CORPORATE GOVERNANCE IN TEXAS

By

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UCLA Conference on the American Law Institute's Restatement of the Law, Corporate Governance

April 21, 2023

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BACKGROUND, EDUCATION AND PRACTICE

Byron F. Egan is a partner of Jackson Walker LLP in Dallas. He is engaged in a corporate, partnership, securities, mergers and acquisitions ("***M&A***") and financing practice. Mr. Egan has extensive experience in business entity formation and governance matters, M&A and financing transactions in a wide variety of industries including energy, financial and technology. In addition to handling transactions, he advises boards of directors and their audit, compensation and special committees with respect to fiduciary duty and other corporate governance issues, the Sarbanes-Oxley Act, special investigation and other issues.

Involvement: Mr. Egan is Senior Vice Chair and Chair of the Executive Council of the M&A Committee of the American Bar Association and served as Co-Chair of its Asset Acquisition Agreement Task Force, which wrote the Model Asset Purchase Agreement with Commentary. He has been Chair of the Texas Business Law Foundation, the Business Law Section of the State Bar of Texas and that section's Corporation Law Committee. On behalf of these groups, he has been instrumental in the drafting and enactment of many Texas business entity and other statutes. He is also a member of the American Law Institute.

Honors: For more than twenty-five years, Mr. Egan has been listed in The Best Lawyers in America under Corporate, M&A or Securities Law. He is a 2018 recipient of the Texas Lawyer Lifetime Achievement Award, a 2018 recipient of the Distinguished Alumni Award of the Highland Park Independent School District, and a 2015 recipient of the Texas Bar Foundation's Dan Rugeley Price Memorial Award, which is presented annually to a lawyer who has an unreserved commitment to clients and to the legal profession. A four-time winner of the Burton Award for distinguished legal writing, in 2009 his article entitled "Director Duties: Process and Proof" was awarded the Franklin Jones Outstanding CLE Article Award and an earlier version of that article was honored by the State Bar Corporate Counsel Section's Award for the Most Requested Article in the Last Five Years. Mr. Egan has been recognized as one of the top corporate and M&A lawyers in Texas by a number of publications, including Corporate Counsel Magazine, Texas Lawyer, Texas Monthly, The M&A Journal (which profiled him in 2005) and Who's Who Legal. See www.jw.com for additional information regarding his civic and other activities.

Education: Mr. Egan received his B.A. and J.D. degrees from the University of Texas. After law school, he served as a law clerk for Judge Irving L. Goldberg on the United States Court of Appeals for the Fifth Circuit.

Publications: Mr. Egan writes and speaks about the areas in which his law practice is focused, and is a frequent author and lecturer regarding M&A, governance of corporations, partnerships and limited liability companies, securities laws, and financing techniques. He is the author of the

treatise EGAN ON ENTITIES: Corporations, Partnerships and Limited Liability Companies in Texas (4th Ed. 2023), 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. In addition, Mr. Egan has written or co-authored the following law journal articles: *Corporate Governance*: Delaware Supreme Court Holds Directors' Fiduciary Duties Require Monitoring Mission-Critical Risks or What's he Scoop? Bluebell Shareholder Serves Caremark Claim to Board of Directors, XXXVII Corporate Counsel Review 271 (November 2019); Fiduciary Duties of Corporate Directors and Officers in Texas, 43 Texas Journal of Business Law 45 (Spring 2009); Responsibilities of Officers and Directors under Texas and Delaware Law, XXVI Corporate Counsel Review 1 (May 2007); *Entity Choice and Formation*: Joint Venture Formation, 44 Texas Journal of Business Law 129 (2012); Choice of Entity Decision Tree After Margin Tax and Texas Business Organizations Code, 42 Texas Journal of Business Law 171 (Spring 2007); Choice of Entity Alternatives, 39 Texas Journal of Business Law 379 (Winter 2004); Choice of State of Incorporation – Texas Versus Delaware: Is it Now Time to Rethink Traditional Notions, 54 SMU Law Review 249 (Winter 2001); *M&A*: Earnouts in M&A Transactions, XXXIX Corporate Counsel Review (November 2020); Confidentiality Agreements are Contracts with Long Teeth, 46 Texas Journal of Business Law 1 (Fall 2014); Private Company Acquisitions: A Mock Negotiation, 116 Penn St. L. Rev. 743 (2012); Asset Acquisitions: Assuming and Avoiding Liabilities, 116 Penn St. L. Rev. 913 (2012); Asset Acquisitions: A Colloquy, X U. Miami Business Law Review 145 (Winter/Spring 2002); *Securities Law*: Major Themes of the Sarbanes-Oxley Act, 42 Texas Journal of Business Law 339 (Winter 2008); Communicating with Auditors After the Sarbanes-Oxley Act, 41 Texas Journal of Business Law 131 (Fall 2005); The Sarbanes-Oxley Act and Its Expanding Reach, 40 Texas Journal of Business Law 305 (Winter 2005); Congress Takes Action: The Sarbanes-Oxley Act, XXII Corporate Counsel Review 1 (May 2003); and *Legislation*: The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law, 41 Texas Journal of Business Law 41 (Spring 2005); Texas Chancery Courts – The Missing Link to More Texas Entities, Texas Bar Journal, Opinion Section, February 2016 Issue.

Selected Pages from Advance Copy of
EGAN ON ENTITIES: Corporations,Partnerships and
Limited Liability Companies (4th Ed.)

EGAN ON ENTITIES

Fourth Edition

Corporations, Partnerships and Limited Liability Companies in Texas

Byron F. Egan

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Cite this publication as: Byron F. Egan, EGAN ON ENTITIES: Corporations, Partnerships and Limited Liability Companies in Texas (Fourth Edition) (April 2023).

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ISBN No.: 978-1-66333-395-7

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2.6. Corporate Fiduciary Duties.

2.6.1. 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.[391] Fiduciary duty principles articulated in the context of public companies

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of the operations and affairs of the corporation, the approval by shareholders or other persons of corporate actions, or the relationship among the shareholders, the directors, and the corporation; or

(12) otherwise governs the exercise of corporate powers, the management of the business and affairs of the corporation, or the relationship among the shareholders, the directors, and the corporation as if the corporation were a partnership or in a manner that would otherwise be appropriate only among partners and not contrary to public policy.

(b) A shareholders' agreement authorized by this section must be:

(1) contained in:

(A) the certificate of formation or bylaws if approved by all of the shareholders at the time of the agreement; or

(B) a written agreement that is:

(i) signed by all of the shareholders at the time of the agreement; and

(ii) made known to the corporation; and

(2) amended only by all of the shareholders at the time of the amendment, unless the agreement provides otherwise.

The existence of a TBOC § 21.101 or TBCA art. 2.30-1 agreement must be conspicuously noted on the certificates representing the shares or on the information statement required for uncertificated shares. TBOC §§ 21.103(a), (b); TBCA art. 2.30-1(C). A purchaser who acquires shares of a corporation without actual or deemed knowledge of the agreement will have a right of rescission until the earlier of (i) 90 days after obtaining such knowledge or (ii) two years after the purchase of the shares. TBOC § 21.105; TBCA art. 2.30-1(D). An agreement permitted under TBOC § 21.101 or TBCA art. 2.30-1 will cease to be effective when shares of the corporation become listed on a national securities exchange, quoted on an interdealer quotation system of a national securities association or regularly traded in a market maintained by one or more members of a national or affiliated securities association. TBOC § 21.109; TBCA art. 2.30-1(E).

A TBOC § 21.101 or a TBCA art. 2.30-1 agreement that limits the discretion or powers of the board of directors or supplants the board of directors will relieve the directors of, and impose upon the person or persons in whom such discretion or powers or management of the business and affairs of the corporation are vested, liability for action or omissions imposed by the TBOC, the TBCA, or other law on directors to the extent that the discretion or powers of the directors are limited or supplanted by the agreement.

TBOC § 21.107 and TBCA art. 2.30-1(G) provide that the existence or performance of a shareholders agreement will not be grounds for imposing personal liability on any shareholder for the acts or obligations of the corporation by disregarding the separate entity of the corporation or otherwise, even if the agreement or its performance (i) treats the corporation as if it were a partnership or in a manner that otherwise is appropriate only among partners, (ii) results in the corporation being considered a partnership for purposes of taxation, or (iii) results in failure to observe the corporate formalities otherwise applicable to the matters governed by the agreement. Thus, TBOC § 21.107 and TBCA art. 2.30-1 provide protection beyond TBOC § 21.223 and TBCA art. 2.21 on shareholder liability.

[391] 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

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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.[392]

Both the Tex. Corp. Stats. and the DGCL[393] provide that the business and affairs of a corporation are to be managed under the direction of its board of directors ("Board").[394] 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.[395] In Texas, the fiduciary duty of a director

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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).

392 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 1318 – 1323 regarding oppression of minority shareholders in the context of closely held entities.

393 DGCL §§ 101 *et seq.* (2006 & Supp. 2017).

394 TBOC § 21.401; TBCA art. 2.31; and DGCL § 141(a); *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227, 238 (Del. 2008) (Board authority to manage the corporation under DGCL § 141(a) may not be infringed by a bylaw adopted by the stockholders under DGCL § 109 in a manner that restricts the power of directors to exercise their fiduciary duties); *see supra* notes 217-218 and related text.

395 Although the DGCL "does not prescribe in detail formal requirements for board meetings, the meetings do have to take place [and] the mere fact that directors are gathered together does not a meeting make"; where there is no formal call to the meeting and no vote taken, directors caucusing on their own and informally deciding among themselves how they would proceed is like simply polling board members and "does not constitute a valid meeting or effective corporate action." *Fogel v. U.S. Energy Sys. Inc.*, No. 3271-CC, 2007 WL 4438978, at *2, 2007 Del. Ch. LEXIS 178, *7-*8 (Del. Ch. Dec. 13, 2007) (citations omitted), *rejected on other grounds by Klassen v. Allegro Dev. Corp.*, 106 A.3d 1035, 1047 (Del. 2014).

The *Fogel* case arose in the context of a confrontation between three independent directors and the Board chairman they sought to terminate (there were no other directors). The opinion by Chancellor William B. Chandler III recounted that U.S. Energy "was in precarious financial condition" when Fogel was hired in 2005 to become both CEO and a director (ultimately, becoming Board chairman as well). 2007 WL 4438978, at *1, 2007 Del. Ch. LEXIS 178, at *2. Fogel's initial tenure with the company was successful, but trouble soon followed.

Upon learning of the entity's financial woes, the Board decided at a June 14, 2007 meeting to hire a financial adviser or restructuring official. The Board resolved to meet again on June 29 to interview potential candidates, but prior to that meeting, the three independent directors communicated with one another about Fogel's performance, ultimately deciding that he would have to be terminated. 2007 WL 4438978, at *1, 2007 Del. Ch. LEXIS 178, at *4-*5.

On the morning of June 29, the three directors met in the law offices of their outside counsel and decided to fire Fogel. They then confronted Fogel in the boardroom where the meeting was to take place, advised that they had lost faith in him, and stated that they wanted him to resign as chairman and CEO. Fogel challenged

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has been characterized as including duties of loyalty (including good faith), care and obedience,[396] and is owed to the corporation and its shareholders collectively.[397] In Delaware, the fiduciary duties

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the directors' ability to fire him and ultimately refused to resign, whereupon an independent director informed him that he was terminated. Thereafter, on July 1, Fogel e-mailed the company's general counsel and the Board, calling for a special shareholder meeting for the purpose of voting on the removal of the other directors and electing their replacements. Later that day, during a scheduled Board meeting, the Board formally passed a resolution terminating Fogel and thereafter ignored Fogel's call for a special meeting. 2007 WL 4438978, at *1-2, 2007 Del. Ch. LEXIS 178, at *5. Litigation ensued.

The issue in the case was whether Fogel was still CEO and Board chairman at the time he called for a special meeting of shareholders. If the independent directors' June 29 decision to fire Fogel constituted formal Board action, Fogel was terminated before July 1 and lacked authority to call for a special meeting of shareholders. If not, Fogel remained Board chairman and CEO until the July 1 formal resolution, which passed after Fogel called for the special meeting of shareholders.

The Court noted that under DGCL § 141 termination of the chairman and CEO required Board "action, and the board can only take action by means of a vote at a properly constituted meeting. * * * Although the [DGCL] does not prescribe in detail formal requirements for board meetings, the meetings do have to take place." 2007 WL 4438978, at *2, 2007 Del. Ch. LEXIS 178, at *7. In this case, the Chancellor concluded that the June 29 confrontation between Fogel and the independent directors did not constitute a meeting. The mere fact that directors were gathered and caucusing did not constitute a meeting as there was no formal call to the meeting and there was no vote whatsoever.

"Simply 'polling board members does not constitute a valid meeting or effective corporation action,'" the Chancellor instructed. 2007 WL 4438978, at *2, 2007 Del. Ch. LEXIS 178, at *7-*8. In any event, the Court added, if the meeting did occur, it would be void because the independent directors – who kept secret their plan to fire Fogel – obtained Fogel's attendance by deception. Although Fogel lacked the votes needed to protect his employment, the Chancellor reasoned that had he known of the defendants' plans beforehand, "he could have exercised his right under the bylaws to call for a special meeting before the board met. The deception renders the meeting and any action taken there void." 2007 WL 4438978, at *4, 2007 Del. Ch. LEXIS 178, at *12. Accordingly, Fogel was still authorized on July 1 to call for a special shareholder meeting, and corporation and its Board were ordered to hold such a meeting.

The Chancellor disagreed with the independent directors' argument that, even if the June 29 meeting and termination were deficient, "any problems were cured" when the Board ratified its June 29 actions during the July 1 meeting, and explained: "When a corporate action is void, it is invalid *ab initio* and cannot be ratified later." 2007 WL 4438978, at *4, 2007 Del. Ch. LEXIS 178, at *13; but *see infra* § 2.9.8(b) regarding subsequent amendment of DGCL § 204 to provide a mechanism for ratifying and validating prior void acts. The Chancellor said the action taken at the July 1 meeting may have resulted in Fogel's termination, but the termination was effective only as of that vote. By that time, however, Fogel already had issued his call for a special shareholders' meeting. *Id.* Nonetheless, the Court concluded that the independent directors ignoring Fogel's call for a special meeting was not to thwart a shareholder vote, but because they "believed in good faith" that Fogel had been terminated and thus "lacked the authority to call for such a meeting." 2007 WL 4438978, at *4, 2007 Del. Ch. LEXIS 178, at *14. Accordingly, the Chancellor held that the three independent directors did not breach their fiduciary obligations of loyalty. *But see Klassen v. Allegro Dev. Corp.*, 106 A.3d 1035, 1047 (Del. 2014) (holding that Board action by deception is voidable, not void *ab initio*).

396 *Gearhart Indus., Inc.*, 741 F.2d at 719.

397 *Ritchie v. Rupe*, 443 S.W.3d 856, 883 (Tex. 2014), *reh'g denied* (Oct. 24, 2014) ("[t]he directors must make those decisions in compliance with the formal fiduciary duties that they, as officers or directors, owe to the corporation, *and thus to the shareholders collectively*" (emphasis added)); *Redmon v. Griffith*, 202 S.W.3d 225, 233 (Tex. App. – Tyler 2006, pet. denied), *disapproved of by Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014) ("[t]raditionally, *a corporate officer owes a fiduciary duty to the shareholders collectively, i.e., the corporation,* but he does not occupy a fiduciary

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include those of loyalty (including good faith) and care.[398] 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.[399] 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.[400]

2.6.2. 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,"[401] and "under the commerce clause a state has no interest in regulating the internal affairs of foreign corporations."[402] "Internal corporate affairs" are "those matters which are peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders,"[403] 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 cor-

relationship with an individual shareholder unless some contract or special relationship exists between them in addition to the corporate relationship" (emphasis added)).

398 While good faith was once "described colloquially as part of a 'triad' of fiduciary duties that includes the duties of care and loyalty," the Delaware Supreme Court in 2006 clarified the relationship of "good faith" to the duties of care and loyalty, explaining:

> [T]he 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.

Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006). *See infra* notes 530-535 and related text.

399 "Once [directors] traveled down the road of partial disclosure . . . an obligation to provide the stockholders with an accurate, full, and fair characterization" attaches. *Arnold v. Soc'y for Sav. Bancorp, Inc.*, 650 A.2d 1270, 1280 (Del. 1994); *see also In re MONY Group S'holders Litig.*, 852 A.2d 9, 24-25 (Del. Ch. 2004) ("[O]nce [directors] take it upon themselves to disclose information, that information must not be misleading.").

400 *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998) ("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 honestly. * * * The duty of disclosure obligates directors to provide the stockholders with accurate and complete information material to a transaction or other corporate event that is being presented to them for action."); *Jackson Nat'l Life Ins. Co. v. Kennedy*, 741 A.2d 377, 390 (Del. Ch. 1999) ("[W]hen directors communicate with stockholders, they must recognize their duty of loyalty to do so with honesty and fairness, regardless of the stockholders' status as preferred or common, and regardless of the absence of a request for action required pursuant to a statute, the corporation's certificate of incorporation or any bylaw provision."); *see infra* notes 569-576 and related text.

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

402 *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).

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

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> porations 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.[404]

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,[405] including the liability of an owner or governing person of the entity for actions taken in that capacity.[406] 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.[407] Delaware also subscribes to the internal affairs doctrine.[408]

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

[405] 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.

[406] TBOC § 1.104*; see also Klinek v. LuxeYard, Inc.*, 596 S.W.3d 437, 446-48 (Tex. App. – Houston [14th Dist.], pet. filed April 27, 2020) ("The parties agree that LuxeYard is a Delaware corporation, and that under Texas law, a corporation's 'internal affairs' are governed by the law of the state where it was incorporated. *See* Tex. Bus. Orgs. Code Ann. § 1.102. The parties disagree about whether the existence of a fiduciary duty is among a corporation's 'internal affairs.' Because a corporation's 'internal affairs' include 'the rights, powers, and duties of its governing authority, governing persons, officers, [and] owners' as well as 'matters relating to its . . . ownership interests,' the existence of a fiduciary duty is among a corporation's 'internal affairs.'").

[407] *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).

[408] *See JUUL Labs, Inc. v. Grove*, C.A. No. 2020-0005-JTL (Del. Ch. Aug. 13, 2020) (holding that, because of the "internal affairs doctrine," a stockholder could not use books and records inspection right granted by Section 1601 of the California Corporations Code to inspect the books and records of a Delaware corporation); *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 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).

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

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The DGCL subjects directors and officers of Delaware corporations to personal jurisdiction in the Delaware Court of Chancery over claims for violation of a duty in their capacities as directors or officers of Delaware corporations.[409] Texas does not have a comparable statute.

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involving securities issued by foreign corporations, the corporate securities laws have been consistently applied to such transactions."

[409] Del. Code Ann. tit. 10 § 3114(a) and (b) provide (emphasis added):

> (a) Every nonresident of this State who after September 1, 1977, accepts election or appointment as a director, trustee or member of the governing body of a corporation organized under the laws of this State or who after June 30, 1978, serves in such capacity, and every resident of this State who so accepts election or appointment or serves in such capacity and thereafter removes residence from this State shall, by such acceptance or by such service, be deemed thereby to have consented to the appointment of the registered agent of such corporation (or, if there is none, the Secretary of State) as an agent upon whom service of process may be made in all civil actions or proceedings brought in this State, by or on behalf of, or against such corporation, in which such director, trustee or member is a necessary or proper party, or in any action or proceeding against such director, trustee or member *for violation of a duty in such capacity*, whether or not the person continues to serve as such director, trustee or member at the time suit is commenced. Such acceptance or service as such director, trustee or member shall be a signification of the consent of such director, trustee or member that any process when so served shall be of the same legal force and validity as if served upon such director, trustee or member within this State and such appointment of the registered agent (or, if there is none, the Secretary of State) shall be irrevocable.
>
> (b) Every nonresident of this State who after January 1, 2004, accepts election or appointment as an officer of a corporation organized under the laws of this State, or who after such date serves in such capacity, and every resident of this State who so accepts election or appointment or serves in such capacity and thereafter removes residence from this State shall, by such acceptance or by such service, be deemed thereby to have consented to the appointment of the registered agent of such corporation (or, if there is none, the Secretary of State) as an agent upon whom service of process may be made in all civil actions or proceedings brought in this State, by or on behalf of, or against such corporation, in which such officer is a necessary or proper party, or in any action or proceeding against such officer *for violation of a duty in such capacity*, whether or not the person continues to serve as such officer at the time suit is commenced. Such acceptance or service as such officer shall be a signification of the consent of such officer that any process when so served shall be of the same legal force and validity as if served upon such officer within this State and such appointment of the registered agent (or, if there is none, the Secretary of State) shall be irrevocable. As used in this section, the word "officer" means an officer of the corporation who (i) is or was the president, chief executive officer, chief operating officer, chief financial officer, chief legal officer, controller, treasurer or chief accounting officer of the corporation at any time during the course of conduct alleged in the action or proceeding to be wrongful, (ii) is or was identified in the corporation's public filings with the United States Securities and Exchange Commission because such person is or was 1 of the most highly compensated executive officers of the corporation at any time during the course of conduct alleged in the action or proceeding to be wrongful, or (iii) has, by written agreement with the corporation, consented to be identified as an officer for purposes of this section.

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2.6.3. 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.[410]

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.[411] 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.[412] A director's fiduciary duties ordinarily terminate when he ceases to be a director, but he can be liable for damages occurring after leaving office where the breach while in office contributed to the loss. *Engenium Solutions, Inc. v. Symphonic Techs, Inc.* 924 F Supp. 2d 757, 793 (S.D. Tex. 2013).

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The Texas Supreme Court's June 20, 2014 opinion in *Ritchie v. Rupe*[413] 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[414] – the sole remedy available under Texas law is a statutory receivership, but

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

[411] *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*).

[412] *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 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.).

[413] 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*).

[414] *See infra* notes 1318-1377 regarding oppression of minority shareholders in the context of closely held entities.

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 a 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).[415]

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.[416] In *In re Estate of Poe*[417] the Supreme Court of Texas explained:

> Under Texas law, the business and affairs of a corporation are managed through a board of directors. Tex. Bus. Orgs. Code § 21.401(a). Directors owe a fiduciary duty to their corporations in the actions they take as directors. *Ritchie v. Rupe*, 443 S.W.3d 856, 868 (Tex. 2014). A director's fiduciary status creates three broad duties: duties of obedience, loyalty, and due care. *Loy v. Harter*, 128 S.W.3d 397, 407 (Tex. App. – Texarkana 2004, pet. denied) (citing *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984)). These fiduciary duties run to the corporation, not to individual shareholders or even to a majority of shareholders. *Gearhart Indus.,* 741 F.2d at 721. As we explained in *Ritchie*, a director's fiduciary duty includes a duty to dedicate "uncorrupted business judgment for the sole benefit of the corporation." 443 S.W.3d at 868 (quoting *Int'l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 577 (Tex. 1983)).

In a closely held corporation, passing references to shareholders as "partners" in the course of their transactions do not establish a fiduciary relationship between equal shareholders individually because "a co-shareholder in a closely held corporation does not as a matter of law owe a fiduciary duty to his co-shareholder."[418] A shareholder has no individual cause of action for personal damages caused solely by a wrong done to the corporation.[419]

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[415] 443 S.W.3d at 868.

[416] *Guerra v. Guerra*, No. 04-10-00271-CV, 2011 Tex. App. LEXIS 6730 (Tex. App. – San Antonio Aug. 24, 2011, no pet.).

[417] 648 S.W.3d 277 (Tex. 2022).

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

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

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.[420] 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.[421] The first is a formal fiduciary relationship, which arises as a matter of law.[422] The second is an informal fiduciary relationship, which may arise from a moral, social, domestic or purely personal relationship of trust and confidence, generally called a confidential relationship.[423]

Whether undisputed facts give rise to a formal fiduciary relationship is a question of law.[424] Whether an informal fiduciary relationship exists is ordinarily a question of fact because the underlying material facts are disputed.[425] When the underlying facts are undisputed, however, the determination of whether a fiduciary relationship exists is a question of law for the court.[426]

Controlling shareholders generally do not owe formal fiduciary duties to minority shareholders.[427] 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."[428]

The Texas Supreme Court followed and reinforced its holding in *Ritchie v. Rupe* as follows in *In re Estate of Poe*:[429]

> Our Court has recognized that an "informal" fiduciary duty may arise from "a moral, social, domestic or purely personal relationship of trust and confidence."

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420 *See* TBOC § 21.418(b).

421 *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).

422 *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)).

423 *Id.* (quoting *Assoc. Indem. Corp. v. CAT Contracting, Inc.*, 964 S.W.2d 276, 287 (Tex. 1998)); *see infra* notes 480-484 and related text.

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

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

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

427 *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)).

428 443 S.W.3d 874-75 n.27.

429 65 Tex. Sup. J. 1464, 648 S.W.3d 277 (Tex. 2022).

> *Meyer*, 167 S.W.3d at 331 (quoting *Associated Indem. Corp. v. CAT Contracting, Inc.,* 964 S.W.2d 276, 287 (Tex. 1998)). We have described the types of confidential relationships that can give rise to a fiduciary duty imprecisely as those "in which influence has been acquired and abused, in which confidence has been reposed and betrayed." *Crim Truck & Tractor Co., v. Navistar Int'l Transp. Corp.,* 823 S.W.2d 591, 593 (Tex. 1992) (Quoting *Tex. Bank & Tr. Co. v. Moore,* 595 S.W.2d 502, 507 (Tex. 1980)). But we have always made clear that "we do not create such a relationship lightly." *Schlumberger Tech. Corp. v. Swanson*, 959 S.W.2d 171, 177 (Tex. 1997). And we have never recognized an informal fiduciary duty within the context of the operation or management of a corporation, in which the corporation's directors have clearly defined duties to exercise their business judgment for the sole benefit of the corporation. *See Ritchie*, 443 S.W.3d at 868.

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.[430] A controlling shareholder may owe informal fiduciary duties to the minority shareholders.[431] 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.

(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.[432] Whether there exists a personal interest by the director will be a question of fact.[433] The good faith of a director will be determined on whether the director acted with an intent to confer a benefit to the corporation.[434]

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[430] *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).

[431] *See infra* notes 480-485 and related text.

[432] *Gearhart*, 741 F.2d at 719.

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

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

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."[435]

(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.[436] 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.[437]
>
> In *Ritchie v. Rupe*,[438] 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,"[439] including full disclosure respecting matters affecting the principal's interests.[440] There is a "general prohibition against the fiduciary using his relationship with the corporation to benefit his personal interest."[441] 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

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435 *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)).

436 *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).

437 *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*).

438 443 S.W.3d at 887.

439 *See supra* notes 432-435 and related text.

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

441 *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)).

to ensure fairness to the corporation and its shareholders and the materiality of the director's personal interests or influences.[442]

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.[443] A contract or transaction is "fair" if it is "characterized by honesty and justice" and "free from fraud, injustice, prejudice, or favoritism."[444]

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[442] *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. 1963); *Popperman v. Rest Haven Cemetery, Inc.*, 162 Tex. 255, 345 S.W. 2d 715 (Tex. 1961); *Phil H. Pierce Co. v. Rude*, 291 S.W. 974 (Tex.Civ.App. – Dallas, 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 (Tex.Civ.App. – Fort Worth, 1928, no writ hist.); *Wiberg v. Gulf Coast Land* & *Development Company*, 360 S.W. 2d 563 (Tex.Civ.App. – Beaumont, 1962, ref., n.r.e.).

[443] TBOC § 21.418; TBCA art. 2.35-1. *See infra* notes 840-841 and related text.

[444] *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).

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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.[445]

(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*,[446] 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.[447] 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.[448] The central question is whether or not the director has appropriated something for himself that, in all fairness, should belong to his corporation.[449]

Landon v. S & H Marketing Group, Inc.[450] 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

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445 TBOC § 2.101(21), TBCA art. 2.02(20); *see infra* note 840 and related text.

446 844 F. Supp. 300, 306 (N.D. Tex. 1994).

447 *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).

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

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

450 82 S.W.3d 666, 672 (Tex. App. – Eastland 2002, no pet.).

> 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 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.[451] 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.[452] 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.[453] 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 must 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.[454] To recover monetary damages for usurpation, the corporation must prove the amount of the profits (not revenues) it lost as a result.[455]

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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) Candor. In Texas the duty of loyalty includes a fiduciary duty of candor when communicating

[451] *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).

[452] *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.).

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

[454] *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).

[455] *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.

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.[456] The duty of candor applies when a director is communicating with the corporation regarding a business opportunity.[457]

(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.[458]

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*,[459] 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*[460] the year before and the Fifth Circuit in *Gearhart*,[461] the Texas Supreme Court in *Sneed v. Webre* cited and quoted from the early Texas decision of *Cates v. Sparkman*[462] 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.[463]

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

[456] *Icom Systems, Inc. v. Davies*, 990 S.W.2d 408, 410 (Tex. App. – Texarkana 1999, no pet.).

[457] *See supra* note 439 and related text.

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

[459] 465 S.W.3d 169, 173 (Tex. 2015).

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

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

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

[463] 465 S.W.3d at 178.

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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 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.[464]

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."[465]

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."[466] 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.[467]

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."[468] In *FDIC v. Harrington*, the Court concluded "that a director's total abdication of duties falls within this definition of gross negligence."[469]

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[464] *Gearhart*, 741 F.2d at 723 n.9.

[465] *Gearhart*, 741 F.2d at 721.

[466] *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).

[467] *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).

[468] *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)).

[469] *Harrington*, 844 F. Supp. at 306 n.7.

The burden of proof is on the plaintiff to disprove the business judgment rule, an important distinction that protects corporate directors and officers further.[470]

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.[471]

(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 persons as to matters the director reasonably believes are within the person's professional or expert competence.[472]

(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.[473] 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.[474] Officers do not have the benefit of the limitation of director liability authorized in the Tex. Corp. Stats.[475]

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470 *In re Estate of Poe*, 648 S.W.3d 277, 290 (Tex. 2022).

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

472 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.

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

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

475 *See infra* note 646.

(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.[476] 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.

The RTC's complaint in *RTC v. Norris*[477] asserted that the directors of a failed financial institution breached their fiduciary duty of obedience by failing to cause the institution to adequately respond to regulatory warnings: "The defendants committed *ultra vires* acts by ignoring warnings from [regulators], by failing to put into place proper review and lending procedures, and by ratifying loans that did not comply with state and federal regulations and Commonwealth's Bylaws."[478] In rejecting this RTC argument, the Court wrote:

> The RTC does not cite, and the court has not found, any case in which a disinterested director has been found liable under Texas law for alleged *ultra vires* acts of employees, absent pleadings and proof that the director knew of or took part in the act, even where the act is illegal.
>
> . . . .
>
> Under the business judgment rule, Texas courts have refused to impose personal liability on corporate directors for illegal or *ultra vires* acts of corporate agents unless the directors either participated in the act or had actual knowledge of the act . . . .[479]

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(2) Informal Fiduciary Duties. In *Ritchie v. Rupe*,[480] 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' plaintiff and defendant."[481] 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."[482]

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

477 *RTC v. Norris*, 830 F. Supp. 351, 355 (S.D. Tex. 1993).

478 *Id.* at 357.

479 *Id.*

480 443 S.W.3d 856 (Tex. 2014).

481 443 S.W.3d at 891-92.

482 443 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

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.[483] 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*, 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).

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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).

[483] *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.

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> 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).[484]

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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[485] 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 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

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

[485] *See id.*

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.

2.6.4. Fiduciary Duties in Delaware Cases. Under Delaware law the principal fiduciary duties are loyalty (director duty to put interests of the corporation and its stockholders as a whole ahead of the director's personal interest) and care (director duty to discharge duties to the corporation with the care of an ordinary prudent director). The duties of loyalty and care are nuanced and subject to exceptions and safe harbors as discussed below.

(a) Loyalty.

(1) Conflicts of Interest. In Delaware, the duty of loyalty mandates "that there shall be no conflict between duty and self-interest."[486] 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.[487] 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.[488]

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.[489] Moreover, the Delaware courts

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

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

488 *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.

489 *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

have emphasized that only material personal interests or influences will imbue a transaction with duty of loyalty implications.

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;[490] usurpations of corporate opportunities; competition by directors or officers with the corporation; actions by directors beyond their authority to act;[491] use of corporate office, property or information for purposes unre-

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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 that all stockholders be treated equally does not "amount to an actionable breach of fiduciary duty."; *infra* notes 786-788 and related text.

[490] *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."

[491] Actions by directors beyond their authority to act can be violations of the duty of loyalty and not protected by the business judgment rule. In *Garfield v. Allen*, C.A. No .2021-0420-JTL (Del.Ch. May 24, 2022), Vice Chancellor Laster in denying a motion to dismiss in a case in which directors had approved the grant of performance shares to the CEO in excess of the number that could be granted to him under the terms of the subject equity compensation plan wrote that to approve the grant was not protected by the business judgment rule because the directors lacked the authority to make the grant and the failure to follow the plan was bad faith and a breach of the fiduciary duty of loyalty like prior decisions had held the backdating of stock options to be and render them subject to a substantial risk of liability; the directors failure to fix the grant after being notified thereof could be a conscious inaction which could be separately actionable under *Caremark*.

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lated to the best interest of the corporation;[492] insider trading[493]; and actions that have the purpose

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[492] *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).

[493] In *Goldstein v. Denner* (C.A. No.2020-1061-JTL Del. Ch. June 2, 2022) a director caused a private equity firm which he controlled to buy more than a million shares of a public company of which he was a director after receiving a bid to acquire the company prior to sharing the offer with the Board and in violation of its insider trading policy. In denying a motion to dismiss a *Brophy* claim, Vice Chancellor Laster wrote:

> The complaint adequately alleges a claim against Denner for breach of fiduciary duty under *Brophy*. The Delaware Supreme Court has framed the elements of a *Brophy* claim as follows: a plaintiff must show that (i) "the corporate fiduciary possessed material, nonpublic company information," and (ii) "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.
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> Delaware law follows the federal standard for materiality. *Rosenblatt v. Getty Oil Co.,* 493 A.2d 929, 944 (Del. 1984) (adopting materiality standard from *TSC Industries, Inc. v. Northway, Inc.,* 426 U.S. 438 (1976)). Information is material if it "'would have assumed actual significance in the deliberations' of a person deciding whether to buy, sell, vote or tender stock."
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> The complaint supports a reasonable inference that Sanofi's initial expression of interest was material under that standard. Sanofi expressed interest in acquiring the Company at [a premium price].
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> * * * *
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> The defendants argue boldly that Sanofi's initial expression of interest was not material because it was a "casual inquir[y]" and not "sufficiently substantive or advanced to constitute material information."
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> * * * *
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> To advance this argument, they rely on *Bershad v. Curtiss-Wright Corp.,* 535 A.2d 840 (Del. 1987), a decision where the Delaware Supreme Court held that a board of directors did not breach its fiduciary duties by failing to disclose "certain casual inquiries" regarding a potential transaction that the target company flatly rejected and which never led to a sale. *Id.* at 847. The high court stated: "Efforts by public corporations to arrange mergers are immaterial under the *Rosenblatt v. Getty* standard, as a matter of law, until the firms have agreed on the price and structure of the transaction." *Id.*
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> One year later, the Supreme Court of the United States issued its decision in *Basic v. Levinson*, 485 U.S. 224 (1988), which rejected the price-and-structure rule (also known as the agreement-in-principle test) as contrary to the materiality standard set forth in *TSC Industries. Id.* at 232-40. The *TSC Industries* standard is the test for materiality that the Delaware Supreme Court adopted in *Rosenblatt*, 493 A.2d at 944.
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> In the aftermath of *Basic*, there was uncertainty whether the price-and-structure rule continued to govern under Delaware law. No longer.
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> * * * *

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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.[494]

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 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

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> Chancellor Chandler then explained at length [in *Alessi vs. Beracha*, 849 A.2d 939 (Del. Ch. 2004)] why the fact-specific ruling in *Bershad* could not be read as establishing a "broad and inflexible rule" in which no duty to disclose arose until there was an agreement on price and structure.
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> * * * *
>
> A Brophy claim does not require a determination that the fiduciary who engaged in insider trading possessed information that was sufficiently material that the corporation's fiduciaries were obligated to disclose that information promptly to all of the corporation's investors. This decision is not holding, for example, that the Board had an obligation to disclose Sanofi's approach promptly after it was made. Denner and Posner had an obligation to disclose Sanofi's approach promptly to their fellow directors, and the Board had an obligation to describe Sanofi's initial approach accurately when making a recommendation to the Company's stockholders in connection with the Transaction. But that does not mean the Board had an obligation in May 2017 to issue a Form 8-K broadcasting Sanofi's expression of interest to the market.
>
> Nor does a Brophy claim depend on the existence of such a disclosure obligation. A Brophy claim rests on the premise that a fiduciary should not have taken advantage of the information to obtain a self-interested benefit. The Brophy decision did not speak in terms of material information in the sense of facts the corporation was obligated to disclose; it spoke in terms of *confidential* information which, if disclosed, would have an impact on the trading price.
>
> Generally speaking, the inquiry for evaluating whether a fiduciary possessed material, non-public information under Brophy will be identical to the inquiry for evaluating whether the fiduciary had a duty to disclose the information. See *Oracle, 867 A.2d at 940.* But the two inquiries can diverge. For purposes of a Brophy claim, assessing whether the information is material under *TSC Industries* serves two purposes. First, it provides a method of evaluating whether the information would have had an impact on the price of the stock such that the fiduciary obtained an improper benefit by engaging in insider trading. Second, it establishes an appropriately high bar for establishing the point when a fiduciary must abstain from trading or face an obligation to disgorge profits.
>
> In this case, the complaint easily supports an inference that disclosure of Sanofi's initial expression of interest would have had an effect on the price of the stock. Accepting for purposes of this analysis that the Board did not have a duty to issue a prompt public statement about Sanofi's approach, it remains reasonably conceivable that Sanofi's initial expression of interest represented material, non-public information in the sense required for a Brophy claim.
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> * * * *

[494] *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).

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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.[495]

Federal laws can subject corporate directors and officers to additional exposure in conflict of interest situations.[496] Directors and officers have been convicted for "honest services fraud" under 18 U.S.C. § 1346 for entering into contracts on behalf of their employer with entities in which they held an interest without advising their employer of the interest.[497]

(2) Good Faith. Good faith is far from a new concept in Delaware fiduciary duty law.[498] 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.*[499] recognized the duty of good faith as a distinct directorial duty.[500] 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.[501] In *Stone v. Ritter*,[502] 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.

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The concept of good faith is also a limitation on the ability to rely on Delaware statutes.[503] In one of the early, landmark decisions analyzing the contours of the duty of loyalty, the Delaware

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495 *See infra* notes 832-839 and related text.

496 *See infra* Appendix D – Effect of Sarbanes-Oxley Act of 2002 on Common Law Fiduciary Duties.

497 18 U.S.C. § 1346 defines "scheme or artifice to defraud" under the U.S. mail and wire fraud statutes to include "a scheme or artifice to deprive another of the intangible right to receive honest services." 18 U.S.C. § 1346 (2012). *See* Frank C. Razzano and Kristin H. Jones, *Prosecution of Private Corporate Conduct – The Uncertainty Surrounding Honest Services Fraud*, 18 Bus. L. Today 37 (Jan.–Feb. 2009).

498 *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.

499 634 A.2d 345, 361 (Del. 1993), *decision modified on reargument*, 636 A.2d 956 (Del. 1994).

500 *See* Strine et al, *supra* note 498.

501 911 A.2d 362, 369-370 (Del. 2006).

502 911 A.2d 362 at 370.

503 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*

Supreme Court observed that "no hard and fast rule can be formatted" for determining whether a director has acted in "good faith."[504] While that observation remains true today, the case law and applicable commentary provide useful guidance regarding some of the touchstone principles underlying the duty of good faith.[505]

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."[506]

Directors may be acting in good faith for the benefit of the stockholders if they authorize the corporation to breach a contract and risk damages therefor where the directors can determine that the corporation will be better off afterward. Under the "*efficient breach of contract*" doctrine the Board could, consistently with its fiduciary duties, repudiate a contract if it can show the corporation is better off after the breach, but needs to be able to quantify the basis for the business decision. The doctrine of efficient breach of contract, as explained in *The Frederick HSU Living Trust v. ODN Holding Corporation*,[507] is as follows:

> It is true that the fiduciary status of directors does not give them Houdini-like powers to escape from valid contracts. The Delaware Supreme Court definitively settled this question in *Smith v. Van Gorkom*, albeit in a less noticed (and less criticized) aspect of that famous decision. Only if the directors breached their fiduciary duties *when entering into a contract* does it become possible to invalidate it on fiduciary grounds.
>
> But the fact that a corporation is bound by its valid contractual obligations does not mean that a board does not owe fiduciary duties when considering how to han-

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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).

[504] *See Guth*, 5 A.2d at 510.

[505] *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).

[506] *In re Disney*, 906 A.2d at 63.

[507] C.A. No. 12108-VCL (Del Ch. April 25, 2017).

> dle those contractual obligations; it rather means that the directors must evaluate the corporation's alternatives in a world where the contract is binding. Even with an iron-clad contractual obligation, there remains room for fiduciary discretion because of the doctrine of efficient breach. Under that doctrine, a party to a contract may decide that its most advantageous course is to breach and pay damages. Just like any other decision maker, a board of directors may choose to breach if the benefits (broadly conceived) exceed the costs (again broadly conceived.) *See Orban v. Field*, 1997 WL 153831, at *9 (Del. Ch. Apr. 1, 1997) (Allen, C.) ("Certainly in some circumstances a board may elect (subject to the corporation's answering in contract damages) to repudiate a contractual obligation where to do so provides a net benefit to the corporation.") A corollary of this principle is that directors who choose to comply with a contract when it would be value-maximizing (broadly conceived) to breach could be subject, in theory, to a claim for breach of duty. For a contract with a third party, the business judgment rule typically will govern and prevent such a claim from getting beyond the pleading stage, but the fiduciary standard of conduct remains operative and the underlying legal theory therefore exists. *See Hokanson*, 2008 WL 5169633, at *8 (dismissing claim for breach of fiduciary duty where "there is no indication that if the directors had refused to allow Exactech to exercise the Buyout Option unless it paid a higher price, the plaintiffs would have been better off").
>
> The corporation's legal duty to comply with a binding contract also does not foreclose the fiduciary standard of conduct from governing decisions that affect the extent to which a contingent, conditional, or otherwise potentially limited contractual obligation comes into effect. Envision, for example, that a board faces two choices. One path generates higher nominal returns for the stockholders but would cause the corporation's debt to accelerate, yielding lower net returns for the equity. The other path generates lower nominal returns for the equity but would not cause the debt to accelerate, generating higher net returns. In this simplistic example, the fiduciary principle dictates the common sense result: the board should cause the corporation to pursue the option that generates the higher net returns for the undifferentiated equity in their capacity as residual claimants. If the board chose the path that triggered the corporation's debt, the board could be subject, in theory, to a claim for breach of duty. Here too, as a practical matter, the business judgment rule typically will govern and prevent such a claim from surviving a motion to dismiss, but the fiduciary standard of conduct remains operative.

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The efficient breach principle was further explained in *In re Essendant, Inc. Stockholder Litigation*[508] as follows:

> Absent direct evidence of an improper intent, a plaintiff must point "a decision [that] lacked any rationally conceivable basis" associated with maximizing stockholder value to survive a motion to dismiss. To begin, Plaintiff's references to alleged breaches of the GPC merger agreement do not implicate bad faith, at

[508] Consolidated C.A. No. 20180789-JRS, (December 30, 2019).

> least not in the fiduciary duty context. Indeed, [e]ven with an iron-clad contractual obligation, there remains room for fiduciary discretion because of the doctrine of efficient breach. A board may even have a duty to breach a contract if it determines that the "benefits [of breach] (broadly conceived) exceed the costs (broadly conceived)." Thus, in the absence of well-pled allegations that the Essendant Board breached the GPC merger agreement for no reason, the breach of that contract cannot serve as a factual predicate to support a non-exculpated breach of fiduciary duty claim."

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.[509] However, DGCL § 102(b)(7) also expressly provides that directors cannot be protected from liability for either actions not taken in good faith[510] or breaches of the duty of loyalty.[511] 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."[512] 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.[513] Thus, in cases involving decisions 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

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509 *See infra* notes 625-628 and related text.

510 *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,* 98 Geo. L.J. 629 (2010); 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).

511 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.

512 DGCL §§ 145(a)-(b).

513 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 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).

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.[514]

(3) Good Faith and Fair Dealing. The duty of good faith is a fiduciary duty and is different from the contractual duty of good faith and fair dealing which is inherent in every contract.[515] The 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.[516]

(4) Waste. "Waste" constitutes "bad faith."[517] 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."[518] Waste is a derivative claim.[519]

(5) 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[520] – i.e., they act in bad faith.[521] In an important Delaware Chancery Court decision on this issue, *In re Caremark International, Inc. Derivative Litigation*,[522] 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-

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[514] 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.

[515] *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").

[516] *See Oxbow Carbon* & *Minerals Holdings, Inc. v. Crestview-Oxbow Acquisition, LLC*, 202 A.3RD 482 (Del. 2019); *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

[517] *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).

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

[519] *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.").

[520] *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* https://www.jw.com/wp-content/uploads/2016/05/2033.pdf; *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.").

[521] 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).

[522] 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).

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 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.[523]

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."[524] 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."[525] 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,"[526] 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.[527] As a result, "[a]ny action seeking recovery for losses would logically entail a judicial determination of proximate cause."[528] 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.[529]

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

[524] *Id.*

[525] *Id.* at 971.

[526] *Id.* at 970.

[527] *Id.*

[528] *Id.* at 970 n.27.

[529] *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*,

In *Stone v. Ritter*[530] 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*,[531] . . . 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:
>
>> 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.

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).

[530] 911 A.2d 362, 365 (Del. 2006).

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

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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.

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

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fiduciary obligation in good faith.[532]

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."[533] In dismissing the derivative complaint, the Court of Chancery concluded:

> 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.[534]

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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.

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[532] 911 A.2d at 369-70.

[533] *Id.* at 370.

[534] *Id.* at 370-71.

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' 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.[535]

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In June 2019, *Caremark* and *Stone v. Ritter* were followed by the Delaware Supreme Court in *Marchand* v. *Barnhill,*[536] 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

[535] *Id.* at 372-73.

[536] 212 A. 3d 805 (Del. 2019). *See* Byron F. Egan, *Delaware Supreme Court Holds Directors' Fiduciary Duties Require Monitoring Mission-Critical Risks or What the Scoop? Blue Bell Shareholder Serves Caremark Claim to Board of Directors,* XXXVIII Corporate Counsel Review 271 (Nov. 2019).

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 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.[537] Subsequent to *Marchand*, there have been several other reported Delaware cases involving *Caremark* duty of oversight claims against directors,[538] and in *In re McDonald's Corporation*[539] the duty of oversight was held applicable to officers.

Texas courts have not embraced the *Caremark* doctrine and would likely have treated *Marchand* as a duty of care case and afforded the defendant directors the benefit of Texas' strong deference to their business judgment to delegate the monitoring of compliance risks to management. In *Sneed v. Webre*,[540] 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 held: "The business judgment rule in Texas generally protects corporate officers and directors, who owe fiduciary duties to the corporation, from liability for acts that are within the honest exercise of their business judgment and discretion."[541]

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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

537 212 A.3d at 36-37.

538 *See* e.g.: (i) *Juan C. Rojas derivatively on behalf of J.C. Penney Company*, C.A. No. 2018-0755-2018-0755-AGB) (Del. Ch. July 29, 2019); (ii) *In re Clovis Oncology, Inc. Derivative Litigation*, C.A./Mp/3027-0222-JRS (Oct. 1, 2019); (iii) *In re LendingClub Derivative Litigations*, C.A. No. 12984-VCM (Del. Ch. Oct. 31, 2019); (iv) *In re Hughes Hv,* C.A. No. 2019-0272-JTL (Del. Ch. April 27, 2020); (v) *In re The Boeing Company*, C.A. No. 2019-0907-MTZ (Del. Ch. Sept. 7, 2021) ; and (vi) *City of Detroit Police and Retirement Sys. v. Hamrock*, C.A. No. 2021-0370-KSJM (June 30, 2022) (*Caremark* claim dismissed on Rule 12b-6 motion against the Board of a natural gas company in the wake of a horrific explosion that occurred during the replacement of an old pipe and resulted in death, injuries and devastation to a small community, where a Board-level committee specifically charged with addressing the core risks posed by its business – including the risks of explosion – which met regularly, received reports on related safety issues and was actively engaged in attempting to have the company improve its safety practices).

539 C.A. No. 2071-0324-JTL Jan. 23, 2023.

540 465 S.W.3d 169, 178 (Tex. 2015).

541 *But see In re Life Partners Holdings, Inc.,* 2015 WL 85 23103 (W.D. Tex. 2015).

> 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.[542]

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.[543] 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.'"[544] 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.[545]

Shortly thereafter, in *In re Citigroup Inc. Shareholder Derivative Litigation*,[546] the Chancery Court distinguished *AIG* and dismissed *Caremark* claims[547] brought against current and former directors of Citigroup for failing to properly monitor and manage the risks that Citigroup faced concerning

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542 *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* https://www.delawarelitigation.com/files/2013/02/puda-case.pdf.

543 965 A.2d 763, 774 (Del. Ch. 2009).

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

545 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."

546 964 A.2d 106, 111 (Del. Ch. 2009).

547 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

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 profits.[548] 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[549] 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."[550] 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.
>
> 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.
>
> 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

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filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to the demand."

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

549 *See supra* notes 520-538 and related text.

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

> 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.
>
> 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 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.[551]

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*[552] 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:

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> 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

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[551] *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").

[552] *See supra* note 542 and related text.

> 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 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.[553]

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?[554]

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.

(6) Business Opportunities. Like its Texas counterpart, the corporate opportunity doctrine

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

554 *Id.* at 131 n.78.

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.*[555] 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-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.*[556] 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.
>
> 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

555 5 A.2d 503, 510-11 (Del. 1939).

556 673 A.2d 148 (Del. 1996).

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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.[557] 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.

(7) Confidentiality. A director may not use confidential company information, or disclose it to third parties, for personal gain without authorization from his fellow directors.[558] This principle is often memorialized in corporate policies.[559] In *Shocking Technologies, Inc. v. Michael*,[560] 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**

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[557] DGCL § 122(17).

[558] *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).

[559] *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 https://impact.disney.com/app/uploads/2022/01/Code-of-Business-Conduct-and-Ethics-for-Directors.pdf.

[560] 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).

> **is a shareholder, may not engage in conduct that is "adverse to the interests of [his] corporation**." (Emphasis added)[561]

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 if the investor either (i) withheld any additional investment in the company, thereby leaving the company desperate for funding,[562] 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.[563] 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.[564] 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

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561 2012 WL 4482838, at *8, 2012 Del. Ch. LEXIS 224, at *28-*29.

562 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.

563 *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").

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

> investment commitments that he made – strikes an observer from a distance as somewhere between disingenuous and self-righteous self-interest.
>
> * * *
>
> 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.
>
> 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 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.[565]

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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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[565] 2012 WL 4482838, at *10-*11, 2012 Del. Ch. LEXIS 224, at *34-*38.

> 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.[566]

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 cause significant harm to Shocking amounts to nothing less than a breach of the fiduciary duty of loyalty.[567]

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."[568]

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 con-

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[566] 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."

[567] 2012 WL 4482838, at *10, 2012 Del. Ch. LEXIS 224, at *32-*33.

[568] 2012 WL 4482838, at *14 n.71, 2012 Del. Ch. LEXIS 224, at *47-*48 n.71.

fidentiality 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.[569]

(8) 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."[570] 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."[571] 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."[572]

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.
>
> * * *
>
> Although directors have a responsibility to communicate with complete candor in all shareholder communications, those that are issued with respect to a request

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569 *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.

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

571 *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.

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

> 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.[573]

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.[574]

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.[575] 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:

> 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 disclo-

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

[574] *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).

[575] 965 A.2d 695, 710 (Del. 2009).

sure 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.[576]

In *Pfeffer v. Redstone*[577] 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,[578] the Delaware Supreme Court explained that it was not a breach of the duty of candor to fail to disclose in the exchange offer

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[576] *Id.* at 710-11.

[577] 965 A.2d 676, 681 (Del. 2009).

[578] 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

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.[579]

(9) 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.[580] In other instances, the omissions complained of are found to be immaterial.[581]

Directors can, and in larger transactions typically do, rely on expert advice in the form of an investment banker's ("banker") fairness opinion.[582] These opinions generally state that the merger

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any prediction of the prices at which the respective shares would trade after the exchange offer expired. 965 A.2d at 689.

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

580 *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).

581 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:

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.

582 *See infra* notes 1163-1171.

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.[583]

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.[584] Thus, a "Denny's buffet" of disclosure claims is included in almost every complaint.[585] The pressure to get a deal to a shareholder vote results in frequent settlements.[586] Despite so much litigation, the law governing disclosure claims remains unsettled.

Skeen v. Jo-Ann Stores, Inc.[587] 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 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."

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583 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).

584 Hon. Myron Steele, *supra* note 582.

585 Hon. Myron Steele, *supra* note 582.

586 Hon. Myron Steele, *supra* note 582.

587 750 A.2d 1170, 1172 (Del. 2000).

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 signifi-

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cantly 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.[588]

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[588] *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

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In re Pure Resources, Incorporated Shareholders Litigation,[589] the SEC filings contained financial advisor opinions, historical financial information and projections. Then Vice Chancellor Leo 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

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disclose all material facts to the minority shareholders. The disclosure violations alleged in McMullin's Amended Complaint are, if true, sufficient to withstand a motion to dismiss.

[589] 808 A.2d 421, 448 (Del. Ch. 2002).

must do so in a manner that is materially complete and unbiased by the omission of material facts.

* * *

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 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

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> 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.[590]

In an effort to avoid being delayed by proceedings in the Chancery Court, M&A practice has evolved to reflect a *Pure* standard.[591]

A disclosure only settlement of class action litigation was dismissed in the *In re Trulia, Inc. Stockholder Litigation*,[592] 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,[593] 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 have triggered stockholder litigation in this country has more than doubled, from 39.3% in 2005 to a peak of 94.9% in 2014.[594]

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

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590 *Id.* at 447-49.

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

592 129 A.3d 884, 894 (Del. Ch. 2016).

593 *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).

594 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.

> 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. * * *
>
> 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

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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.[595]

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