FIDUCIARY DUTIES OF DIRECTORS AND OFFICERS UNDER TEXAS LAW

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Introduction

• Fiduciary duties form the cornerstone for corporate governance

• Federal laws which touch on these subjects include:
  — Sherman Anti-Trust Act
  — Securities Act of 1933 and Securities Exchange Act of 1934
  — Sarbanes-Oxley
Introduction

• Directors have three main fiduciary duties under Texas law:

(1) **Duty of Obedience**
   Duty to refrain from committing *ultra vires* acts

(2) **Duty of Loyalty**
   Duty to act in good faith and not allow personal interest to prevail over that of the corporation

(3) **Duty of Care**
   Duty to act and perform corporate duties in same manner as an ordinarily prudent person would under similar circumstances
Fiduciary Duty of Obedience

• The fiduciary duty of obedience forbids a director from committing *ultra vires* acts (i.e. acts beyond the scope of the powers of the corporation as defined in its corporate governance documents and under Texas law). *Gearhart Indus. v. Smith Int’l*, 741 F.2d 707, 719 (5th Cir. 1984).

  — Rarely implicated due to the current corporate laws which permit broad purpose of corporation provisions in the Certificate of Formation and corporate governance documentation. Exception: The *ultra vires* act violates a specific statute.
Fiduciary Duty of Obedience

• Directors generally not susceptible to personal liability unless the Director:

  (1) directly participated in the act; or

  (2) had knowledge of the *ultra vires* act of another corporate agent.

Fiduciary Duty of Loyalty

• The duty of loyalty requires that a “director must act in good faith and must not allow his personal interests to prevail over the interests of the corporation.” *Gearhart Indus. v. Smith Int’l*, 741 F.2d 707, 719 (5th Cir. 1984).

• Interested director transactions (BOC § 21.418):
  — Disclose material facts as to interest.
  — Refrain from discussion.
  — Although not required by Section 21.418, recommend abstaining from voting.
  — Make a record.
Fiduciary Duty of Due Care

• Standard for duty of care applied by the Texas courts with respect to a Director:
  — “a director must handle his corporate duties with such care as ‘an ordinarily prudent man would use under similar circumstances.’”

  *Gearhart Indus. v. Smith Int’l, 741 F.2d 707, 720 (5th Cir. 1984).*

• Informed decision making
Fiduciary Duties in Limited Liability Companies

- The BOC does not expressly impose fiduciary duties on governing managers/members of an LLC; however, many of the provisions imply these duties exist for governing persons of an LLC.
  - For example:
    - The duty of loyalty is implied by the statutory provisions involving interested manager transactions and renunciation of business opportunities. See BOC § 101.255.
    - BOC provides that the company agreement of an LLC may “expand or restrict any duties, including fiduciary duties, and related liabilities that a member, manager, officer . . . has to the company . . . .” BOC § 101.401 (emphasis added).
Members do not necessarily owe fiduciary duties as a matter of law to other members (but can owe them to each other in certain contexts—for example if provided in the company agreement) but generally owe them to the LLC.


— *See also Cardwell v. Gurley*, 2011 WL 6338813 (E.D. Tex. 2011) (ruling state court’s findings that the managing member owed other member fiduciary duties of loyalty, care and, disclosure had preclusive effect in the bankruptcy case).
Fiduciary Duties in Partnerships

- BOC expressly provides that a partner owes the partnership and other partners two duties: (1) duty of loyalty and (2) duty of care.
  — BOC § 152.204(a).

- BOC also expressly negates the existence of other fiduciary duties and provides that a partner is not a trustee and is not held to the same standards as a trustee.
  — BOC § 152.204(d).
Fiduciary Duties in Partnerships

- **Duty of Loyalty in Partnership has 3 parts:**
  - Account to the partnership for any benefit derived by a person from the use of the partnership’s property;
  - Refrain from dealing with the partnership on behalf of a party having an interest adverse to the partnership; and
  - Refrain from competing or dealing with the partnership in a manner adverse to the partnership.
  - BOC § 152.205.
Duty of Care in Partnership (BOC § 152.206):

- A partner’s duty of care requires the partner to act with the degree of care an ordinarily prudent person would use in similar circumstances.

- Partner presumed to have satisfied duty of care if acted on an informed basis, in good faith, and in a manner he or she believes to be in the best interest of the partnership.
Reliance on Experts
BOC § 3.102

(a) In discharging a duty or exercising a power, a Director 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 Director may not rely on this information if he or she has knowledge of a matter that makes the reliance unwarranted.

Note: Under the Code, partnerships and limited liability companies may revise these rules by agreement in their governing documents.
Constituencies

- **BOC § 21.401(b):**
  - In discharging the duties of director under this code or otherwise and in considering the best interests of the corporation, a director may 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.

Corporate Duties of Directors of a Financially Distressed Entity

• Duty to Creditors?
  
  — Directors of Texas corporations do not owe fiduciary duties directly to creditors, unless

  (1) there has been prejudice to the creditors*, or

  (2) if the corporation is insolvent.

  *Prejudice to creditors occurs when “the transaction is a fraudulent conveyance or one which led to corporate insolvency.”


Corporate Duties of Directors of a Financially Distressed Entity

Directors of an insolvent corporation owe a fiduciary duty to creditors to deal fairly with the corporation’s creditors.

- includes a duty to preserve the value of the corporate assets to pay corporate debts without preferring one creditor over another or preferring themselves to the injury of other creditors.

Corporate Duties of Directors of a Financially Distressed Entity

- Insolvency is just one circumstance where Texas courts hold that Directors may have fiduciary duties to creditors to deal fairly.

- Other circumstances where Directors can be held to owe this fiduciary duty to a creditor include:
  - When the corporation is “in the vicinity of insolvency;”
  - If a transaction leads to the corporation’s insolvency; or
  - When a transaction is a fraudulent conveyance.

Standard For Proving a Breach of Fiduciary Duties

• Interested Directors and the duty of loyalty:
  — Whether a director is interested is a question of fact. 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. Gearhart, 741 F.2d at 719-20
Standard For Proving a Breach of Fiduciary Duties (continued)

• Disinterested Directors and the duty of care:
  — Disinterested Directors in Texas accused of violating the duty of care are subject to the business judgment rule
  — “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.” Gearhart Indus. v. Smith Int’l, 741 F.2d 707, 721 (5th Cir. 1984).

• A Director is “disinterested” in a contract or transaction if the person or person’s associate: (1) is not a party to the contract or transaction; and (2) does not have a material financial interest in the outcome. BOC § 1.003.
In re Teleglobe Commc’ns Corp., 493 F.3d 345 (3d Cir. 2007).

Parent corporation sued by a subsidiary in adversary proceeding in bankruptcy – Case raises issues of privilege and conflict of interest arising in context of insolvency with ramifications for both directors and in-house counsel.


“[G]enerally, in a parent and wholly-owned subsidiary context, directors of the subsidiary are obligated only to manage the affairs of the subsidiary in the best interest of the parent and its shareholders. However . . . this rule . . . does not apply when the subsidiary is insolvent or when the transaction at issue would render the subsidiary unable to meet its legal obligations. Instead, directors of a wholly-owned subsidiary owe a duty to the subsidiary not to take action benefiting a parent corporation that they known will render the subsidiary unable to meets its legal obligations.” Id. at 817 (citations and internal quotation marks omitted).
Indemnification

• **Mandatory Indemnification** (BOC § 8.051(a)):
  — Required to indemnify a Director who is “wholly successful on the merits or otherwise.”

• **Permissive Indemnification** (BOC § 8.101):
  — Permitted to indemnify a Director who qualifies under the standards in Section 8.101 which include that the Director:
    - (1) acted in good faith;
    - (2) reasonably believed:
      - the conduct was in the best interest of the corporation if the conduct was in an official capacity; and
      - in any other case, that person’s conduct was not opposed to the corporation’s best interest; and
    - (3) in the case of a criminal proceeding, had no reasonable cause to believe the conduct was unlawful.
Indemnification (continued)

• Advancement of Expenses (BOC § 8.152):
  — An entity shall report in writing to the owners or members of the entity an indemnification of or advance of expenses to a governing person.
  — This report must be made with or before:
    ➢ the notice or waiver of notice of the next meeting of the owners or members of the entity; or
    ➢ the next submission to the owners or members of a consent to action without a meeting.
  — The report must be made not later than the first anniversary of the date of the indemnification or advance.
Authority and Duties of Officers

• Authority of Officers
  – Authority of officers is delegated from the directors.

• Duties of Officers
  – Texas case law suggests officers are presumed to be fiduciaries and have duties of care and loyalty akin to directors, but such duties are not codified.
Standards Applicable to Officers

• Under BOC Section 21.220, officers in charge of the corporation’s share transfer records are subject to liability to a shareholder who suffers damage for failing to: (1) prepare the list of shareholders; (2) keep the list on file for a 10-day period; or (3) produce and keep the list available for inspection at the annual meeting.
Practical Application
Changes in Control
Typical Process

• **Example:**
  
  — Non-public corporation with 100 shareholders.
  
  — Management and the Board of Directors desire to pursue the possibility of selling the corporation.
  
  — Lawyer asked to attend a meeting of the Board of Directors to advise the directors on how to proceed.
Changes in Control
Typical Process (continued)

• What do you do?
  
  — Lawyer advises the directors on their fiduciary duties to start the record of reasonable conduct by prudent directors.

  — Lawyer provides additional advice and guidance on:
    ➢ Potential conflicts of interest;
    ➢ Confidentiality of the process;
    ➢ No trading in shares of the selling company; and
    ➢ No comment on rumors about a possible transaction.
Changes in Control
Applicable Duties

• Extensive case law which is always evolving.
  — *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985)
  — *O’Neill v. Church’s Fried Chicken, Inc.*, 910 F.2d 263 (5th Cir. 1990).
Evolving Role of Directors

- The Board of Directors’ role in the governance of modern corporations continues to evolve.
  - Traditionally served an advisory/guidance function and was active in business strategy, tactics, hiring and firing, technology decisions, etc.
  - Today, directors serve a compliance function to ensure that the corporation complies with applicable legal, accounting and regulatory requirements.