OVERVIEW OF FIDUCIARY DUTIES, EXCULPATION, AND INDEMNIFICATION IN TEXAS BUSINESS ORGANIZATIONS

ELIZABETH S. MILLER
Professor of Law
Baylor University School of Law
Waco, Texas

The University of Texas School of Law

38th ANNUAL CONFERENCE ON SECURITIES AND BUSINESS LAW
February 11-12, 2016

Table of Contents

FIDUCIARY DUTIES ARISING OUT OF BUSINESS RELATIONSHIPS: OVERVIEW OF FIDUCIARY DUTIES, EXCULPATION, AND INDEMNIFICATION IN TEXAS BUSINESS ORGANIZATIONS

I. Introduction

Statutory developments beginning in the 1990s 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 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.

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 the corporation (but not individual shareholders) a duty of obedience, a duty of care, and a duty of loyalty. *See Ritchie v. Rupe,* 443 S.W.3d 856, 868 (Tex. 2014); *Gearhart Indus, Inc. v. Smith Int'l, Inc.,* 741 F.2d 707, 719-721 (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).

1. Director's 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. Orgs. Code §§ 2.001, 2.003, 2.007, 2.008, 2.101, 3.005(a)(3); *see also* Tex. Bus. Orgs. 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).

2. Director's Duty of Care

Until the 1990s, 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 Industries, Inc. v. Smith International, 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.

Id. at 622, 11 S.W. at 849. Even though *Cates* was decided in 1889, and despite the ordinary care standard announced in *McCollum v. Dollar*, *supra*, 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. See *Robinson v. Bradley*, 141 S.W.2d 425 (Tex.Civ.App.—Dallas 1940, no writ); *Bounds v. Stephenson*, 187 S.W. 1031 (Tex.Civ.App.—Dallas 1916, writ ref.); *Caffall v. Bandera Tel. Co.*, 136 S.W. 105 (Tex.Civ.App. 1911); *Farwell v. Babcock*, 27 Tex.Civ.App. 162, 65 S.W. 509 (Tex.Civ.App. 1901); see also *Zauber v. Murray Sav. Ass'n*, 591 S.W.2d 932 (Tex.Civ.App.—Dallas 1979, writ ref'd n.r.e.). Such is the business judgment rule in Texas.

741 F.2d at 720-21.

Thus, despite the "ordinary care" standard announced in early Texas cases, the Fifth Circuit characterized the business judgment rule in Texas as protecting all but fraudulent or *ultra vires* conduct, which would literally protect even grossly negligent conduct and thus provide more protection than the Delaware business judgment rule. The tension between the standard of care and standard of liability in Texas received little attention in the reported cases until federal banking regulatory agencies began seeking recovery from the directors of failed financial institutions (and their liability insurers) for their alleged mismanagement of the failed institutions. Federal district courts were then faced squarely with the issue of what degree of negligence, if any, would subject the directors to liability under Texas corporate law. These federal district courts generally rejected the argument of the FDIC and RTC that directors are liable under Texas common law for acts of mismanagement that amount to simple negligence, but concluded that the business judgment rule does not protect a breach of the duty of care that amounts to gross negligence or an abdication of responsibilities resulting in a failure to exercise any judgment. *See FDIC v. Schreiner*, 892 F.Supp. 869 (S.D. Tex. 1995); *FDIC v. Daniel*, 158 F.R.D. 101 (E.D. Texas. 1994); *RTC v. Acton*, 822 F.Supp. 307 (N.D. Tex. 1994); *FDIC v. Benson*, 867 F.Supp. 512 (S.D. Tex. 1994); *FDIC v. Harrington*, 844 F.Supp. 300 (N.D. Tex. 1994); *Resolution Trust Corp. v. Norris*, 830 F.Supp. 351 (S.D. Tex.. 1993); *FDIC v. Brown*, 812 F.Supp. 722 (S.D. Tex. 1992); *Resolution Trust Corp. v. Bonner*, 1993 WL 414679 (S.D. Tex. 1993). At least one court in Texas has relied upon this line of cases outside the banking context. *See Weaver v. Kellog*, 216 B.R. 563, 584 (S.D. Tex. 1997).

In *Floyd v. Hefner*, 2006 WL 2844245 (S.D. Tex. 2006), however, Judge Harmon followed the *Gearhart* opinion and rejected the proposition that corporate directors can be held liable for gross negligence under current Texas law. The court concluded that the district court opinions that followed a gross-negligence standard appear to be the product of the special treatment that

Title search: Overview of Fiduciary Duties, Exculpation, and Indemnification in Texas Business Organizations

Also available as part of the eCourse
The Fundamentals of Fiduciary Duty

First appeared as part of the conference materials for the
38th Annual Conference on Securities and Business Law session
"The Fundamentals of Fiduciary Duty"