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10 Principles That Will Guide the New Texas Business Courts in Breach of Fiduciary Duty Litigation

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The new Texas business courts recently opened their doors on Sept. 1, 2024 in Dallas, Fort Worth, Austin, San Antonio, and Houston. The courts have jurisdiction concurrent with district courts over, among other cases, actions alleging that a corporate director breached a duty owed to the corporation, generally subject to a $5 million minimum amount in controversy, unless a party to the action is a publicly traded company (in which case there is no minimum amount in controversy). Tex. Gov't Code Sections 25A.004(b)(5), (c). Unlike the Delaware Court of Chancery, the Texas business courts do not have the benefit of dozens of precedent-setting opinions in breach of fiduciary duty litigation from the state's court of last resort in civil matters. But this area of the law is not completely uncharted in Texas. Below are 10 principles that will guide the Texas business courts in breach of fiduciary duty litigation against corporate directors, as well as a few questions that the courts may address in their early days.

Courtesy photos

L-R: Monica H. Smith, John B. Lawrence and Tom O'Brien of Baker Botts.

1. Tripartite Duties

Under Texas law, corporate directors owe three fiduciary duties to their corporation: loyalty, obedience, and due care. *In the Matter of Estate of Poe*, 648 S.W.3d 277, 287 (Tex. 2022); *Gearhart Indus. v. Smith Int'l*, 741 F.2d 707, 719 (5th Cir. 1984). While these duties are not expressly defined in the Texas Business Organizations Code (TBOC), they are recognized in case law, and the statute creating the business courts expressly references actions for "breach of a duty of loyalty

or good faith." Tex. Gov't Code Section 25A.004(b)(5).

2. Duty of Loyalty

The duty of loyalty requires a director to act in good faith and not allow his or her personal interests to prevail over the corporation's interests. *Gearhart*, 741 F.2d at 719. A corporation's charter cannot exculpate claims for breach of this duty. Tex. Bus. Orgs. Code Section 7.001(c).

To prove a breach of the duty of loyalty, a plaintiff must show that a director was "interested" in a particular transaction. *Gearhart*, 741 F.2d at 719. Under Texas common law, a director is interested in a transaction if he or she (i) makes a personal profit from the transaction by dealing with the corporation; (ii) usurps a corporate opportunity; (iii) buys or sells assets of the corporation; (iv) transacts business in his or her director capacity with a second corporation of which he or she is also a director, officer, or significantly associated; (v) transacts business in his or her director capacity with a family member; or (vi) takes actions in response to a takeover threat with the sole or primary goal of entrenching themselves as a director. *A. Copeland Enters. v. Guste*, 706 F. Supp. 1283, 1290–91 (W.D. Tex. 1989). The TBOC provides that, for purposes of the Code, a director is disinterested with respect to the approval of a transaction if the director or the director's associate (i) is not a party to the transaction, and (ii) does not have a material financial interest in the outcome of the transaction. Tex. Bus. Orgs. Code Section 1.003(a).

If a plaintiff shows that a director was interested in a transaction, the burden shifts to the director to show that he or she acted in good faith (i.e., he or she intended to benefit the corporation), and that the transaction was fair to the corporation (i.e., it carries the earmark of an arm's-length bargain). *Gearhart Indus.*, 741 F.2d at 720, 723; see Tex. Bus. Orgs. Code Section 21.418(b)(2) (a director will not be liable for breach of the duty of loyalty with respect to an interested-director transaction if the transaction is fair to the corporation when it is authorized, approved, or ratified by the board of directors, a committee of the board of directors, or the shareholders). "The standard of loyalty is measured by no fixed scale," *Imperial Grp. (Texas) v. Scholnick*, 709 S.W.2d 358, 365 (Tex. App.—Tyler 1986, writ ref'd n.r.e.) (quotations omitted), but directors may be able to prove the good faith and fairness of a transaction by showing, among other facts, that they had credible business reasons for the transaction, hired well-respected financial experts and counsel to aid them, followed their advisors' advice, negotiated at arm's length with sophisticated businesspeople on both sides of the transaction, and/or obtained comparable terms to other comparable transactions. *Gearhart Indus.*, 741 F.2d at 723.

The TBOC also sets forth procedures that, if followed, protect directors from liability for breach of the duty of loyalty in connection with interested-director transactions. Neither the corporation nor any of the corporation's shareholders will have a cause of action against a director for breach of the duty of loyalty with

respect to an interested-director transaction if the director discloses the material facts of the transaction and a majority of the shareholders or a majority of the disinterested directors on the board or a committee of the board approve the transaction. Tex. Bus. Orgs. Code Sections 21.418(b), (e).

3. Duty of Obedience

The duty of obedience forbids illegal or ultra vires acts—acts outside the scope of the corporation's powers as defined by its charter or applicable law. *Gearhart Indus.*, 741 F.2d at 719; *In re Life Partners Holdings*, Case No. DR-11-CV-43-AM, 2015 WL 8523103, at *16 (W.D. Tex. Nov. 9, 2015); see also Tex. Bus. Orgs. Code Section 20.002 (addressing ultra vires acts). Applying Texas's business judgment rule, however, courts have refused to impose personal liability on exculpated disinterested directors for breach of this duty unless the directors committed or approved an illegal act with actual knowledge of its illegality. See *Gearhart Indus.*, 741 F.2d at 719 ("An ultra vires act, negligent or not, may be voidable under Texas law, but the director is not personally liable for it unless the action in question is also illegal."); *In re Life Partners Holdings*, 2015 WL 8523103, at *16 ("If a disinterested director approves a corporate act that violates positive law with actual knowledge of its illegality, he is liable for breach of fiduciary duty, which, as a knowing violation of law, cannot be exculpated.") (quotations omitted); *Resolution Trust v. Norris*, 830 F. Supp. 351, 357 (S.D. Tex. 1993) (that acts are illegal does "not make directors liable for the results, absent pleading and proof that the directors knew about the illegal conduct"); see Tex. Bus. Orgs. Code Section 7.001(c)(2)(B) (the liability of a director cannot be eliminated or limited to the extent the director is found liable for an act or omission not in good faith that involves a knowing violation of the law). If a director is accused of breaching the duty of obedience by committing an ultra vires act, the director may also be able to raise as a defense the broad scope of the corporation's powers, if the corporation's charter provides that the corporation is formed for any lawful purpose or purposes, as permitted by the TBOC. See Tex. Bus. Orgs. Code Section 2.001.

4. Duty of Due Care

The duty of care requires directors to manage the corporation's affairs with diligence and prudence. *Gearhart Indus.*, 741 F.2d at 720. Directors must exercise the level of care an ordinarily prudent person would use under similar circumstances. Id. Under Texas's business judgment rule, however, the negligence of a director does not constitute a breach of the duty of care if the act was within the honest exercise of his or her discretion and judgment in managing the corporation. *Sneed v. Webre*, 465 S.W.3d 169 (Tex. 2015); *Cates v. Sparkman*, 73 Tex. 619, 622 (Tex. 1889); *Gearhart Indus.*, 741 F.2d at 721. The TBOC also provides that a director may, in good faith and with ordinary care, rely on information, opinions, reports, or statements prepared or presented by officers or employees of the corporation, legal counsel, certified public accountants, investment bankers, others with professional expertise, or a committee of the board of which the director

is not a member, Tex. Bus. Orgs. Code Section 3.102, and that a corporation's charter may eliminate the liability of a director for breach of the duty of care, id. Section 7.001.

In the near future, the Texas business courts may be faced with two questions regarding the duty of care and the business judgment rule: (i) whether the business judgment rule protects gross negligence; and (ii) whether a corporation's charter provisions may exculpate claims for gross negligence. Regarding the first issue, some courts have held, mostly in the banking context, that directors can be liable for grossly negligent acts. See, e.g., *In re Life Partners Holdings*, 2015 WL 8523103, at *7; *F.D.I.C v. Harrington*, 844 F. Supp. 307, 306 (N.D. Tex. 1994). But other courts have rejected the proposition that directors can be held liable for gross negligence. See *Roels v. Valkenaar*, No. 03-19-00502-CV, 2020 WL 4930041, at *9 (Tex. App.—Austin 2020, no pet.); *Chapman v. Arfeen*, No. 09-16-00272-CV, 2018 WL 4139001, at *15 (Tex. App.—Beaumont 2018, pet. denied); *Floyd v. Hefner*, CA No. H-03-5693, 2006 WL 2844245, at *19, *24 (S.D. Tex. Sept. 29, 2006). As to the second issue, at least one court has held that the TBOC authorizes the adoption of charter provisions that exculpate claims for gross negligence. *In re Life Partners Holdings*, 2015 WL 8523103, at *9.

5. Duty of Reasonable Oversight

Either as part of the duty of care or the duty of loyalty, or as a standalone duty, some courts have held that directors also have a duty to exercise reasonable oversight over the corporation and its affairs. See id. at *10. In their early days, the Texas business courts may address (i) whether directors have such a duty, and, if so, (ii) under what circumstances liability will attach for breach of such duty, and (iii) whether such liability is exculpable. One court addressing these issues looked to Delaware law and held that directors may be held personally liable for a failure to monitor only where they intentionally fail to act in the face of a known duty to act, demonstrating a conscious disregard for their duties. Id. at *12. The court specified two situations in which directors consciously disregard their oversight responsibility: (i) when they utterly fail to implement or consciously fail to oversee a sound monitoring system (e.g., where a corporation lacks an audit committee or the committee members do not regularly attend their meetings); and (ii) when directors are alerted to, but refuse to address, an obvious sign of possible wrongdoing that requires further investigation and, potentially, corrective action (e.g., where an audit committee knows facts suggesting potential accounting improprieties but takes no action to respond to them). Id. As to the second situation, the court clarified that directors lack the scienter necessary to establish oversight liability if, based on reasonable support, they conclude that no wrongdoing had occurred and, therefore, believed in good faith that the red flags were false alarms. Id. at *14. The court also concluded that because director oversight liability entails bad faith and a breach of the duty of loyalty, such liability is not exculpable. Id. at *12.

6. Interests Directors May Consider

The TBOC provides that in discharging their duties and in considering the best interests of the corporation, "a director is entitled to consider the long-term and short-term interests of the corporation and the shareholders of the corporation, including the possibility that those interests may be best served by the continued independence of the corporation." Tex. Bus. Orgs. Code Section 21.401(b). This statutory provision sets Texas law apart from Delaware law, which requires directors to act for the purpose of maximizing the long-term value of the corporation. *In re Rural/Metro Corp. S'holders Litig.*, 102 A.3d 205, 253 (Del. Ch. 2014).

7. Takeover Defenses

Texas courts have examined the validity of poison pills and other takeover defenses from two perspectives: (i) their validity at the time of adoption; and (ii) their continued validity in light of events after their adoption. *A. Copeland Enters.*, 706 F. Supp. at 1291. A director may be able to prove the good faith and fairness of adopting a takeover defense by showing that the defense bought the board time to negotiate for alternatives, gave the board negotiating power, and/or propped up the prices of the corporation's shares on the market. Id. at 1292. Subsequent events, however, may nullify the usefulness of a takeover defense. Id. For example, if a board that has put in place a poison pill decides that a sale of the corporation through an open sale process is in the shareholders' best interest, the board is charged with getting the best price for the shareholders and typically should remove the poison pill after the process because keeping it in place would dilute the investment of anyone triggering its provisions. Id.

8. Shareholders' Standing

Because a director's duties run to the corporation and not to individual shareholders or even to a majority of shareholders, claims concerning breach of a director's fiduciary duties can be brought only by a shareholder derivatively in the name of the corporation so that each shareholder will be made whole if the corporation obtains compensation from the suit. *Gearhart Indus.*, 741 F.2d at 721. Earlier decisions held that a director may owe fiduciary duties to an individual shareholder—and an individual shareholder may have an individual action against a director for wrongs done to him or her—if a contract or confidential relationship exists between them in addition to the corporate relationship. See, e.g., *Cotton v. Weatherford Bancshares*, 187 S.W.3d 687, 698 (Tex. App.—Fort Worth 2006, pet. denied). But in 2022, the Supreme Court of Texas clarified that a director's fiduciary duty in the management of a corporation is solely for the benefit of the corporation, and that a director cannot owe an informal duty to operate or manage the corporation in the best interest of or for the benefit of an individual shareholder. *In the Matter of Estate of Poe*, 648 S.W.3d at 289–90.

9. Demand Requirement

In Delaware, a shareholder may bring suit derivatively in the name of the corporation, without making a pre-suit demand on the board to

act, if he or she can prove that making a demand would be futile. See *Brehm v. Eisner*, 746 A.2d 244, 256–57 (Del. 2000). The same is not true in Texas, which does not recognize the principle of demand futility. *In re Schmitz*, 285 S.W.3d 451, 455 (Tex. 2009). Texas law requires presuit demand in all cases; a shareholder cannot avoid a demand by proving it would have been futile. Id. Under the TBOC, a shareholder may not file a derivative proceeding until the 91st day after he or she submits a written demand to the corporation stating with particularity the subject of the claim and requesting that the corporation act, unless the shareholder can show irreparable injury will otherwise result. Tex. Bus. Orgs. Code Section 21.553. The demand cannot be made anonymously and must meet the statute's "with particularity" requirement. *In re Schmitz*, 285 S.W.3d at 455, 458. If a majority of the independent and disinterested directors decides in good faith, after conducting a reasonable inquiry, that pursuing the claim is not in the company's best interest, any suit that has been or is filed must be dismissed. Id. Section 21.558(a).

10. Creditors' Standing

Directors generally stand in a fiduciary relationship to the corporation, not its creditors. *Fagan v. La Gloria Oil & Gas*, 494 S.W.2d 624, 628 (Tex. App.—Houston [14th Dist.] 1973, no writ). However, courts have recognized a narrow exception to this rule. See, e.g., *Tow v. Bulmahn*, No. 15-CV-3141, 2016 WL 1722246, at *7–8 (E.D. La. Apr. 29, 2016), *aff'd sub nom.*, 711 F. App'x 216 (5th Cir. 2017). Under what is known as the "trust fund doctrine," when a corporation is insolvent and ceases doing business, the corporation's assets become a trust fund primarily for the benefit of the corporation's creditors and directors of the corporation are placed in a fiduciary relationship to the creditors, requiring them to administer the corporate assets for the benefit of the creditors and to ratably distribute them. *Conway v. Bonner*, 100 F.2d 786, 787 (5th Cir. 1939); *Aurelius Cap. Master v. Acosta*, No. 13-CV-1173, 2014 WL 10505127, at *3–5 (N.D. Tex. Jan. 28, 2014); *Floyd*, 2006 WL 2844245, at *19, *24; *Fagan*, 494 S.W.2d at 628; see also *Lyons-Thomas Hardware v. Perry Stove Mfg.*, 24 S.W. 16, 21 (Tex. 1893) ("[T]he assets of an insolvent corporation, which has ceased to carry on business and does not intend to resume, is a fund from which all creditors, not secured by valid liens existing before the condition was fixed, have the right to be paid on terms of perfect equality. If such a fund be a trust fund, then the assets of a corporation so circumstanced are trust funds, and those whose rights and duty it is to administer such a fund are trustees"). If a director breaches that duty, creditors may sue the director for breach of fiduciary duty. *Fagan*, 494 S.W.2d at 628.

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