

**AVOIDING COMMON PITFALLS AND TRAPS
WHEN PLANNING AND DRAFTING FOR LLCs:
DUTIES, EXCULPATION, AND INDEMNIFICATION
PROVISIONS IN GOVERNING DOCUMENTS OF
TEXAS BUSINESS ORGANIZATIONS**

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DUTIES, EXCULPATION, AND INDEMNIFICATION PROVISIONS IN GOVERNING DOCUMENTS OF TEXAS BUSINESS ORGANIZATIONS

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I. Introduction

Statutory developments beginning in the 1990's have impacted the analysis of fiduciary duties in the business organizations context. The duties of general partners are now defined by statutory provisions that delineate the duties without referring to them as “fiduciary” duties and specifically provide that partners shall not be held to the standard of a trustee. Whether limited partners in a limited partnership have fiduciary duties is not well-settled, but the new Business Organizations Code (“BOC”) clarifies that a limited partner does not owe the duties of a general partner solely by reason of being a limited partner. While the fiduciary duties of directors are still principally defined by common law, various provisions of the corporate statutes are relevant to the application of fiduciary duty concepts in the corporate context. Because limited liability companies (LLCs) are a relatively recent phenomenon and the Texas LLC statutes do not specify duties of managers and members, there is some uncertainty with regard to the duties in this area, but the LLC statutes allude to or imply the existence of duties, and managers in a manager-managed LLC and members in a member-managed LLC should expect to be held to fiduciary duties similar to the duties of corporate directors or general partners. In each type of entity, the governing documents may vary (at least to some extent) the duties and liabilities of managerial or governing persons. The power to define duties, eliminate liability, and provide for indemnification is addressed somewhat differently in the statutes governing the various forms of business entities. For example, some types of provisions typically found in corporate certificates of formation or bylaws may operate quite differently and be much less clear if included in LLC governing documents. The Appendix to this paper contains some examples of problematic exculpation and indemnification provisions in the LLC context.

II. Corporations

A. Fiduciary Duties of Corporate Directors, Officers, and Shareholders

The provisions of the BOC governing for-profit corporations (like the predecessor Texas Business Corporation Act), do not explicitly set forth or define the fiduciary duties of corporate directors; however, case law generally recognizes that directors owe a duty of obedience, a duty of care, and a duty of loyalty. *See Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 718 (5th Cir. 1984); *FDIC v. Harrington*, 844 F.Supp. 300, 306 (N.D. Tex. 1994); *Resolution Trust Corp. v. Norris*, 830 F.Supp. 351 (S.D. Tex. 1993).

Duty of Obedience. The directors' duty of obedience forbids *ultra vires* acts but is rarely implicated given that modern corporation laws define corporate powers expansively and permit broad purpose clauses in the certificate of formation. *See* Tex. Bus. Org. Code §§ 2.001, 2.003, 2.007, 2.008, 2.101, 3.005(a)(3); *see also* Tex. Bus. Org. Code § 20.002 (defining scope of *ultra vires* doctrine). In general, courts appear reluctant to hold directors liable for *ultra vires* acts. As one court has summed up the Texas law in this area, “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.” *Resolution Trust Corp. v. Norris*, 830 F.Supp. 351, 357 (S.D. Tex. 1993).

Duty of Care. Until the 1990's, Texas cases dealing with director liability for breach of the duty of care, as distinct from the duty of loyalty, had been few and far between. The Fifth Circuit analyzed a director's duty of care under Texas law in *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707 (5th Cir. 1984) as follows:

Under the law of most jurisdictions, the duty of care requires a director to be diligent and prudent in managing the corporation's affairs. Ubelaker at 784. The leading case in Texas defining a director's standard of care is *McCollum v. Dollar*, 213 S.W. 259 (Tex.Comm'n App.1919, holding approved). That case held that a director must handle his corporate duties with such care as "an ordinarily prudent man would use under similar circumstances." *Id.* at 261. The question of director negligence is a question of fact and must be decided on a case-by-case basis. *Id.* Texas courts hold directors liable for negligent mismanagement of their corporations, but the decisions do not specifically refer to such acts as violations of the duty of care, preferring to speak in general terms of directors as fiduciaries. *International Bankers Life Ins. Co. v. Holloway*, *supra*; *Tenison v. Patton*, *supra*; *Dowdle v. Texas Am. Oil Corp.*, 503 S.W.2d 647, 651 (Tex.Civ.App.—El Paso 1973, no writ); *Fagan v. La Gloria Oil & Gas Co.*, 494 S.W.2d 624, 628 (Tex.Civ.App.—Houston [14th Dist.] 1973, no writ); *Sutton v. Reagan & Gee*, 405 S.W.2d 828, 834 (Tex.Civ.App.—San Antonio 1966, writ ref'd n.r.e.). Unquestionably, under Texas law, a director as a fiduciary must exercise his unbiased or honest business judgment in pursuit of corporate interests. *In re Westec Corp.*, 434 F.2d 195, 202 (5th Cir.1970); *International Bankers Life Ins. Co. v. Holloway*, *supra* at 577. "The modern view definitely stresses the duty of loyalty and avoids specific discussion of the parameters of due care." Ubelaker at 789.[footnote omitted]

In other jurisdictions, a corporate director who acts in good faith and without corrupt motive will not be held liable for mistakes of business judgment that damage corporate interests. Ubelaker at 775; *see, e.g., Lasker v. Burks*, 404 F. Supp. 1172 (S.D.N.Y.1975). This principle is known as the business judgment rule and it is a defense to accusations of breach of the duty of care. Ubelaker at 775, 790. Few Texas cases discuss the issues of a director's standard of care, negligent mismanagement, and business judgment. An early case, *Cates v. Sparkman*, 73 Tex. 619, 11 S.W. 846 (1889), set the standard for judicial intervention in cases involving these issues:

[I]f the acts or things are or may be that which the majority of the company have a right to do, or if they have been done irregularly, negligently, or imprudently, or are within the exercise of their discretion and judgment in the development or prosecution of the enterprise in which their interests are involved, these would not constitute such a breach of duty, however unwise or inexpedient such acts might be, as would authorize interference by the courts at the suit of a shareholder.

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