Fiduciary Duty Litigation and Burden Shifting

By Michael W. Stockham and Mackenzie S. Wallace – March 4, 2014

When the duties of a fiduciary (e.g., a partner, trustee, agent, member, attorney, director, or officer) are at issue, what key questions should the parties consider in formulating their strategy for the case?

> Fiduciaries are ordinarily held to an extraordinary standard of behavior:
> "[A fiduciary] is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of [] honor . . . is [] the standard behavior. As to this there has developed a tradition that is *unbending* and *inveterate*."

Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) (quoting Chief Justice Cardozo) (emphasis added).

This high standard of duty necessitates an early evaluation of *the existence and breach* of the fiduciary duty at issue. The elements for a breach of fiduciary duty cause of action are (1) proof of a fiduciary relationship and duty, (2) breach of that fiduciary duty, and (3) damages directly caused by the defendant's breach. *E.g.*, *Deblinger v. Sani-Pine Prods. Co.*, 107 A.D.3d 659, 660 (N.Y. App. Div. 2013).

From the outset, litigants should carefully examine four important questions in fiduciary duty cases: (1) What are the parameters of the defendant's fiduciary obligations? (2) By what standards will the defendant's fiduciary obligations be measured? (3) Who has the burden of proof? and (4) Are there any documents or facts altering the defendant's fiduciary obligations?

Does the Defendant Owe a Fiduciary Duty?
The exact duties owed by a fiduciary will vary by the type of relationship established by the evidence Fiduciary relationships may arise by statute, contract, conduct, or a confidential relationship. The following have been held to be fiduciaries under certain circumstances: agents, partners, trustees, attorneys, brokers, majority shareholders, directors, officers, and managing members. The existence of a fiduciary duty and its scope are questions of law. *E.g.*, *Kirschner Bros. Oil, Inc. v. Natomas Co.*, 185 Cal. App. 3d 784, 790 (Cal. Ct. App. 1986). Plaintiffs uniformly bear the burden of proving that a fiduciary duty exists. Certain formal fiduciary relationships, such as attorney-client or partner-partner, may exist as a matter of law as a relationship of trust and confidence; however, the existence of an informal relationship of trust and confidence is usually a question of fact.

Did the Defendant Breach That Fiduciary Duty?
After establishing the limits of the fiduciary duty at issue, the litigants should evaluate who has the burden of proving a breach of the fiduciary duty and whether the facts dictate a shift of the burden of proof to the defendant.

> **Burden of proof for partners, trustees, agents, and non-statutory fiduciaries.**
> Generally, plaintiffs have the burden of proving each element: (1) existence of a fiduciary duty, (2) breach of that fiduciary duty, and (3) damages directly stemming from that breach. *Model Jury Instructions: Business Torts Litigation* (American Bar Ass'n Section of Litigation 4th ed. 2005). Arizona, Arkansas, California, Colorado, New York, Oklahoma, Pennsylvania, and Washington have jury charge instructions that clearly set out that it is the plaintiff's burden to prove breach of fiduciary duty. The majority of states place the burden of proving each element of a breach of fiduciary duty on the plaintiff.
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> However, the burden of proving a breach may shift where the defendant-fiduciary has profited or benefited from the transaction with the beneficiary. *Keck, Mahin & Cate v. Nat'l Union Fire Ins. Co. of Pittsburgh*, 20 S.W.3d 692, 699 (Tex. 2000) (finding that when a fiduciary profits or benefits in any way from a transaction with the beneficiary, a presumption of unfairness arises that shifts the burden of persuasion to the fiduciary to show that the transaction was fair and equitable to the beneficiary); *Tex. Bank & Trust Co. v. Moore*, 595 S.W.2d 502, 509 (Tex. 1980).
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> In this circumstance, the defendant bears the burden of proof on the second element—whether the defendant breached a fiduciary duty. *See,* e.g., *Stephens Cnty. Museum, Inc. v. Swenson*, 517 S.W.2d 257, 260 (Tex. 1974) (where a fiduciary business advisor was an officer/director of a museum but was also advising his sisters to donate their estate to the museum, there was a presumption

of unfairness that the fiduciary needed to rebut); *Int'l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 576 (Tex. 1963) (holding the burden on the fiduciaries to prove fairness where the fiduciaries were engaging in transactions for their personal profit). The presumption of unfairness operates to shift both the burden of producing evidence and the burden of persuasion to the fiduciary. *Sorrell v. Elsey*, 748 S.W.2d 584, 586 (Tex. App.—San Antonio 1988); *Miller v. Miller*, 700 S.W.2d 941, 945–46 (Tex. App.—Dallas 1985) (writ refused, no reversible error); *Gum v. Schaefer*, 683 S.W.2d 803, 806 (Tex. App.—Corpus Christi 1984) (no writ); *Fillion v. Troy*, 656 S.W.2d 912, 914 (Tex. App.—Houston [1st Dist.] 1983) (writ refused, no reversible error).

To prevail, the defendant must prove that (1) the questioned transaction was fair and equitable to the beneficiary; (2) the fiduciary made reasonable use of the confidence that the beneficiary placed in him or her; (3) the fiduciary acted in the utmost good faith and exercised the most scrupulous honesty toward the beneficiary; (4) the fiduciary placed the interests of the beneficiary before the fiduciary's own, did not use the advantage of his or her position to gain any benefit for himself or herself at the expense of the beneficiary, and did not place himself or herself in any position where his or her self-interest might conflict with his or her obligations as a fiduciary; and (5) the fiduciary fully and fairly disclosed all important information to the beneficiary concerning the transaction. Tex. Pattern Jury Charge 104.2 (2008).

Burden of proof for directors and officers. Another example of the complexities of fiduciary litigation involves the acts of corporate officers and directors. The burden of proof for directors and officers is completely different than that for other types of fiduciaries. Most states follow the framework created by the Delaware chancery courts. Although the case-specific facts related to each suit can affect the burdens, Delaware generally has three tiers of review for evaluating director decision making: (1) the business-judgment rule—for a decision to remain independent or to approve a transaction not involving a sale of control; (2) enhanced scrutiny—for a decision to adopt or employ defensive measures or to approve a transaction involving a sale of control; and (3) entire fairness—for a decision to approve a transaction involving management or a principal shareholder or for any transaction in which a plaintiff successfully rebuts the presumption of the business-judgment rule. *See Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 457 (Del. Ch. 2011). Numerous courts, construing the law of Delaware and the law of other states, have referred to the business-judgment rule as a doctrine protecting directors and officers without distinguishing between the rule's applicability to directors and officers. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162 (Del. 1995).

Whether the burden will be on the party challenging the defendants' actions (under the business-judgment rule), or on the directors or officers (under the enhanced scrutiny or entire fairness rule) requires a fact-specific analysis with no bright-line tests. "There is no single blueprint that a board must follow to fulfill its duties." *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286 (Del. 1989). The burden shifting within the Delaware standard of review is very fact-specific and beyond the scope of this article. This article can only emphasize the critical nature of determining who carries the burdens of proof and persuasion and note when such burdens may shift.

The Business-Judgment Rule

The business-judgment rule 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 was in the best interests of the company. *Reis*, 28 A.3d at 457. The business-judgment rule "operates as both a procedural guide for litigants and a substantive rule of law." *Cinerama*, 663 A.2d at 1162 (finding that as a procedural guide, the business-judgment presumption is a rule of evidence that places the initial burden of proof on the plaintiff). Procedurally, the initial burden is on the plaintiff to rebut the presumption of the business-judgment rule by providing evidence that the defendant breached any one of its triad of fiduciary duties—loyalty, good faith, or due care. *McMullin v. Beran*, 765 A.2d 910, 916–17 (Del. 2000). Substantively, if the shareholder-plaintiff fails to meet that evidentiary burden, the business-judgment rule attaches and operates to protect the defendant from personal liability for making the decision at issue. *Id.*

Under the business-judgment rule, the court gives great deference to the directors' decisions. The court will not examine the reasonableness of the directors' decision and will not substitute the court's views for those of the board (if the board's decision has any rational business purpose). *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971); *Trenwick Am. Litig. Trust v. Ernst & Young, LLP*, 906 A.2d 168, 194 (Del. Ch. 2006), *aff'd*, 931 A.2d 438

(Del. 2007).

In *Trenwick*, the Delaware chancery court dismissed a complaint that "attempt[ed] to challenge the wisdom of an independent board's strategy to grow by acquiring, for stock, third-parties in the same industry." 906 A.2d at 194. The court stated that "[w]hether or not the mergers turned out well, there [was] nothing in the complaint that support[ed] the notion that the idea of putting the businesses together in order to achieve economies of scale and a larger share was irrational." *Id.* The plaintiff, a litigation trust, sued the defendants, the directors of an insurance holding company, after the directors authorized two transactions involving the acquisition of unaffiliated publicly traded insurance companies. *Id.* at 172. Because the plaintiff only asserted in its complaint that the board undertook a business strategy that was "all consuming and foolhardy," implying that the transactions resulted from a grossly deficient level of effort or from disloyal motives, the court held that the plaintiff failed to state a claim that the directors breached their duty of care or loyalty and that the business-judgment rule applied to protect their decisions. *Id.* At 194. The plaintiff failed to allege that the defendants were disinterested or lacked independence and thus failed to rebut the business-judgment rule.

As demonstrated in *Trenwick*, who carries the burden of proof can be critical to the outcome of the case in both legal and practical terms. The business-judgment rule requires the plaintiff to present affirmative proof of wrongdoing. The entire fairness standard of review—with its shifting burden of proof and more detailed factual analysis (as discussed in more detail below)—requires defendants to affirmatively demonstrate an absence of wrongdoing. Which standard is applied could preclude dismissal of a complaint on a Rule 12(b)(6) motion or termination of an action by summary judgment. *Orman v. Cullman*, 794 A.2d 5, 20 n.36 (Del. Ch. 2002). This, in turn, has a practical effect on settlement negotiations and the containment of legal costs because ultimate resolution of a case applying the entire fairness standard of review will likely require a full trial.

"[T]he effect of the proper invocation of the business judgment rule is so powerful and the standard of entire fairness so exacting" that "the determination of the appropriate standard of judicial review, frequently, is determinative of the outcome." *AC Acquisitions Corporation v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986).

Enhanced Scrutiny

When applicable, the enhanced scrutiny standard of review places on defendants the burden of proving they acted reasonably. Before conferring the protections of the business-judgment rule, courts engage in enhanced scrutiny as to whether the rule should be applied. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). Directors must satisfy two tests: (1) the reasonableness test—a judicial determination regarding the adequacy of the decision-making process employed by directors; and (2) the proportionality test—a judicial examination of the reasonableness of the directors' actions in light of the circumstances then existing. *Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 45 (Del. 1994). Courts typically apply enhanced scrutiny in takeovers or in the context of changes of control. But even if the court applies enhanced scrutiny, the court will apply the protections of the business-judgment rule if the directors can satisfy the reasonableness and proportionality tests. *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1288 (Del. 1989).

In *Paramount Communications Inc. v. QVC Network Inc.*, the Delaware supreme court affirmed the application of enhanced judicial scrutiny in a sale of control and held that the directors violated their fiduciary duties in approving a merger. 637 A.2d at 51. The plaintiffs sought preliminary and permanent injunctive relief against Paramount, arising out of a proposed sale of control—the acquisition of Paramount by Viacom through a tender offer followed by a second-step merger that was approved by the Paramount board. *Id.* at 37. The Paramount directors had the burden of proving that they were adequately informed and acted reasonably to seek the transaction offering the best value reasonably available to the shareholders. *Id.* They were unable to meet this burden under enhanced scrutiny as their process was deficient. *Id.* at 51. The Delaware supreme court thus affirmed the chancery court's finding that the directors breached their fiduciary duties. Had the directors been able to meet the reasonableness and proportionality tests, the burden would have shifted back to the plaintiff to prove that the directors' actions were irrational and in violation of the business-judgment rule.

As is evidenced by the application of enhanced scrutiny in *Paramount*, it is critical for the plaintiff and the defendant to understand the nuances of enhanced scrutiny in the application of the business-judgment rule so that they can vigorously advocate for the proper standard in dispositive motions and at trial.

Entire Fairness

The entire fairness standard replaces the business-judgment rule, requiring the defendants to prove the entire fairness of the transaction when the plaintiff successfully rebuts the presumption of valid business judgment by showing the directors are interested and lack independence. *Aronson*, 473 A.2d at 812. The plaintiff may evidence a director's interest by showing a potential personal benefit or detriment to the director as a result of the decision. *Beam v. Stewart*, 845 A.2d 1040, 1049 (Del. 2004). The term "independence" means "that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences." *Aronson*, 473 A.2d at 816. To establish lack of independence, a plaintiff must prove that a director is "so beholden to an interested director that his or her discretion would be sterilized." *Beam*, 845 A.2d at 1050. To rebut the business-judgment rule, the proponent has the burden of providing evidence that the directors, in reaching their challenged decision, breached any one of the triad of fiduciary duties—good faith, loyalty, or due care. *Id.* If the business-judgment rule's presumption is rebutted by this proof, the burden shifts to the defendant-directors, to prove the entire fairness of the transaction to the shareholder, in terms of both fair dealing and fair price. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993).

In *Reis v. Hazelett Strip-Casting Corp.*, the Delaware chancery court held that the reverse stock split by the defendant was subject to review for entire fairness. 28 A.3d at 443. The plaintiff sued the defendant, who cashed out the minority shares held by the estate of his deceased brother via a reverse stock split, on behalf of the beneficiaries of the estate who would have received shares but for the reverse stock split. *Id.* at 449. The court ultimately held that the reverse split was not fair and reasonable, but in doing so, the court applied the entire fairness standard. *Id.* The court explained that when a controlling shareholder uses a reverse split to freeze out minority shareholders without any procedural protections, the transaction is subject to review for entire fairness due to interestedness and lack of independence. *Id.* at 460. Following a bench trial, the court held that there was no fair dealing in the reverse stock split and that the minority shareholder was entitled to a fair value award. *Id.* at 465. *Reis* evidences the often harsh result of the entire fairness standard.

Where the directors are obviously interested or lack independence, avoiding the result of the application of the entire fairness standard may be impossible. Even still, as in any fiduciary duty case, if the plaintiff or the defendant knows that the entire fairness standard will apply and understands the burden he or she faces, it can help to shape the attack or defense and affect settlement decisions. Cases in which entire fairness is the initial standard will likely result in a full trial. *Orman v. Cullman*, 794 A.2d at 20 n.36 (finding that application of the entire fairness standard often will preclude dismissal of a complaint on a Rule 12(b)(6) motion and may also preclude the entry of a final judgment after a motion for summary judgment). Thus, for the defendant, preparing a defense from the outset to avoid application of the entire fairness standard could mean the difference between whether the case can be terminated by motion or must proceed to a full trial.

Application in Other States

The business-judgment rule and its framework have been adopted not just by courts applying Delaware law but also by courts applying the law of more than 35 other jurisdictions (Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, the District of Columbia, Florida, Georgia, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Nebraska, Nevada, New Jersey, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, Puerto Rico, Rhode Island, Tennessee, Texas, Utah, Virginia, Washington, Wisconsin, and Wyoming). Even those states that have not expressly adopted the business-judgment rule in their codes often follow the Delaware framework in analyzing director and officer breach of fiduciary duty cases.

What Documents May Alter the Burden on Fiduciaries?

The exact parameters of the duties owed by fiduciaries may vary based on the agreement of the parties, e.g., partnership agreements, contracts, and corporate formation documents. Recent case law indicates a trend toward limiting the scope of fiduciary duties in the contractual relationship of the parties. *See Pappas v. Tzolis*, 20 N.Y.3d 228, 232–33 (N.Y. 2012); *see also Nat'l Plan Admins., Inc. v. Nat'l Health Ins. Co.*, 235 S.W.3d 695, 700–704 (Tex. 2007).Thus, potential fiduciaries should take care to expressly address the nature of their fiduciary obligations, if any, in their agreements with their clients.

A fiduciary cannot—by contract, a waiver, or a disclaimer provision—relieve itself of the fiduciary obligation of full disclosure by withholding the very information the beneficiary of the duty needs in order to make a reasoned judgment whether to agree to the proposed contract. *Dube-Forman v. D'Agostino*, 61 A.D.3d 1255, 1257 (N.Y. App. Div. 2009). However, that principle does not preclude a sophisticated investor from knowingly releasing a fiduciary from claims where the relationship is no longer one of trust and the principal understands that the fiduciary is acting in his or her own interest. *Pappas*, 20 N.Y.3d at 232–33.

Specifically, as set forth in a Kansas jury instruction, "[a] fiduciary is not responsible to another party for acts or omissions occurring after the other party voluntarily and intentionally relieves the fiduciary of the obligation to perform. This can occur when the other party expressly discharges the fiduciary or acts in a manner inconsistent with the right to the fiduciary's performance." Pattern Inst. Kan. Civil 125.03.

In *Pappas v. Tzolis*, three businessmen formed and managed a limited liability company to enter into a real estate transaction. 20 N.Y.3d at 231. The operating agreement disclaimed any relationship of trust between the parties. *Id.* Moreover, over time, the relationship between the members became antagonistic. *Id.* at 233. Two of the members ultimately sued the third member for breach of fiduciary duty. *Id.* at 232. The New York supreme court reversed the trial court, dismissing the plaintiffs' claims in their entirety, finding that the defendant owed the plaintiffs no fiduciary duty. *Id.* at 234. The court explained that "a sophisticated principal is able to release its fiduciary from claims—at least where the fiduciary relationship is no longer one of unquestioning trust—so long as the principal understands that the fiduciary is acting in its own interest and the release is knowingly entered into." *Id.* at 232. The test, in essence, is whether, given the nature of the parties' relationship at the time of the release, the principal is aware of information about the fiduciary that would make reliance on the fiduciary unreasonable. *Id.* In *Pappas*, because the plaintiffs released the defendant's relationship of trust in an agreement and admitted in their pleadings that the relationship between the plaintiffs and the defendant had become antagonistic to the extent that the plaintiffs could no longer reasonably rely on the defendant as trustworthy, the supreme court found that the plaintiffs could not prevail on their claim for breach of fiduciary duty. *Id.* at 233.

It is important that the plaintiff and the defendant identify at the commencement of the litigation any documents between the plaintiff and the alleged fiduciary that could alter the confidential nature of the relationship between the parties. Moreover, to avoid the commencement of litigation altogether, sophisticated parties should be aware of their ability to contract around fiduciary duties.

Conclusion

In cases involving potential breaches of fiduciary duties, it is critical that plaintiffs and defendants understand the law of fiduciary obligations (including presumptions and shifting burdens of proof) to prosecute or defend the case strategically. At the outset, four important questions should be addressed by both sides: (1) What are the parameters of defendant's fiduciary obligations? (2) By what standards will the defendant's fiduciary obligations are measured? (3) Who has the burden of proof? and (4) Are there any documents or facts altering the defendant's fiduciary obligations?

Keywords: litigation, trial evidence, fiduciary duty, breach, business-judgment rule, enhanced scrutiny, entire fairness, reasonableness test, proportionality test

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