduciary duties under this Agreement." Although the default duties of loyalty and care remain, this provision requires more than application of a standard like entire fairness and requires that Kelly allege facts showing scienter. That is, under Section 7.9, liability attaches only where a Manager willfully breaches his fiduciary duties.

* * *

As with LLC managers, "in the absence of provisions in the LLC agreement explicitly disclaiming the applicability of default principles of fiduciary duty," controlling members in a manager-managed LLC owe minority members "the traditional fiduciary duties" that controlling shareholders owe minority shareholders. Controlling shareholders-typically defined as shareholders who have voting power to elect directors, cause a break-up of the company, merge the company with another, or otherwise materially alter the nature of the corporation and the public shareholder's interests-owe certain fiduciary duties to minority shareholders. Specifically, and very pertinently to this case, such fiduciary duties include the duty "not to cause the corporation to effect a transaction that would benefit the fiduciary at the expense of the minority stockholders."

* * *

Because the 2008 LLC Agreement is silent as to what duties controlling members owe minority members, I find that MBC Investment and MBC Lender owed Kelly traditional fiduciary duties, including, among others, the duty not to cause Marconi to enter a transaction that would benefit the controlling Members at the expense of Kelly, Marconi's minority Member. I also find that Kelly has stated facts that, if true, are sufficient to show that MBC Investment and MBC Lender did, with the aid of their appointed Managers, effect the Merger in order to benefit themselves at the expense of Kelly. Thus, Kelly has stated a direct claim that is not subject to any exculpation provision in the Agreement, and I deny Defendants' motion to dismiss Count II of Kelly's Complaint as to MBC Investment and MBC Lender.

Id.

amended, effective August 1, 2013, to provide that unless modified in an LLC's governing documents, common law fiduciary duties apply to LLCs.[368]

The DLLCA aggressively adopts a "contracterian approach" (i.e., the bargains of the parties manifested in LLC Agreements are to be respected and rarely trumped by statute or common law).[369] The

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368 DLLCA § 18-1104 was amended, effective August 1, 2013, as follows: "In any case not provided for in this chapter, the rules of law and equity, including the rules of law and equity relating to fiduciary duties and the law merchant, shall govern." [new language underlined]. The synopsis accompanying the amendment in Delaware H.B. 126 explains it as follows:

> Section 8 amends Section 18-1104 to confirm that in some circumstances fiduciary duties not explicitly provided for in the limited liability company agreement apply. For example, a manager of a manager-managed limited liability company would ordinarily have fiduciary duties even in the absence of a provision in the limited liability company agreement establishing such duties. Section 18-1101(c) continues to provide that such duties may be expanded, restricted or eliminated by the limited liability company agreement.

369 In *Fisk Ventures, LLC v. Segal*, C.A. No. 3017-CC, 2008 WL 1961156, 2008 Del. Ch. LEXIS 158 (Del. Ch. May 7, 2008), *judgment aff'd*, 984 A.2d 124 (Del. 2009), Delaware Chancellor William Chandler wrote that LLCs are creatures of contract and that a prerequisite to any breach of contract analysis is to determine if there is a *duty* in the document that has been breached. The Chancellor quoted in footnote 34 Chief Justice Steele's article entitled *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 Del. J. Corp. L. 1, 4 (2007) ("Courts should recognize the parties' freedom of choice exercised by contract and should not superimpose an overlay of common law fiduciary duties…"), and found no provision in the LLC Agreement at issue that: "create[d] a code of conduct for all members; on the contrary, most of those sections expressly claim to limit or waive liability." The Chancellor wrote:

> There is no basis in the language of the LLC Agreement for Segal's contention that all members were bound by a code of conduct, but, even if there were, this Court could not enforce such a code because there is no limit whatsoever to its applicability.

In addressing the breach of fiduciary duty claims asserted by plaintiff, the Chancellor focused on DLLCA § 18-1101(c) which allows for the complete elimination of all fiduciary duties in an LLC Agreement. The Court then read the subject LLC Agreement to eliminate fiduciary duties because it flatly stated that:

> No Member shall have any duty to any Member of the Company except as expressly set forth herein or in other written agreements. No Member, Representative, or Officer of the Company shall be liable to the Company or to any Member for any loss or damage sustained by the Company or to any Member, unless the loss or damage shall have been the result of gross negligence, fraud or intentional misconduct by the Member, Representative, or Officer in question….

2008 WL 1961156, at *9, 2008 Del. Ch. LEXIS 158, at *31.

Because the foregoing LLC Agreement exception for gross negligence, fraud or intentional misconduct did not create a fiduciary duty and the LLC Agreement did not otherwise expressly articulate fiduciary obligations, the foregoing LLC Agreement provision was held to be sufficient to eliminate defendant's fiduciary duties.

The Chancellor considered and disposed of plaintiff's "implied covenant of good faith and fair dealing" claim as follows:

> Every contract contains an implied covenant of good faith and fair dealing that "requires a 'party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits' of the bargain." Although occasionally described in broad terms, the implied covenant is not a panacea for the disgruntled litigant. In fact, it is clear that "a court cannot and should not use the implied covenant of good faith and fair dealing to fill a gap in a contract with an implied term unless it is clear from the contract that the parties would have agreed to that term had they thought to negotiate the matter." Only rarely invoked successfully, the implied covenant of good faith and fair dealing protects the spirit of what was *actually bargained and negotiated for* in the contract. Moreover, because the implied covenant is, by definition, *implied*, and because it protects the *spirit* of the agreement rather than the form, it cannot be invoked where the contract itself expressly covers the subject at issue.
>
> Here, Segal argues that Fisk, Rose and Freund breached the implied covenant of good faith and fair dealing by frustrating or blocking the financing opportunities proposed by Segal. However, neither the LLC Agreement nor any other contract endowed him with the right to unilaterally decide what fundraising or financing opportunities the Company should pursue, and his argument is "another in a long line of cases in which a

plaintiff has tried, unsuccessfully, to argue that the implied covenant grants [him] a substantive right that [he] did not extract during negotiation." Moreover, the LLC Agreement *does* address the subject of financing, and its specifically requires the approval of 75% of the Board. Implicit in such a requirement is the right of the Class B Board representatives to disapprove of and therefore block Segal's proposals. As this Court has previously noted, "[t]he mere exercise of one's contractual rights, without more, cannot constitute … a breach [of the implied covenant of good faith and fair dealing]." Negotiating forcefully and within the bounds of rights granted by the LLC agreement does not translate to a breach of the implied covenant on the part of the Class B members.

2008 WL 1961156, a5 *10-*11, 2008 Del. Ch. LEXIS 158, at *39-*46.

In *Related Westpac LLC v. JER Snowmass LLC*, C.A. No. 5001-VCS, 2010 WL 2929708, at *1, 2010 Del. Ch. LEXIS, at *2-*3 (Del. Ch. July 23, 2010), the Delaware Chancery Court held that one Member of an LLC could not force another to advance funds in a joint redevelopment project and consent to related projects, finding that the partner's refusal was permitted by the project's operating agreements. In so deciding, the Court refused to find that a condition of reasonableness to the right to refuse consent:

> In this decision, I dismiss the complaint. Under the operating agreements that govern the LLCs, the defendant member could not unreasonably withhold its consent to certain decisions. But as to the type of decisions at issue in this case — so-called "material actions" — the defendant member was not subject to such a constraint and had contractually bargained to remain free to give or deny its consent if that was in its own commercial self-interest. Here, the plaintiff operating member seeks to have the court impose a contractual reasonableness overlay on a contract that is clearly inconsistent with the parties' bargain. Delaware law respects contractual freedom and requires parties like the operating member to adhere to the contracts they freely enter. The operating agreements here preclude the relief the operating member seeks, including its attempt to end-run the operating agreements by arguing that the defendant member had a fiduciary duty to act reasonably in granting consent. Under the plain terms of the operating agreements, the defendant member had bargained for the right to give consents to decisions involving material actions or not, as its own commercial interests dictated. Having bargained for that freedom and gained that concession from the operating member, the defendant member is entitled to the benefit of its bargain and the operating member cannot attempt to have the court write in a reasonableness condition that the operating member gave up. The words "not unreasonably withheld" are well known and appear in other sections of the operating agreements. They do not qualify the defendant member's right to deny consent to major decisions involving a material action.
>
> Likewise, the operating agreements clearly state the sole remedy the operating member has if the defendant member fails to meet a capital call. The operating member again seeks to have this court impose a remedy inconsistent with the plain terms of the operating agreements. This court cannot play such a role, and the operating member's claims relating to the capital call are dismissed because they are inconsistent with the operating agreements.

DLLCA does not have any provision which itself creates or negates Member or Manager fiduciary duties, but instead allows modification or elimination of fiduciary duties[370] by an LLC Agreement,[371] but does not

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370 DLLCA § 18-1101 provides as follows:

> **18-1101 CONSTRUCTION AND APPLICATION OF CHAPTER AND LIMITED LIABILITY COMPANY AGREEMENT.**
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> (a) The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter.
>
> (b) It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.
>
> (c) To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.
>
> (d) Unless otherwise provided in a limited liability company agreement, a member or manager or other person shall not be liable to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement for breach of fiduciary duty for the member's or manager's or other person's good faith reliance on the provisions of the limited liability company agreement.
>
> (e) A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.
>
> (f) Unless the context otherwise requires, as used herein, the singular shall include the plural and the plural may refer to only the singular. The use of any gender shall be applicable to all genders. The captions contained herein are for purposes of convenience only and shall not control or affect the construction of this chapter.

371 *See* Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 25 (2007), in which Delaware Supreme Court Chief Justice Steele argues that parties forming limited liability companies should be free to adopt or reject some or all of the fiduciary duties recognized at common law, that courts should look to the parties' agreement and apply a contractual analysis, rather than analogizing to traditional notions of corporate governance, in LLC fiduciary duty cases, and that:

> Delaware's Limited Liability Company Act does not specify the duties owed by a member or manager. It does, however, like the Limited Partnership Act, provide for a default position "to the extent, at law or in equity" limited liability companies have "duties (including fiduciary duties)." These duties, in turn, "may be expanded or restricted or eliminated" in the agreement, provided that the "agreement may not eliminate the implied contractual covenant of good faith and fair dealing."
>
> The same issues and considerations that arise in limited partnerships arise in governance disputes in limited liability companies. There is an assumed default to traditional corporate governance fiduciary duties where the agreement is silent, or at least not inconsistent with the common law fiduciary duties. Lack of clarity in the agreements on this point may confuse the court and cause it to focus improperly when addressing the conduct complained of in a derivative action or in an action to interpret, apply, or enforce the terms of the limited liability company agreement. Predictably, but not necessarily correctly, Delaware courts will gravitate toward a focus on the parties' status relationship and not their contractual relationship in the search for a legal and equitable resolution of a dispute unless the agreement explicitly compels the court to look to its terms and not to the common law fiduciary gloss.

See supra note 291 and related text regarding Chief Justice Steele's views in respect of fiduciary duties in the limited partnership context.

allow the elimination of "the implied contractual covenant of good faith and fair dealing."[372] An LLC Agreement eliminating fiduciary duties as permitted by the DLLCA could read as follows:

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[372] *Id.* *See* RESTATEMENT (SECOND) OF CONTRACTS and related Comment which provide:

§ 205. Duty of Good Faith and Fair Dealing

Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.

Comment:

a. Meanings of "good faith." Good faith is defined in Uniform Commercial Code § 1-201(19) as "honesty in fact in the conduct or transaction concerned." "In the case of a merchant" Uniform Commercial Code § 2-103(1)(b) provides that good faith means "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade." The phrase "good faith" is used in a variety of contexts, and its meaning varies somewhat with the context. Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving "bad faith" because they violate community standards of decency, fairness or reasonableness. The appropriate remedy for a breach of the duty of good faith also varies with the circumstances.

b. Good faith purchase. In many situations a good faith purchaser of property for value can acquire better rights in the property than his transferor had. See, e.g., § 342. In this context "good faith" focuses on the honesty of the purchaser, as distinguished from his care or negligence. Particularly in the law of negotiable instruments inquiry may be limited to "good faith" under what has been called "the rule of the pure heart and the empty head." When diligence or inquiry is a condition of the purchaser's right, it is said that good faith is not enough. This focus on honesty is appropriate to cases of good faith purchase; it is less so in cases of good faith performance.

c. Good faith in negotiation. This Section, like Uniform Commercial Code § 1-203, does not deal with good faith in the formation of a contract. Bad faith in negotiation, although not within the scope of this Section, may be subject to sanctions. Particular forms of bad faith in bargaining are the subjects of rules as to capacity to contract, mutual assent and consideration and of rules as to invalidating causes such as fraud and duress. See, for example, §§ 90 and 208. Moreover, remedies for bad faith in the absence of agreement are found in the law of torts or restitution. For examples of a statutory duty to bargain in good faith, see, e.g., National Labor Relations Act § 8(d) and the federal Truth in Lending Act. In cases of negotiation for modification of an existing contractual relationship, the rule stated in this Section may overlap with more specific rules requiring negotiation in good faith. See §§ 73, 89; Uniform Commercial Code § 2-209 and Comment.

d. Good faith performance. Subterfuges and evasions violate the obligation of good faith in performance even though the actor believes his conduct to be justified. But the obligation goes further: bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty. A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance.

e. Good faith in enforcement. The obligation of food faith and fair dealing extends to the assertion, settlement and litigation of contract claims and defenses. See, e.g., §§ 73, 89. The obligation is violated by dishonest conduct such as conjuring up a pretended dispute, asserting an interpretation contrary to one's own understanding, or falsification of facts. It also extends to dealing which is candid but unfair, such as taking advantage of the necessitous circumstances of the other party to extort a modification of a contract for the sale of goods without legitimate commercial reason. See Uniform Commercial Code § 2-209, Comment 2. Other types of violation have been recognized in judicial decisions: harassing demands for assurances of performance, rejection of performance for unstated reasons, willful failure to mitigate damages, and abuse of a power to determine compliance or to terminate the contract. For a statutory duty of good faith in termination, see the federal Automobile Dealer's Day in Court Act, 15 U.S.C. §§ 1221-25 (1976).

In *Kuroda v. SPJS Holdings, L.L.C.*, 971 A.2d 872, 888 (Del. Ch. 2009), a dispute among members of an LLC, the Chancellor dismissed plaintiff's allegations that the defendant members had breached the implied covenant of good faith

> Except as expressly set forth in this Agreement or expressly required by the Delaware Act, no Manager or Member shall have any duties or liabilities, including fiduciary duties, to the Company or any Member, and the provisions of this Agreement, to the extent that they restrict, eliminate or otherwise modify the duties and liabilities, including fiduciary duties, of any Manager or Member otherwise existing at law or in equity, are agreed by the Company and the Members to replace such other duties and liabilities of the Managers and Members; provided that nothing here shall be construed to eliminate the implied contractual covenant of good faith and fair dealing under Delaware law.

Provisions such as the foregoing are often subject to intense negotiations and some investors may not agree to the limitations on duties and liabilities that those in control propose.

Provisions in LLC Agreements purporting to limit fiduciary duties need to be explicit and conspicuous as LLC Agreement coyness can lead to unenforceability.[373] Language in an LLC Agreement

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and fair dealing by failing to pay him monies due, disparagements and threats because plaintiff had "failed to articulate a contractual benefit he was denied as a result of defendants' breach of an implied provision in the contract," and explained:

> The implied covenant of good faith and fair dealing inheres in every contract and "requires 'a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits' of the bargain." The implied covenant cannot be invoked to override the express terms of the contract. Moreover, rather than constituting a free floating duty imposed on a contracting party, the implied covenant can only be used conservatively "to ensure the parties' 'reasonable expectations' are fulfilled." Thus, to state a claim for breach of the implied covenant, Kuroda "must allege a specific implied contractual obligation, a breach of that obligation by the defendant, and resulting damage to the plaintiff." General allegations of bad faith conduct are not sufficient. Rather, the plaintiff must allege a specific implied contractual obligation and allege how the violation of that obligation denied the plaintiff the fruits of the contract. Consistent with its narrow purpose, the implied covenant is only rarely invoked successfully.

Id.

This contractual duty of good faith and fair dealing is to be contrasted with the fiduciary duty of good faith, which is a component of the common law fiduciary duty of loyalty. *See Stone v. Ritter*, 911 A.2d 362 (Del. 2006). DLLCA §§ 18-1101(a)-(f) are counterparts of, and virtually identical to, DRLPA §§ 17-1101(a)-(f). Thus, Delaware cases regarding contractual limitation of partner fiduciary duties should be helpful in the LLC context.

373 *Solar Cells, Inc. v. True N. Partners, LLC,* C.A. No. 19477, 2002 WL 749163, at *4, 2002 Del. Ch. LEXIS 38, at *13-*14 (Del. Ch. Apr. 25, 2002). In *Solar Cells*, Chancellor Chandler enjoined the merger of an LLC with an affiliate of the controlling owner on the basis of the Delaware "entire fairness" doctrine notwithstanding an operating agreement section providing in relevant part as follows:

> Solar Cells and [First Solar] acknowledge that the True North Managers have fiduciary obligations to both [First Solar] and to True North, which fiduciary obligations may, because of the ability of the True North Managers to control [First Solar] and its business, create a conflict of interest or a potential conflict of interest for the True North Managers. Both [First Solar] and Solar Cells hereby waive any such conflict of interest or potential conflict of interest and agree that neither True North nor any True North Manager shall have any liability to [First Solar] or to Solar Cells with respect to any such conflict of interest or potential conflict of interest, provided that the True North managers have acted in a manner which they believe in good faith to be in the best interest of [First Solar].

Id.

Chancellor Chandler noted that the above clause purports to limit liability stemming from any conflict of interest, but that Solar Cells had not requested that the Court impose liability on the individual defendants; rather it was only seeking to enjoin the proposed merger. Therefore, exculpation for personal liability would have no bearing on whether the proposed merger was inequitable and should be enjoined. Further, Chancellor Chandler wrote that "even if waiver of liability for engaging in conflicting interest transactions is contracted for, that does not mean that there is a waiver of all fiduciary duties [for the above quoted provision] expressly states that the True North Managers must act in 'good faith.'"

to the effect that no member or manager shall be liable for any act or omission unless attributable to gross negligence, fraud or willful misconduct provides limited exculpation from monetary liabilities, but having used a bad faith limit on exculpation, has been held to assume (rather than eliminate) common law fiduciary duties.[374] A provision which purports to limit fiduciary duties in the LLC context "to the maximum extent permitted by the laws in effect at the effective date of this Company Agreement, as such Agreement may be amended from time to time" probably is not adequate.

Persons who control Members can be held responsible for fiduciary duty breaches of the Members.[375] A legal claim exists in some jurisdictions for aiding and abetting a breach of fiduciary duty, whether arising under statute, contract, common law or otherwise.[376]

CHAPTER 5. CONCLUSION.

As the preceding pages demonstrate, both Texas and Delaware have well developed bodies of statutory and case law governing business entities which deal with the fiduciary duties of governing and controlling persons when they deal with the entities that they serve. Under the laws of both states, the

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Noting that the LLC was in financial distress and that the owners had been negotiating unsuccessfully to develop a mutually acceptable recapitalization, the Chancellor found that the managers appointed by the controlling owners appeared not to have acted in good faith when they had adopted the challenged plan of merger by written consent without notice to the minority managers. Chancellor Chandler commented:

> The fact that the Operating Agreement permits action by written consent of a majority of the Managers and permits interested transactions free from personal liability does not give a fiduciary free reign to approve any transaction he sees fit regardless of the impact on those to whom he owes a fiduciary duty.

2002 WL 749163, at *5, 2002 Del. Ch. LEXIS 38, at *17.

374 *Feeley v. NHAOCG, LLC*, 62 A.3d 649 (Del Ch. 2012).

375 In *Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC*, C.A. No. 3658-VCS, 2009 WL 1124451, 2009 Del. Ch. LEXIS 54 (Del. Ch. April 20, 2009), Delaware Vice Chancellor Strine wrote that "in the absence of a contrary provision in the LLC agreement, the manager of an LLC owes the traditional fiduciary duties of loyalty and care to the members of the LLC," and held that LLC Agreement provisions that "Members shall have the same duties and obligations to each other that members of a limited liability company formed under the Delaware Act have to each other" and "except for any duties imposed by this Agreement . . . each Member shall owe no duty of any kind towards the Company or the other Members in performing its duties and exercising its rights hereunder or otherwise" had the effect of leaving in place the traditional Delaware common law fiduciary duties. The Vice Chancellor then summarized those duties as follows in footnote 33:

> The Delaware LLC Act is silent on what fiduciary duties members of an LLC owe each other, leaving the matter to be developed by the common law. The LLC cases have generally, in the absence of provisions in the LLC agreement explicitly disclaiming the applicability of default principles of fiduciary duty, treated LLC members as owing each other the traditional fiduciary duties that directors owe a corporation. Moreover, when addressing an LLC case and lacking authority interpreting the LLC Act, this court often looks for help by analogy to the law of limited partnerships. In the limited partnership context, it has been established that "[a]bsent a contrary provision in the partnership agreement, the general partner of a Delaware limited partnership owes the traditional fiduciary duties of loyalty and care to the Partnership and its partners." (Citations omitted)

The court then held the owner and manager of the LLC personally liable for the fiduciary duty breaches of the LLC's managing member.

See also In re USACafes, L.P. Litigation, 600 A.2d 43, 48 (Del. Ch. 1991); *Carson v. Lynch Multimedia Corp.*, 123 F. Supp. 2d 1254, 1264 (D. Kan. 2000).

376 *Fitzgerald v. Cantor*, C.A. No. 16297-NC, 1999 WL 182573, at *1, 1999 Del. Ch. LEXIS 52, at *1 (Del. Ch. Mar. 25, 1999) (holding that the elements of a claim for aiding and abetting a breach of fiduciary duty are: (1) the existence of a fiduciary relationship; (2) the fiduciary breached its duty; (3) a defendant, who is not a fiduciary, knowingly participated in a breach; and (4) damaged to the plaintiff resulted from the concerted action of the fiduciary and the non-fiduciary).

process followed by the governing persons determines whether the issue becomes a problem for those involved.