The Duty of Loyalty and the Business Judgment Rule in Texas

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1. Fiduciary duties

“Corporation officers and directors are fiduciaries.”1 “Directors, or those acting as directors, owe a fiduciary duty to the corporation in their directorial actions.”2 This paper considers the officer/director fiduciary duties and the application of the business judgment rule in Texas in light of recent case law.

A. Traditional Formulation of Fiduciary Duties

Under the traditional formulation, corporate fiduciary duties constitute three separate duties. “Corporate officers and directors owe three distinct duties to the corporations they serve: obedience, loyalty, and due care.”3

“The duty of obedience requires a director to avoid acting beyond the scope of their enumerated powers (also referred to as ultra vires acts).”4 The duty of obedience also requires the directors to comply with the law, the governing documents of the corporation, and any limits on their authority.

The duty of loyalty requires that that a director act in good faith and not allow his or her personal interests to prevail over the interests of the corporation.5 The duty of loyalty is concerned with self-dealing—whether or not a director is “interested” in the transaction. “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)

5 Id.
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.6 “Transactions involving an interested director are subject to strict judicial scrutiny but are not voidable unless they are shown to be unfair to the corporation.”7 “[T]he burden of proof is on the interested director to show that the action under fire is fair to the corporation. A challenged transaction found to be unfair to the corporate enterprise may nonetheless be upheld if ratified by a majority of disinterested directors or the majority of the stockholders. An interested director who is also a shareholder is entitled to vote his shares to ratify his challenged act.”8

And finally, the duty of care “requires a director to be diligent and prudent in managing the corporation’s affairs.”9 The duty of care is basically a negligence standard. It concerns “mishandling” and is based on the negligence standard of conduct that the director must use ordinary care.10

B. Ritchie Formulation of the Duty of Loyalty

The Texas Supreme Court in Ritchie v. Rupe formulated the duty of loyalty in a particular way: “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.’”11 The Court makes clear from its citation of Gearhart Industries v. Smith that this statement of the duty is not exclusive. Fiduciary duties “include” the duty to dedicate uncorrupted business judgment for the sole benefit of the corporation, but the duties continue to include duties of obedience and care. This formulation of the duty of loyalty is taken from International Bankers v. Holloway.12 However, the Ritchie Court reiterates this same formulation of the duty of loyalty five times on a variety of topics.13 The following year the Texas

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7 Id. at 720.
8 Id.
10 Smith v. Chapman, 897 S.W.2d 399, 401 (Tex. App.—Eastland 1995, no writ) (“In ordinary circumstances where a director mismanages corporate affairs or takes funds for himself, which in fairness and equity belong to the corporation, a cause of action on behalf of the corporation arises.”); Fagan v. La Gloria Oil & Gas Co., 494 S.W.2d 624, 628 (Tex. Civ. App.—Houston [14th Dist.] 1973, no writ) (“It is a basic rule of law that officers and directors of a corporation owe to it duties of care and loyalty. They stand in a fiduciary relationship to the corporation. … [In] ordinary circumstances where an officer or director negligently mismanages corporate business to its injury …, a cause of action in behalf of the corporation arises.”).
11 Ritchie v. Rupe, 443 S.W.3d at 868.
12 Intl Bankers Life Ins. Co. v. Holloway, 368 S.W.2d at 577 (“The responsibility of the corporate fiduciary includes the dedication of his uncorrupted business judgment for the sole benefit of the corporation.”).
13 Ritchie v. Rupe, 443 S.W.3d at 869 (“a director is duty-bound to exercise business judgment for the sole benefit of the corporation, and not for the benefit of individual shareholders” and citing Holloway, 368 S.W.2d at 577–78, for the proposition that corporate officers’ and directors’ have a duty to maximize corporate returns and value of corporation’s shares); id. at 883 (in the context of decisions to declare dividends); id. at 884 (noting the standard to obtain relief in a derivative action); id. at 886 (in the context of decisions to terminate corporate officers); id. at 876 n. 27 (in the context of usurping corporate opportunities).
The Supreme Court again used the same formulation in *Sneed v. Webre*: “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.’”

Going forward the standard for the duty of loyalty is clearly whether the fiduciary utilized his uncorrupted business judgement for the sole benefit of the corporation.

The *Ritchie* formulation of the duty of loyalty is not really novel but the emphasis seems to be different from the traditional formulation. “Uncorrupted” business judgment seems clearly to point to the need for a disinterested status, but the further requirement of “sole benefit of the corporation” takes this concept much further. A director could be disinterested personally and yet still not be acting for the sole benefit of the corporation. The example emphasized in *Ritchie* is that a director may not act for the benefit of the majority shareholder over that of the corporation. A director may not act for non-business reasons. Also the *Ritchie* formulation makes no reference to harm to the corporation or the concept of fairness. It is easy to imagine a transaction—for example, executive compensation—which is not harmful to the corporation but is not done for the sole benefit of the corporation. What about a self-dealing transaction that is otherwise fair to the corporation, such as leasing property from the majority shareholder at market rates? Such a transaction is almost certainly not for the sole benefit of the corporation. It is difficult to conceive that the Texas Supreme Court would hold that a fair transaction would violate the duty of loyalty, but the emphasis on avoiding divided loyalties under the *Ritchie* formulation certainly makes such a result possible.

### 2. Business Judgment Rule as a Defense

“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.” The rule protects corporate officers and directors from being held liable to the corporation 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.’”

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15 *See Ritchie v. Rupe*, 443 S.W.3d at 869 (“a director is duty-bound to exercise business judgment for the sole benefit of the corporation, and not for the benefit of individual shareholders”).


17 *Sneed*, 465 S.W.3d at 178 (quoting *Cates*, 11 S.W. at 849). See also *Lowry v. Tarbox*, 537 S.W.3d at 615-16 (“The business judgment rule generally protects corporate officers and directors, who owe fiduciary duties to the corporation, from liability for alleged breach of duties based on actions that are negligent, unwise, 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.’”); *In re Life Partners Holdings, Inc.*, DR-11-CV-43-AM, 2015 WL 8523103,
derivative lawsuit that asserts claims against the corporation’s officers or directors for breach of duties that result in injury to the corporation.”

The business judgment rule is the inverse of duty of loyalty. A self-interested transaction would never qualify as the “honest” or “uncorrupted” use of business judgment. Rather, as the El Paso court of appeals recently held, the business judgment rule is a defense to a claim for mismanagement—i.e., a claim based on the duty of care. This is necessarily true, notwithstanding the Texas Supreme Court’s cagey footnote in Sneed v. Weber that seemed to leave open the question of to which duty the business judgment rule applied: “We refer to breach of duty claims generally because this case does not require us to consider which duties are subject to the business judgment rule.” Nevertheless, it seems clear that the business judgment rule would never provide a defense to a breach of the duty of loyalty—which would not be an honest use of business judgment—or to a breach of the duty of obedience—which would involve actions outside the scope of an officer’s or director’s legitimate discretion. The business judgment rule deals only with claims based on the duty of care. As the Texas Supreme Court noted, “courts will not interfere with the officers or directors in control of the corporation’s affairs based on allegations of mere mismanagement, neglect, or abuse of discretion.”

Although the caselaw addressing the business judgment rule in Texas is quite limited, Texas courts frequently look to Delaware for guidance. Texas courts routinely utilize Delaware corporate law on issues that have not yet been decided in Texas, including business judgment rule issues. The Delaware Supreme Court is regarded as the “mother court” for corporate law. Under Delaware law, the business judgment rule is a rebuttable presumption that “in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” The business

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18 Sneed v. Webre, 465 S.W.3d at 178–79.
19 Matter of Estate of Poe, 2019 WL 4058592, at *19 (“The duty of care, the breach of which is sometime referred to as mismanagement in our record, is subject to the business judgment rule.”).
20 Sneed v. Webre, 465 S.W.3d at 178 n. 7.
21 Id. at 186 (citing Cates v. Sparkman, 11 S.W. at 849).
22 L Series, LLC v. Holt, 571 S.W.3d 864, 871 (Tex. App.—Fort Worth 2019, pet. filed) (“We have no qualms looking to Delaware law....”).
23 Id. at 875 (Delaware case law is “persuasive” “in the absence of Texas authority.”); Coates v. Parnassus Sys., Inc., 2002 WL 534595, at *2 (Tex. App.—Austin Apr. 11, 2002, no pet.) (following Delaware law where the court had “not found any Texas cases addressing the critical” issue); Tow v. Bulmahn, 2016 WL 1722246, at *14 (E.D. La. Apr. 29, 2016) (Texas courts consider Delaware decisional law persuasive in resolving unsettled issues of Texas corporate law); In re Life Partners Holdings, Inc., 2015 WL 8523103, at *11 (W.D. Tex. 2015) (Texas Supreme Court would look to Delaware in deciding a director oversight claim).
24 Matter of Estate of Poe, 2019 WL 4058592, at *20 (finding Delaware cases on the business judgment rule “persuasive but not controlling”).
25 In re Aguilar, 344 S.W.3d 41, 47 (Tex. App.—El Paso 2011, no pet.) (“Courts throughout the country look to Delaware for guidance on matters of corporate law.”).
judgment rule in Delaware is comprised of four elements: (1) a business decision; (2) disinterestedness and independence; (3) due care; and (4) good faith. The presumption of the business judgment rule can be rebutted by demonstrating that one of these elements is not present.27

3. When the Business Judgment Rule Does Not Apply

When does the business judgment rule not apply to a claim of mismanagement? Obviously, the business judgment rule does not apply to a claim not brought under the duty of care. If the management steals money, then the claim would be made as a violation of the duty of loyalty. If the board commits an ultra vires act, then the claim would be made as a violation of the duty of obedience. There would be no need for the plaintiff to take the extra step of proving negligence or a breach of due care. The business judgment rule would never be at issue.

The business judgment rule is an absolute defense to a claim based on negligence or imprudence, except when the business judgment rule does not apply. Claims of negligent mismanagement are viable only when some exception to the business judgment rule applies. There are several.

A. Self-Dealing

Under Delaware law, self-dealing in any transaction excludes the application of the business judgment rule: “First, its protections can only be claimed by disinterested directors whose conduct otherwise meets the tests of business judgment. From the standpoint of interest, this means that directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally.”28 Texas law is equally clear that the business judgment rule does not protect self-dealing.29

The only instance in which this principle would apply is in a transaction that is imprudent, but not necessarily unfair. For example, the directors might vote themselves extremely generous salaries, but within what might be provable as the market price for executive compensation in comparable companies. However, the plaintiff might be able prove that the decision to hire themselves at this salary failed to exercise due care because other candidates were readily available who could do the same job for much less. The plaintiff’s claim would be that a person of reasonable prudence would have hired the cheaper but equally qualified candidate. The corporation is damaged by this negligent or imprudent decision in the amount of the difference between the cheaper and more expensive salaries. Although the choice of candidates to hire is ordinarily a matter of business judgment, the self-dealing nature of the transaction would remove the protection of the business judgment rule. Under the Ritchie formulation of the duty of loyalty, the same result


28 Aronson v. Lewis, 473 A.2d at 812.

29 Cardwell v. Gurley, 05-09-01068-CV, 2018 WL 3454800, at *9 (Tex. App.—Dallas July 18, 2018, pet. denied) (“The rule does not protect a corporate officer or director from liability for dishonest, fraudulent, or self-dealing acts.”); Lowry v. Tarbox, 537 S.W.3d at 616 (“Thus, impliedly, the business judgment rule does not apply to protect a corporate officer from liability for acts that are dishonest, fraudulent, or self-dealing.”).
might be true even in a non-self-dealing transaction (e.g., outside directors hired the majority shareholder), where it could be proven that the directors did not exercise their business judgment for the sole benefit of the corporation.

**B. Abdication of Duty**

“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.’”\(^{30}\) The business judgment rule only protects the exercise of judgment and discretion. Simply rubber-stamping whatever a majority shareholder wants arguably is outside the protection of the rule because it involves no exercise of judgment. A board that abdicates its responsibilities has no protection.\(^{31}\) “[T]he business judgment rule also fails to protect officers and directors who abdicate their responsibilities and fail to exercise any judgment.”\(^{32}\) This would include an action that “results from an obvious and prolonged failure to exercise oversight or supervision.”\(^{33}\) A recent court of appeals case held that “[b]ound up within the duty of care is the obligation to actually manage the affairs of the corporation.”\(^{34}\) However, that court also held that there was no “obligation to micromanage corporate affairs. Good corporate boards often rely on skilled employees to handle day-to-day operating decisions.”\(^{35}\)

**C. Lack of Information**

In order to actually exercise discretion, the board must have a certain amount of information. Under Delaware law, “to invoke the rule’s protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them.”\(^{36}\) “A director has a duty to act advisedly with due care, as well as in good faith. The defense of the business judgment rule is available only to Directors ‘who have both adequately informed themselves before voting on the business transaction at hand and acted with the requisite care.’”\(^{37}\) However, “[i]t is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken

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30 Sneed v. Webre, 465 S.W.3d at 178.

31 Resolution Tr. Corp. v. Acton, 844 F. Supp. 307, 315 (N.D. Tex. 1994), aff’d, 49 F.3d 1086 (5th Cir. 1995) (“In general, the Texas business judgment rule restricts the liability of officers and directors to liability for acts of gross negligence, which may include the complete abdication of their responsibilities.”).

32 Id. at 314.

33 Id. (quoting Joy v. North, 692 F.2d 880, 886 (2d Cir.1982), cert. denied, 460 U.S. 1051, 103 S.Ct. 1498, 75 L.Ed.2d 930 (1983)).


35 Id.

36 Aronson v. Lewis, 473 A.2d at 812.

was in the best interests of the company.”\textsuperscript{38} The plaintiff must overcome the presumption of good faith and adequate information.

Some courts have applied this standard in Texas: “[T]he standard to be applied should be whether a fully informed, wholly disinterested, reasonably courageous director would dissent from the board’s act in any material part. The subjective good faith of the participants is irrelevant; it is rational and objective fidelity by which they shall be judged.”\textsuperscript{39}

D. Inaction

Likewise, the exercise of business judgment requires that something have been done. If the board negligently fails to act, resulting in harm to the corporation, then arguably the business judgment rule does not apply. Under Delaware law: “However, it should be noted that the business judgment rule operates only in the context of director action. Technically speaking, it has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act. But it also follows that under applicable principles, a conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment and enjoy the protections of the rule.”\textsuperscript{40}

E. Absence of Business Purpose

The use of business judgment that is protected by the rule is “exercise of their discretion and judgment in the development or prosecution of the enterprise in which their interests are involved.”\textsuperscript{41} Therefore, the absence of a legitimate business purpose for a decision will remove the protection of the business judgment rule. \textit{Ritchie} postulates an example in which the termination of a key employee for “no legitimate business purpose” may be actionable.\textsuperscript{42}

F. Waste

Waste of corporate assets is not protected by the business judgment rule.\textsuperscript{43} However, waste is extremely hard to prove. “Delaware courts have described the standard for corporate waste as ‘onerous, stringent, extremely high, and very rarely satisfied,’ and to recover, the plaintiff has the burden to prove that a transaction was so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration, and such a

\begin{itemize}
\item \textsuperscript{38} \textit{Aronson v. Lewis}, 473 A.2d at 812.
\item \textsuperscript{40} \textit{Aronson v. Lewis}, 473 A.2d at 813.
\item \textsuperscript{41} \textit{Sneed v. Webre}, 465 S.W.3d at 178.
\item \textsuperscript{42} \textit{Ritchie v. Rupe}, 443 S.W.3d at 886.
\item \textsuperscript{43} \textit{Gearhart Indus., Inc. v. Smith Intern., Inc.}, 741 F.2d at 720 (“If the director is found to have committed fraud, over-reaching, or waste of corporate assets, the transaction will be set aside.”).
\end{itemize}
claim will be sustained only in the rare, unconscionable case where directors irrationally squander or give away corporate assets.”

G. Fraud

The business judgment rule is not a defense to a claim of fraud.

H. Illegal Actions

Actions that are illegal or against public policy are not protected by the business judgment rule. For example, an “affirmative decision to cause a company to violate (or to continue to violate) antitrust law is, of course, a decision that is not protected under the business judgment rule.”

I. Gross Negligence/Intentional Misconduct

The protection of the business judgment rule against claims of negligence is not unlimited. Numerous Texas courts have acknowledged that protection of the rule does not extend to matters once there is a showing of “something beyond unsound business judgment.” Most courts have interpreted Gearhart as exempting from the protection of the business judgment rule any breach of the duty of care that amounts to gross negligence.

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44 In re Soporex, Inc., 463 B.R. 344, 398 (Bankr. N.D. Tex. 2011). See also Espinoza v. Zuckerberg, 124 A.3d 47, 67 (Del. Ch. 2015) (“[W]aste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade.”); Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997) (“Roughly, a waste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade. Most often the claim is associated with a transfer of corporate assets that serves no corporate purpose; or for which no consideration at all is received. Such a transfer is in effect a gift.”).

45 Voskamp v. Arnoldy, 749 S.W.2d 113, 121 (Tex. App.—Houston [1st Dist.] 1987, writ denied) (“‘We note that the ‘business judgment’ rule is not a defense to suits alleging fraud; otherwise it could thereby be used to justify fraud if the fraudulent act were thought to be convenient or profitable.’); Lowery v. Tarbox, 537 S.W.3d 719, 729 (Del. Ch. 2017) (“An illegal act in this context is one in violation of a specific statute, malum in se, malum prohibitum, or against public policy.”).

46 Gearhart Indus., Inc. v. Smith Intern., Inc., 741 F.2d at 719 (“An illegal act in this context is one in violation of a specific statute, malum in se, malum prohibitum, or against public policy.”).

47 In re Brick, 351 S.W.3d 601, 605 (Tex. App.—Dallas 2011, no pet.).


Delaware law imposes liability for gross negligence. Under Delaware law, “[g]ross negligence is a reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason.”

The Texas Supreme Court has recently held:

“Gross negligence has both an objective and a subjective component.” First, “viewed objectively from the actor's standpoint, the act or omission complained of must involve an extreme degree of risk, considering the probability and magnitude of the potential harm to others.” Second, “the actor must have actual, subjective awareness of the risk involved, but nevertheless proceed in conscious indifference to the rights, safety, or welfare of others.” Under the first, objective element, an extreme risk is “not a remote possibility of injury or even a high probability of minor harm, but rather the likelihood of serious injury to the plaintiff.” To establish the subjective component, “the plaintiff must show that the defendant knew about the peril, but his acts or omissions demonstrate that he did not care.” The risk should be “examined prospectively from the perspective of the actor, not in hindsight.” The defendant need not have anticipated the precise manner of harm or to whom the injury would befall to have had awareness of the extreme risk.

J. Ordinary Course of Business

The Texas business judgment rule protects the exercise of business judgment “in the development or prosecution of the enterprise in which their interests are involved.” Therefore, transactions outside the ordinary course of a corporation’s business might not be protected under the business judgment rule. Examples might include substantial sales of assets, investments in unrelated businesses, or initiating litigation. Some courts have reached that conclusion.

50 See also Aronson v. Lewis, 473 A.2d at 812 (“Having become so informed, they must then act with requisite care in the discharge of their duties. While the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence.”).

51 Elloway v. Pate, 238 S.W.3d 882, 891 (Tex. App.—Houston [14th Dist.] 2007, no pet.) (citing Benihana of Tokyo, Inc. v. Benihana, Inc., 891 A.2d 150, 192 (Del.Ch.2005), aff'd, 906 A.2d 114 (Del.2006)).


53 Sneed v. Webre, 465 S.W.3d at 178.

54 See In re Gen. Homes Corp., 199 B.R. 148, 152 (S.D. Tex. 1996) (“Because the directors were interested in the decision and acted outside the ordinary course of business, they do not have the protection of the business judgment rule.”).
K. Closely-held corporation

Finally, one recent court of appeals decision indicated that the business judgment rule does not protect officers and directors in closely-held corporations.\(^{55}\) However, that holding is clearly inconsistent with the Texas Supreme Court’s holdings in *Sneed v. Webre* and *Ritchie v. Rupe*.\(^{56}\)

4. Sample Claim: Sale to a Looter

An example of a claim that is brought under the duty of care is liability for selling control of a corporation to a looter. No such cases have been decided in Texas, but the claim is well established in Delaware. Controlling shareholders and directors of a Delaware corporation owe fiduciary duties of care and loyalty to non-controlling shareholders.\(^{57}\) These fiduciary duties include an obligation to investigate the *bona fides* of a potential purchaser of their controlling interest under certain circumstances.\(^{58}\) Specifically, the controlling shareholders must investigate the buyer when the controlling shareholders are aware of facts that the buyer intends to or is likely to plan any depredations to the corporation.\(^{59}\) The standard of care is whether the controlling seller is aware of facts that would give rise to suspicion by a reasonably prudent person.\(^{60}\)

Assume a situation in which a majority shareholder (with control of the board of directors) owns a controlling interest in a corporation. For whatever reason, the majority shareholder wishes to divest its ownership of the corporation and arranges for the sale of majority control to a third party. However, the third party turns out to be a crook and proceeds to loot the corporation once it has gained control. Obviously, the remaining minority shareholders could bring a derivative claim against the crook for misappropriation in violation of the duty of loyalty—but the crook may have vanished or be unable to pay the judgment. Therefore, the minority shareholders sue the former majority shareholder on the grounds that the sale to the looter had been negligent and a violation of its duty of care because the actions of the looter were reasonably foreseeable.

In *Harris v. Carter*, the Delaware Court of Chancery addressed the sale of controlling interest in Atlas Energy Corporation to a purported looter.\(^{61}\) The plaintiff (a non-controlling shareholder of a Delaware corporation) alleged that the prospective purchaser made fictitious representations to the controlling shareholders both in the sale agreement and in the draft financials

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\(^{55}\) *Lowry v. Tarbox*, 537 S.W.3d at 616 (“Moreover, the business judgment rule does not apply in an action for fraud or breach of fiduciary duty action brought by a shareholder against an officer of a closely-held corporation.”).

\(^{56}\) *See Sneed v. Webre*, 465 S.W.3d at 179 (“Our recent decision in *Ritchie* affirms that the business judgment rule applies to closely held corporations.”); *Matter of Estate of Poe*, 2019 WL 4058592, at *21 (“But *Sneed* also reaffirms that the business judgment rule still applies to closed corporations, and more particularly to the determination of the merits of a claim.”).


\(^{58}\) *Harris v. Carter*, 582 A.2d 222, 234 (Del. Ch. 1990).

\(^{59}\) Id. (citing *Insuranshares Corporation*, 35 F.Supp. 22 (E.D. Pa. 1940)).

\(^{60}\) Id.

\(^{61}\) Id. at 225.
circulated prior to closing. The CFO of the corporation raised several questions regarding the accuracy of the financial statements, but the controlling shareholders ignored these concerns and sold their interest without investigating the buyer. As part of the sale, the sellers agreed to resign as directors of the corporation and allow the purchasers to fill the director positions with their designees. Following the sale, the purchasers pursued a series of self-dealing transactions to the detriment of the corporation.

Focusing on the fact that the controlling shareholders ensured that the buyers would assume control over the corporation, Chancellor Allen held that the plaintiff had stated a claim for breach of fiduciary duty. Specifically, the Court found that the controlling shareholders placed others at risk of foreseeable injury, and that there was no privilege that would allow controlling shareholders to exempt themselves from this general principle:

It is established American legal doctrine that, unless privileged, each person owes a duty to those who may foreseeably be harmed by her action to take such steps as a reasonably prudent person would take in similar circumstances to avoid such harm to others. While this principle arises from the law of torts and not the law of corporations or of fiduciary duties, that distinction is not, I think, significant unless the law of corporations or of fiduciary duties somehow privileges a selling shareholder by exempting her from the reach of this principle. The principle itself is one of great generality and, if not negated by privilege, would apply to a controlling shareholder who negligently places others foreseeably in the path of injury.

The touchstone of the Court’s inquiry is foreseeability. Entering into an arrangement with a potential buyer is certainly a transaction involving the exercise of business judgment. Assuming that the sale was “negligent, unwise, inexpedient, or imprudent,” why doesn’t the business judgment rule protect the selling shareholder? Many of the exceptions potentially apply to this factual scenario. First, because there is a transaction between the defendant and the looter in which the defendant receives a benefit, the self-dealing exception may bar the protection of the business judgment rule—particularly if it could be demonstrated that the majority shareholder was paid a premium for control. Second, the majority shareholder may have been so eager to sell that it never even considered the issue of whether the sale was good for the corporation. Information may have been reasonably available as to the background and nature of the looter, which the selling shareholder didn’t even investigate. In that situation, the abdication of duty and lack of information exceptions would apply. Alternatively, the selling shareholder may have been so desperate to sell that he ignored negative information about the buyer and was consciously indifferent to the risk.

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62 Id.
63 Id. at 226-227.
64 Id. at 234.
65 Id. at 234-235 (emphasis added).
66 It should be noted that Texas courts also look to foreseeability as “the foremost and dominant consideration” governing whether a duty exists. See Greater Houston Transp. Co. v. Phillips, 801 S.W.2d 523, 525 (Tex. 1990) (citing El Chico Corp. v. Poole, 732 S.W.2d 306, 311 (Texas 1987)).
that the looter would subsequently harm the corporation. In that situation, the jury might find that the selling shareholder had acted with gross negligence and thus was not protected by the business judgment rule. Finally, the business judgment rule might not apply because the sale to a looter involved a transaction not in the ordinary course of business.

5. **Pleading**

While the business judgment rule is referred to frequently as a “defense,” it is not an affirmative defense and need not be pleaded by the defendant. On the contrary, it is the plaintiff’s burden to plead and prove that the business judgment rule does not apply when a breach of the duty of care is alleged.

In *Sneed v. Webre*, the Court characterized the business judgment rule as a matter that the “plaintiff must plead and prove.” The Court wrote that it would be “insufficient” for a shareholder to merely allege mismanagement or neglect or an abuse of discretion in conducting the affairs of the corporation. The El Paso Court of Appeals recently wrote that “a plaintiff carries the burden the on merits to plead (and then of course to prove) something more.”

6. **Burden of Proof**

The El Paso Court of Appeals held: “To best give effect to the policy rationale underpinning the business judgment rule, we conclude that it was part of [the plaintiff’s] case to disprove the business judgment rule.”

7. **Special Exceptions and Summary Judgment**

The application of the business judgment rule is a legal question, so it would ordinarily be addressed in special exceptions or summary judgment. If the plaintiff pleads a claim of merely negligent mismanagement and fails to plead clearly an exception to the business judgment rule, then “[s]uch allegations may be disposed of on special exceptions or summary judgment.”

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67 *Matter of Estate of Poe*, 2019 WL 4058592, at *20 (“Looking to Texas authority, the business judgment rule has been referred to as a ‘defense,’ but we find no case holding that it is an ‘affirmative defense’ under Tex.R.Civ.P. 94.”).

68 *Id.* at *21. See also *F.D.I.C. v. Benson*, 867 F. Supp. 512, 521 (S.D. Tex. 1994) (“the Texas business judgment rule is a substantive rule of law that requires of the FDIC both pleading and proof to avoid its reach.”).

69 *Sneed v. Webre*, 465 S.W.3d at 187.

70 *Id.*


72 *Id.*

73 *Sneed v. Webre*, 465 S.W.3d at 187.
8. Jury Charge

Assuming that the plaintiff successfully pleads an exception to the business judgment rule and raises more than a scintilla of evidence to support it in response to the summary judgment, then the jury will need to be charged as to the plaintiff’s theory of liability. The business judgment rule is not an affirmative defense, therefore it would not be proper to instruct the jury that the defendant would not be liable if his actions were “merely negligent, imprudent, or unwise.” Rather, negating the business judgment rule is part of the plaintiff’s case, and the specific basis must be part of the plaintiff’s liability question.

For example, if the basis for negating the business judgment rule is gross negligence, then the plaintiff’s liability question would include a definition of gross negligence, and the jury would not be instructed on any definition of simple negligence or mismanagement.

If the basis is abdication of duty or lack of information, then there would probably need to be a separate question, such as “Did [Defendant] fail to exercise reasonable business judgment in [the subject transaction],” or “Did [Defendant] fail to reasonably inform himself prior to deciding [the subject transaction].”

Some exceptions would almost always be established as a matter of law and thus would not figure into the jury charge at all. Examples would include self-dealing, ordinary course of business, and inaction. Also, no instruction would be given if the theory of liability precluded application of the business judgment rule: breach of the duty of loyalty, ultra vires, illegal misconduct, or fraud.

9. Directed Verdict

The El Paso Court of Appeals recently made clear that the business judgment rule gives the defendant a significant second bite at the apple on a motion for directed verdict. That case involved a claim for mismanagement against officers and directors of a corporation on the basis of several discrete transactions that the plaintiff contended were negligent and harmed the company. The court of appeals held that, “on directed verdict, [the plaintiff] carried the burden of showing the corporate actions of which he complains were not protected by the rule.”\(^74\) The trial court granted directed verdict on the claims. The court of appeals reviewed the factual record regarding each of the subject corporate actions and held that the plaintiff failed to establish any basis for overcoming the business judgment rule and affirmed.\(^75\)

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\(^74\) Matter of Estate of Poe, 2019 WL 4058592, at *21.

\(^75\) Id. at *22 (“We find no evidence of the breach of the duty of care in this record and the directed verdict was properly granted on that claim.”).