EXCULPATORY CLAUSES

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Utilizing Disclosure Rules to Obtain Discovery in Trust Litigation, Tarrant County Probate Litigation Seminar, Fort Worth, September 2008 Fort Worth

Role of Guardian Ad Litem in a Trust Case. Texas Bar CLE 13th Annual Advanced Estate Planning Strategies Course, 2007

Trustee Duties and Fiduciary Litigation, Recent Developments In Trust Law. Dallas Bar Association, May 2006.

Fiduciary Liability and Litigation: Are you a Target? Texas Bankers Association Advanced Trust Forum, November 2005.

Recent Developments in Trust Litigation, Tri County Bar Association, January 2005.

Fiduciary Litigation, Dallas Estate Planning Council, September 2004.

Fiduciary Litigation, Executors & Trustees, Fiduciary Litigation Seminar, May 2004.

Negotiating Fee Contracts and Recovering Fees in Fiduciary Litigation, Advanced Estate Planning Strategies, April 2004.

Trust Litigation in Texas, Second Annual Probate Litigation Seminar, October 2003.

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Negotiating Fee Contracts and Recovering Fees in Fiduciary Litigation, Dallas Bar Association, November 2002.

Discretionary Distributions, 26th Annual Estate Planning & Probate Course, 2002.

Trust Litigation in Texas, Texas Society of CPA's Estate Planning and Probate Seminar, August 2002.

Trust Litigation in Texas, Tarrant County Probate Assoc. Litigation Seminar, 2002.

Specialty Drafting Regarding the Fiduciary, Travis County Bar Association, Probate and Estate Planning Seminar, March 2001.

Fiduciary Duties: What are They and How to Modify Them, Texas Banker's Association Estate Administration Seminar, October 2000.

What Property Are You Administering?/Conducting Inventory/Making Consistent Valuation of Assets/Sections 177 and 706 Issues, Co-Author Alvin J. Golden, Wills, Estates, and Probate (A Satellite Production), State Bar of Texas, January 2000.

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EXCULPATORY CLAUSES

I. METHODS USED TO ELIMINATE FIDUCIARY LIABILITY:

Over the years, numerous methods have evolved to reduce or eliminate a fiduciary's liability for breach of fiduciary duty. While most of these methods apply only to executors or trustees, some of them may apply to fiduciaries in business organizations. While the focus of this paper is on exculpatory clauses, it is useful to give a general overview of some of the other methods of reducing or eliminating a fiduciary's liability for breach of fiduciary duty.

A) Modification or Elimination of Fiduciary Duties

If a fiduciary is not subject to a fiduciary duty, he cannot breach it. One method of reducing fiduciary liability is to modify or eliminate one or more of the fiduciary's duties. The elimination of the duty eliminates the opportunity to breach the duty. An exculpatory clause, on the other hand, only reduces or eliminates the fiduciary's liability for monetary damages after he has breached his duty.

Most statutory and common law fiduciary duties may be modified or revoked by the person creating the fiduciary relationship. If the fiduciary is not subject to a fiduciary duty then he or she cannot be held to have breached it. The fiduciary duties most often modified are those of prudence, loyalty, disclosure and/or impartiality because breach of one or more of these duties is the most frequent ground for breach of fiduciary duty.

There are statutory and public policy limitations on the extent that some of these duties may be modified or eliminated. These limitations are beyond the scope of this paper but should be considered by anyone attempting to modify or eliminate fiduciary duties.

Modification or elimination of fiduciary duties may be used to protect executors, trustees, partners, directors of corporations, and members or managers of LLCs.

B) Explicit Purpose Clauses

If a fiduciary is given specific directions regarding how to exercise discretion, then he will be less likely to abuse his discretion. While not eliminating either liability or damages, *per se,* this method assists the fiduciary in complying with discretionary fiduciary duties.

When a fiduciary is given broad discretion or is a beneficiary of the fiduciary relationship, then consideration should be given to specific directions to the fiduciary regarding the exercise of his discretionary fiduciary duties.

The use of discretionary purpose clauses may be used to protect executors and trustees.

C) In Terrorem Clauses

In Terrorem Clauses eliminate a beneficiary's status as a beneficiary and his or her standing to sue a fiduciary if he engages in a prohibited action, such as contesting a will or trust or suing a fiduciary.

In Terrorem Clauses were originally drafted for the purpose of preventing contests of wills or trusts. They provide that if a beneficiary contests a will or trust, then he is disinherited. These clauses frequently impose a condition precedent to taking under the will or trust that the beneficiary not initiate or participate in a contest.

In Terrorem Clauses are enforceable in Texas [*Calvary v. Calvary,* 122 Tex. 204, 55 S.W.2d 527 (Tex. Comm. App. 1932, opinion adopted); *Hammer v. Powers,* 819 S.W.2d 669 (Tex. App.—Fort Worth 1991, no writ); *Massie v Massie*, 118 S.W. 219 (Tex. Civ. App. 1909, no writ)] but are strictly construed against enforceability. *Estate of Newbill,* 781 S.W.2d 727 (Tex. App. – Amarillo 1989, no writ); *Gunter v. Poague,* 672 S.W.2d 840 (Tex. App. – Corpus Christi 1984, writ ref'd n.r.e.); *Sheffield v. Scott,* 662 S.W.2d 674 (Tex. App. – Houston [14th Dist.] 1983, writ ref'd n.r.e.).

In Terrorem Clauses are subject to recently enacted "good faith" "probable cause" exceptions. Tex. Prob. Code § 64; Tex. Trust Code § 112.038. In other words, if the contest is brought in good faith with probable cause for recovery, then the clause will not be enforced.

In Terrorem Clauses have evolved to include causes of action other than contests. They sometimes provide that if the beneficiary of a will or trust sues or participates in a lawsuit against the fiduciary, contests an accounting by the fiduciary, or files or participates in a lawsuit to construe a will (without the consent of the fiduciary), then he is disinherited.

The author has serious question regarding whether or not such clauses are valid and enforceable in Texas. If they are, some of them might have the unintended result of giving the fiduciary a general power of appointment over the fiduciary estate being administered.

In Terrorem Clauses are primarily used to protect executors and trustees.

D) Powers of Appointment

Powers of appointment may be used, in the discretion of the fiduciary or another person, to eliminate a person's status as a beneficiary and, consequently, his standing to sue.

A will or trust may give the fiduciary a power of appointment over the fiduciary estate being administered. This power of appointment may be

general (i.e. the fiduciary can appoint to anyone) or limited (i.e. the fiduciary can appoint only to a limited class of beneficiaries). The effect of a power of appointment is that the fiduciary can change the beneficiaries. In theory, if a beneficiary were to sue the fiduciary, the fiduciary could exercise the power and eliminate the plaintiff's status as a beneficiary and his or her standing to sue.

Powers of appointment are primarily used to protect executors and trustees.

E) Releases and/or Indemnities

Releases and indemnities are contracts between a beneficiary and a fiduciary wherein the beneficiary forgives the fiduciary for breaches of fiduciary duty and/or agrees to reimburse the fiduciary or the fiduciary estate for damages caused by litigation. Releases are used as a defense to breach of fiduciary duty claims. Indemnities provide for the payment, by persons or entities other than the fiduciary, of damages, costs and sometimes attorney's fees incurred in fiduciary litigation.

Fiduciaries sometimes ask beneficiaries to give them releases for breach of fiduciary duty. Releases are sometimes sought during the administration of the estate or trust (particularly when the beneficiary seeks to influence a discretionary decision by the fiduciary) but more frequently upon the termination of the administration of an estate or trust.

It is the authors' opinion that it is a breach of fiduciary duty for a fiduciary to require a release as a condition precedent to receiving a distribution that the beneficiary is otherwise entitled to, but for the release. This practice by independent executors is specifically prohibited by the Texas Probate Code. Tex. Prob. Code § 151(d). Some fiduciaries try to circumvent this restriction by threatening to incur the expense and delay of a judicial accounting and discharge if a release is not voluntarily given by the beneficiary.

In rare circumstances the fiduciary will seek an indemnity as well as a release. This is much harder for a fiduciary to justify because he or she is not permitted to receive an indemnity in any court proceeding.

As a general proposition, a fiduciary may not receive a lawful release from a beneficiary for a breach of fiduciary duty that is unknown and/or undisclosed. Tex. Trust Code § 114.005. This is because the fiduciary has a fiduciary duty to disclose information to his or her beneficiary. *Huie v. DeShazo,* 922 S.W.2d 920 (Tex. 1996); *Montgomery v. Kennedy,* 669 S.W.2d 309 (Tex. 1984); *Shannon v. Frost National Bank of San Antonio,* 533 S.W.2d 389 (Tex. Civ. App. - San Antonio 1975, writ ref'd n.r.e.).

Releases and/or indemnities may be used to protect executors and trustees.

F) Exculpatory Clauses

Exculpatory clauses are provisions in legal instruments that purport to relieve a fiduciary from financial liability for breaching one or more of his fiduciary duties.

Exculpatory clauses may be used to protect executors, trustees, directors of corporations, and members or managers of LLCs. This paper deals with this method of limiting fiduciary liability.

II. APPLICATION OF EXCULPATORY PROVISIONS

A) Monetary Damages

Exculpatory clauses purport to eliminate a fiduciary's liability for monetary damages for breaching one or more of his or her fiduciary duties[1].

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[1] **Austin W. Scott and William F. Fratcher,** ***The Law of Trusts*** **(Fourth Edition) § 222.1** provides that: A distinction is to be drawn between provisions in the trust instrument that permits the trustee to do acts that would not otherwise be permissible and a provision that merely relieves the trustee from liability if he does them. Thus by the terms of the trust the trustee may be authorized to invest in securities other than those in which a prudent man would invest. In such a case the powers of the trustee are enlarged by the provision. On the other hand, the trustee may not be authorized to make such investments but it may be provided by the terms of the trust that he shall not be liable for making investments unless he is guilty of an intentional breach of trust or of gross negligence. The effect of a provision enlarging the power of the trustee is to prevent acts from constituting a breach of trust that would otherwise be in breach of trust. The effect of a provision relieving the trustee of liability for breach of trust, however, is not to extend his powers but to restrict his liabilities. Such a provision does not prevent an act by the trustee from being a breach of trust if the act is not within his powers; but it does relieve him to a certain extent from liability for the consequences of his act. The distinction has been recognized in cases in which it has been held that although a trustee who commits a breach of trust may be relieved from liability, yet he cannot recover compensation with respect to the transaction that is in breach of trust. Thus in *Warren v. Pazoli*a trustee expended the greater part of the trust estate in the erection of an office building. It was held that he thereby committed a breach of trust, and that he was not entitled to compensation with respect to this transaction; but it was also held that he was not liable for the loss to the estate resulting from his act, since it was provided in the trust instrument that he should be liable only for "willful neglect or default." So also in *Matter of Mallon* it was held that where it was provided by the terms of the trust that a trustee should be liable only for "his own willful default," and he negligently permitted his co-trustee to misappropriate trust funds, he was not entitled to commissions, but he was not liable for the breach of trust."

B) Other Relief

Generally, exculpatory clauses do not prevent a plaintiff from seeking non-monetary relief from a fiduciary. For example, exculpatory clauses should not prevent a plaintiff in a trust case from pursuing: injunctive relief, receivership, removal, construction or instruction, an accounting, or denial or reduction of compensation[2]. While pursuing such causes of action, a plaintiff should be able to introduce evidence that the fiduciary actually breached one or more of his fiduciary duties, even though an exculpatory clause may protect the fiduciary from actual damages for the breach.

C) Attorney's Fees

An issue remains whether a plaintiff can recover attorney's fees (if they are otherwise recoverable) for bringing a non-monetary cause of action against a fiduciary where there is an exculpatory clause.

D) The General Power of Appointment Problem

Care should be taken not to exculpate a fiduciary from liability for appropriating all or any part of the fiduciary property for his own use. To do so would inadvertently make the fiduciary a beneficiary of the fiduciary relationship.

If exculpatory provisions allow a fiduciary (who is not otherwise a direct beneficiary of the fiduciary relationship) to appropriate all or any part of the fiduciary property for the benefit of the fiduciary, the fiduciary's creditors, the fiduciary's estate or the creditors of the fiduciary's estate, then the fiduciary will be deemed for tax purposes to hold a general power of appointment over the fiduciary property. I.R.C. § 2041(b)(1); Treas. Reg. § 20.2041-1(c)(1-2). This may cause the fiduciary to be taxed on the income from the fiduciary property and may cause the fiduciary property to be included in the fiduciary's federal estate tax base. If exculpatory provisions allow a fiduciary who is also a beneficiary to appropriate all or any part of the fiduciary property other than by an "ascertainable" distribution standard, then the fiduciary will be deemed to have a general power of appointment over the fiduciary property. I.R.C. § 2041(b)(1); Treas. Reg. § 20.2041-1(c)(1-2).

III. VALIDITY OF EXCULPATORY PROVISIONS

A) Validity

Exculpatory clauses are valid in Texas. *Neuhaus v. Richards,* 846 S.W.2d 70 (Tex. App. – Corpus Christi 1992, no writ); *Interfirst Bank of Dallas, N.A. v. Risser,* 739 S.W.2d 882 (Tex. App.—Texarkana 1987, no writ); *Corpus Christi National Bank v. Gerdes,* 551 S.W.2d 521 (Tex. Civ. App. – Corpus Christi 1977, writ ref'd n.r.e.).

B) Strictly Construed

Exculpatory clauses will, however, be strictly construed against exculpation. *Jewett v. Capital National Bank of Austin,* 618 S.W.2d 109 (Tex. Civ. App. – Waco 1981, writ ref'd n.r.e.).

C) Public Policy Restrictions

Prior to December 31, 2002, there was a common law public policy restriction on exculpatory clauses applying to trusts. This restriction was first enumerated in the case of *Langford v. Shamburger,* 417 S.W.2d 438, 444 (Tex. Civ. App. – Fort Worth 1967, *writ ref'd n.r.e.),* in which the court held that: "it would be contrary to public policy of this state to permit the language of a trust instrument to authorize self dealing by a trustee." *Id*; see also *McLendon v. McLendon,* 862 S.W.2d 662, 676 (Tex. App—Dallas 1993, writ denied); *Grider v. Boston Company Co.,* 773 S.W.2d 338, 343 (Tex. App. – Dallas 1989, writ denied); *InterFirst Bank Dallas, N.A. v. Risser,* 739 S.W.2d 882 (Tex. App. – Texarkana 1987, no writ).

This public policy was rejected by the Texas supreme court in the case of *Texas Commerce Bank, N.A. v Grizzle*, 96 S.W.3d 240, 249 (Tex. 2002). In *Grizzle* the supreme court, relying on Texas Trust Code §111.002[3] and §113.051[4] and §113.059,[5] concluded that the Trust Code allows an exculpatory clause to relieve a corporate trustee from liability for self-dealing. *Id.* at 250-51.

The court also held that:

> the State's public policy is reflected in its statutes. And the Legislature has spoken on

[2] *Bogert, Trusts & Trustees (Second Ed. Rev.) §* 542 provides in part that: "Although an exculpatory clause may relieve the trustee from liability for damages, there may be other remedies available to the beneficiary, for example, removal of the trustee, enjoining the trustee from committing an improper act, of denial or reduction of the trustee's compensation."

[3] TX Trust Code § 111.002 at that time provided: "if the provisions of this subtitle and the terms of a trust conflict, the terms of the trust control …"

[4] TX Trust Code § 113.051 at that time provided: "In the absence of any contrary terms in the trust instrument or contrary provisions of this subtitle, in administering the trust the trustee shall perform all of the duties imposed on trustees by common law."

[5] TX Trust Code § 113.059 at that time provided that a settlor may relieve a corporate trustee from a "duty, liability, or restriction imposed by this subtitle."

> self-dealing and exculpatory clauses in the Trust Code. The Legislature has expressly authorized the use of exculpatory clauses, stating that they can relieve a corporate trustee from liability except for certain narrow types of self-dealing not at issue here. We therefore decline to hold that a trust instrument cannot exonerate a trustee from liability for failing to promptly reinvest trust monies based on public policy. …
>
> Public policy, some courts have said, is a term of vague and uncertain meaning, which it pertains to the law-making power to define, and courts are apt to encroach upon the domain of that branch of the government if they characterize a transaction as invalid because it is contrary to public policy, unless the transaction contravenes some positive statute or some well-established rule of law. *Id.* at 250.

The supreme court in *Grizzle* concluded this discussion by holding that: "We therefore conclude that public policy, as expressed by the Legislature in the Trust Code, does not preclude a settlor from relieving a corporate trustee from liability for self-dealing, except for what is specified in sections 113.052 and 113.053. **We disapprove *Langford* and its progeny[6] to the extent they suggest otherwise."** (emphasis supplied)

While the Texas Legislature subsequently amended the Texas Trust Code in response to Grizzle so as to limit the extent a trustee can be exculpated, the holding in *Grizzle* is significant and should be kept in mind when drafting exculpatory clauses in general.

There are no provisions in the Texas Probate Code that correspond to Texas Trust Code § 111.002, § 113.051 and § 113.059. Are there any public policy limitations on a testator's ability to exculpate an executor from liability and, if there are, how are these limitations affected by *Grizzle*?

IV. USE OF EXCULPATORY PROVISIONS

A) Use With Care

Exculpatory provisions should be used with extreme care and should never constitute boiler plate provisions in wills and trusts. The threshold question to consider in evaluating the use of this type of clause is whether the exculpator would want the objects of his bounty to suffer material economic loss in order to protect the fiduciary from liability. Even if the answer to this question is "yes," there remains a question regarding the degree of protection that the exculpator would want the fiduciary to have.

Consideration of the use of any exculpatory clause should begin with the question: "If the fiduciary breaches his trust and as a consequence thereof causes damages to the estate/trust, then who would the testator/settlor want to bear the loss?" Would the answer to this question be different if the fiduciary committed intentional malfeasance rather than negligence?

A law firm that includes an exculpatory clause as boilerplate in its estate planning documents is courting disaster. This is especially true when the fiduciary is an entity with whom the law firm has a pre-existing relationship (such as a bank the law firm represents on a regular basis). Also, if the fiduciary is a corporation charging a full fee for its services as a fiduciary, then exculpation of the fiduciary from liability is hard to justify. In fact, a traditional reason for appointing a corporate fiduciary was the financial resources of a corporate fiduciary to make good any loss they caused the estate of trust.

Factors pertaining to the use of exculpatory clauses may well be different with respect to corporations and LLCs than to estates and trusts. The paramount distinction is that managers and members sign a company agreement with exculpatory provisions and shareholders who agree to bylaws with exculpatory provisions actually agree to the provisions while beneficiaries of trusts and distributees of estates have no say whatsoever in whether or not their fiduciary is exculpated.

B) Typical Usage

As a general proposition, if a settlor or testator has a close personal relationship with a designated fiduciary, and especially if the fiduciary is not receiving compensation for his or her services as a fiduciary, then some form of exculpation from liability may be warranted. For example, if a settlor or testator appoints his or her spouse as a trustee for their children, to serve without compensation, then the settlor may want to limit the trustee's potential liability.

V. EXCULPATORY PROVISIONS IN TRUSTS

A) The Clause

"Notwithstanding anything to the contrary herein, my Trustee shall, to the greatest extent permitted by Texas law at the time this clause is construed, be exculpated from any liability whatsoever for any alleged abuse of discretion, tort, breach of fiduciary duty and/or breach of trust caused by any act or omission in the administration of this trust. As a consequence, no person, firm or corporation ever serving as my trustee shall ever be held personally

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[6] See *McLendon v. McLendon,* 862 S.W.2d 662 (Tex. App.—Dallas 1993, writ denied); *Grider v. Boston Co.,* 773 S.W.2d 338 (Tex. App.—Dallas 1989, writ denied); *InterFirst Bank of Dallas, NA. v. Risser,* 739 S.W.2d 882 (Tex. App. - Texarkana 1987, no writ).

liable to any other person, firm or corporation for any damages directly or indirectly arising out of any act or omission committed in the administration of this trust. This exculpation shall not, however, protect my trustee from any liability for a breach of trust committed in bad faith, intentionally, or with reckless indifference to the interest of a beneficiary; or any profit derived by the trustee from a breach of trust. Even if this exculpation clause shall not protect my trustee because of the foregoing sentence, in no event shall my trustee ever be liable for any punitive or exemplary damages for any act or omission committed in the administration of this trust regardless of whether such act or omission constituted a breach of trust committed in bad faith, intentionally, or with reckless indifference to the interest of a beneficiary; or any profit derived by the trustee from a breach of trust."

B) Applicability of the Clause

In 2006 the Texas legislature amended the Texas Trust code to overrule the *Grizzle* decision. It enacted Texas Trust Code §114.007, which provided that:

§ 114.007 Exculpation of Trustee

(a) A term of a trust relieving a trustee of liability for breach of trust is unenforceable to the extent that the term relieves a trustee of liability for:

(1) a breach of trust committed:

(a) in bad faith;

(b) intentionally; or

(c) with reckless indifference to the interest of a beneficiary; or

(2) any profit derived by the trustee from a breach of trust.

(b) A term in a trust instrument relieving the trustee of liability for a breach of trust is ineffective to the extent that the term is inserted in the trust instrument as a result of an abuse by the trustee of a fiduciary duty to or confidential relationship with the settlor.

(c) This section applies only to a term of a trust that may otherwise relieve a trustee from liability for a breach of trust. Except as provided in Section 111.0035, this section does not prohibit the settlor, by the terms of the trust, from expressly:

(1) relieving the trustee from a duty or restriction imposed by this subtitle or by common law; or

(2) directing or permitting the trustee to do or not to do an action that would otherwise violate a duty or restriction imposed by this subtitle or by common law.

Tex. Trust Code § 114.007 (2006). This language was taken from the *Restatement of the Law of Trusts, 2nd* §222.

At the time that Texas Trust Code §114.007 was passed, the legislature also amended Texas Trust Code §111.0035 to provide that: "The terms of a trust prevail over any provision of this subtitle, except that the terms of a trust may not limit: … the applicability of Section 114.007 to an exculpation term of a trust." Tex. Trust Code § 111.0035 (2006).

The restrictions on exculpation contained in Texas Trust Code §114.007 do not apply to transactions occurring on or after January 1, 1984, regardless of the date of the creation of the trust. This is because of Texas Trust Code §111.006, which provides that:

§ 111.006 Application

This subtitle applies:

(1) to all trusts created on or after January 1, 1984, and all transactions relating to such trusts; and

(2) to all transactions occurring on or after January 1, 1984, relating to trusts created before January 1, 1984; provided that transactions entered into before January 1, 1984, and which were subject to the Texas Trust Act, as amended (Articles 7425b-1 through 7425b-48, Vernon's Texas Civil Statutes), and the rights, duties, and interests flowing from such transactions remain valid on and after January 1, 1984, and must be terminated, consummated, or enforced as required or permitted by this subtitle. Tex. Trust Code § 111.006 (2006).

Is there a possible loophole in the language of Texas Trust Code § 114.007? Is it possible to eliminate all of the fiduciary's fiduciary duties other than the ability to appropriate the fiduciary estate for the fiduciary, the fiduciary's creditors, the fiduciary's estate or the creditors of the fiduciary's estate?

VI. EXCULPATORY PROVISIONS IN WILLS

A) The Clause

"Notwithstanding anything to the contrary herein, my Executor shall, to the greatest extent permitted by Texas law at the time this clause is construed, be exculpated from any liability whatsoever for any alleged abuse of discretion, tort, breach of fiduciary duty and/or breach of trust caused by any act or omission in the administration of my estate. As a consequence, no person, firm or corporation ever serving as the personal representative of my estate shall ever be held personally liable to any other person, firm or corporation for any damages directly or indirectly arising out of any act or omission committed in the administration of my estate. This exculpation shall not, however, protect the personal representative of my estate from any liability for directly taking or appropriating all or any portion of my estate for himself, his creditors, his estate or the creditors his estate. Even if this exculpation clause shall not protect the personal representative of my estate because of the foregoing sentence, in no event shall the personal representative of my estate ever be liable for any punitive or exemplary damages for any act or omission committed in the administration of my estate."

B) Applicability of the Clause

There are no exculpatory provisions in the Texas Probate Code that protect administrators from liability. Consequently, an analysis of the enforceability of exculpatory provisions relating to the personal representatives of estates applies only to executors who are exculpated under the terms of a will.

The fiduciary standards of executors of estates are the same as the fiduciary standards of a trustee. Texas Trust Code § 37; *Humane Society of Austin and Travis County v. Austin Nat'l Bank,* 531 S.W.2d 574, 577 (Tex. 1975), *cert. denied,* 425 U.S. 976, 96 S.Ct. 2177, 48 L.Ed.2d 800 (1976); *McLendon v. McLendon*, 862 S.W.2d 662, 670 (Tex. App.—Dallas 1993, writ denied).

Although executors of estates are subject to the same fiduciary standards as a trustee, the terms of the Texas Trust Code do not apply to executors. Tex. Trust Code §111.003. The fiduciary standards that apply to executors are the common law fiduciary standards of a trustee.

There are two possible ways a court could impose public policy constraints on an exculpatory clause in a will. First the court could directly impose public policy constraints on the exculpation of an executor. Second, a court could rule that, because an executor is subject to the same fiduciary standards as a trustee, exculpation of an executor is subject to the same public policy constraints that purportedly applied to trustees prior to the Grizzle case[7]. These public policy constraints would be those imposed by *Langford* (a limitation on exculpation for self-dealing) and possibly those imposed by § 222 of the *Restatement of the Law of Trusts, 2nd*[8].

VII. EXCULPATING CORPORATE DIRECTORS[9]

Texas business organizations will be governed by the Texas Business Organizations Code (the "TBOC") after January 1, 2010, therefore, for simplicity, this paper will refer only to the relevant provisions in the TBOC.

A) Director Fiduciary Duties

Under Texas law, corporate directors owe three broad fiduciary duties: 1) obedience, 2) loyalty, and 3) care. *Gearhart Industries, Inc. v. Smith Intern, Inc*., 741 F.2d 707, 719-21 (5th Cir. 1984). The duty of obedience requires a director to avoid committing ultra vires acts, or acts beyond the scope of the authority of the corporation as defined by its articles of incorporation or the laws of the state of incorporation. *Id.* at 719. Issues related to the duty of obedience rarely arise because corporations generally have broad purpose clauses in their articles of incorporation.

The duty of loyalty requires a director to act in good faith and he must not allow his personal interests to prevail over the interests of the corporation. *Id.* Conduct implicating the duty of loyalty includes self-dealing and usurpation of corporate opportunity.

The duty of care requires a director to handle his duties with such care as an ordinarily prudent man would use under similar circumstances. *Id.* at 720. This duty will be discussed more thoroughly below.

B) Exculpating "Governing Persons"

The TBOC allows a Texas "organization" to limit a "governing person's" liability for monetary damages owed to the organization or its owners or members for an act or omission in certain instances. Section 7.001(b) states:

> The certificate of formation or similar instrument of an organization to which this

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[7] i.e. the court could resurrect *Langford* and its progeny.

[8] "An exculpatory clause is ineffective to relieve the fiduciary from acts committed in bad faith or intentionally or with reckless indifference to the interest of the beneficiary, or of liability for any profit, which the fiduciary has derived from a breach of trust."

[9] For an excellent and extensive review of director duties, *see* Byron F. Egan, *Director Duties in Troubled Times: Process and Proof*, Texas Bar CLE Webcast (January 27, 2009).

section applies may provide that a governing person of the organization is not liable, or is liable only to the extent provided by the certificate of formation or similar instrument, to the organization or its owners or members for monetary damages for an act or omission by the person in the person's capacity as a governing person. TBOC 7.001(b).

C) To Whom Does § 7.001 Apply?

TBOC § 7.001 applies to a domestic entity other than a general partnership, limited partnership, or LLC. TBOC 7.001(a)(1). Thus, this section applies to corporations.

Additionally, the section only allows the limitation of liability for a "governing person." TBOC § 7.001(b). A "governing person" does include directors of a corporation, however, the term does not include an officer who is acting in the capacity of an officer. TBOC §§ 1.02(35)(A); 1.02(35)(B); 1.02(37).

D) Limits on Exculpating Directors

There are restrictions on the ability to exculpate a corporate director. § 7.001(c) provides that elimination or limitation of liability of a governing person is not authorized to the extent the person is found liable for:

(1) a breach of the person's duty of loyalty, if any, to the organization or its owners or members;

(2) an act or omission not in good faith that:

(A) constitutes a breach of duty of the person to the organization; or

(B) involves intentional misconduct or a knowing violation of law;

(3) a transaction from which the person received an improper benefit, regardless of whether the benefit resulted from an action taken within the scope of the person's duties; or

(4) an act or omission for which the liability of a governing person is expressly provided by an applicable statute.

Because a corporation cannot exculpate a director for the breach of the duty of loyalty, § 7.001 functionally only permits the exculpation of a breach of the duty of care. However, § 7.001(c)(2) provides that the corporation cannot exculpate a director whose act or omission was not in good faith. Therefore, an exculpatory clause drafted under § 7.001 is effective when a director has breached his duty of care, but has not done so in bad faith, and he has not breached his duty of loyalty.

E) Application of § 7.001

Very little Texas caselaw has developed regarding the corporate director duty of care or the standards of such duty of care. Even less Texas caselaw is available concerning the applicability of § 7.001 (or its predecessors) and the exculpation of corporate directors. However, there is an abundance of Delaware caselaw on these subjects as they pertain to Delaware law.

This paper will first examine Texas' treatment of the duty of care, and then Delaware's treatment of the duty of care and exculpatory clauses.

F) The Texas Duty of Care

In Texas, a Director's duty of care is to handle his corporate duties with such care as "an ordinarily prudent man would use under similar circumstances." *Gearhart Industries, Inc. v. Smith International, Inc.*, 741 F.2d 707, 720 (5th Cir. 1984), citing *McCollum v. Dollar*, 213 S.W. 259 (Tex. Comm'n App. 1919, holding approved). In performing his duties, the director must be diligent and informed and exercise honest and unbiased business judgment in pursuit of corporate interests. *Gearhart*, 741 F.2d at 720.

The business judgment rule is a defense to accusations of breach of the duty of care. *Gearhart*, 741 F.2d at 721. Few Texas cases address the issues of a director's standard of care, negligent mismanagement or the business judgment rule. *Id.* However, in 1984, the 5th Circuit announced in *Gearhart* that under the Texas version of the business judgment rule, courts will not interfere with the business judgment of, nor impose liability upon non-interested corporate directors, absent a showing of fraud or an ultra vires act. *Gearhart*, at 721, 724 n 9.

If the standard announced in *Gearhart* is read literally, then even grossly negligent conduct by a director would be protected by the business judgment rule in Texas. This would be a significant departure from the law in other jurisdictions, like Delaware, where the business judgment rule does not protect grossly negligent conduct.

Since *Gearhart*, a number of Federal district court decisions in cases involving financial institutions have held that the Texas business judgment rule does not protect grossly negligent breaches of the duty of care. *FDIC v. Harrington*, 844 F.Supp. 300, 306 (N.D. Tex. 1994); *FDIC v. Schreiner*, 892 F.Supp. 869 (W.D. Tex. 1995); *FDIC v. Benson*, 867 F.Supp. 351, 357-58 (S.D. Tex. 1993); *FDIC v. Brown*, 812 F. Supp. 722, 726 (S.D. Tex 1992. However, there is a question as to whether the holding in those cases is restricted to financial institutions.

One court held in a non-financial institution context that the business judgment rule does not bar claims against a director for gross negligence. See *Weaver v. Kellogg*, 216 B.R. 563, 584 (Bankr. S.D. Tex 1997). However, another court criticized such holding and surmised that there were special public policy reasons for the previous courts to impose liability for gross negligence upon financial institutions' directors specifically. *Floyd v. Hefner*, No. H-03-5693, 2006 WL 2844245, at *28 (S.D. Tex. Sept. 29, 2006). The court in *Floyd* held that under *Gearhart*, in non-financial corporations, a director was not liable for gross negligence under the business judgment rule. *Id*.

The Issue: If the Texas business judgment rule protects a director's grossly negligent breach of the duty of care, then the Texas statute allowing exculpation (TBOC § 7.001) is useless.

The problem is that if in Texas, non-financial institution directors are protected by the business judgment rule for gross negligence, then the only time they would need an exculpatory clause to protect them from paying monetary damages is if they commit an ultra vires act or fraud.

A director is not liable for an ultra vires act unless the act is illegal, and as to a director, an act is "illegal" when his act violates a specific statute, is malum in se (inherently immoral, like murder), malum prohibitum (an act that is a crime merely because it violates a statute), or against public policy. *Gearhart*, 741 F.2d at 719.

If a director commits an act that is ultra vires or fraudulent, then the director would not be protected by the exculpatory clause because such act would violate § 7.001(c)(2) (he would not have acted in good faith and his acts would have involved intentional misconduct or a knowing violation of law) or § 7.001(c)(4) (a governing person cannot be exculpated for an act or omission for which the liability of a governing person is expressly provided by an applicable statute).

Therefore, if the business judgment rule does in fact protect directors from even grossly negligent conduct, then they have no need for an exculpatory clause because any conduct that would render them liable would fall within the statutory exceptions to exculpation.

G) Delaware and the Breach of the Duty of Care

There is a significantly larger body of caselaw in Delaware than in Texas concerning a director's duty of care, and particularly addressing the statutory right of a corporation to exculpate a director from monetary damages for breach of the duty of care. See *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27 (Del. 2006); *Emerald Partners v. Berlin*, 787 A.2d 85 (Del. 2001); *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

Delaware has a very similar provision to Texas' § 7.001. The Delaware Code Annotated (DGCL) authorizes the inclusion in a certificate of incorporation of:

> A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability or a director: (i) For a breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title [dealing with the unlawful payment of dividends or unlawful stock purchase or redemption]; or (iv) for any transaction from which the director derived an improper personal benefit…8 DGCL § 102(b)(7).

One significant difference between Delaware and Texas is that Delaware caselaw has clearly established the standard of liability for a Director's duty of care. The Delaware business judgment rule is that the law presumes 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. *Disney*, 906 A.2d at 52. Directors' decisions are respected by Delaware courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose, or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available. *Id,* citing *Emerald Partners v. Berlin,* 787 A.2d 85, 91 (Del. 2001).

Significantly, in Delaware, a Director may be held personally liable for monetary damages for gross negligence. *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27 (Del. 2006); *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985). Delaware defines gross negligence as including failure to inform one's self of available material facts and conduct that constitutes reckless indifference or actions that are without the bounds of reason. *McPadden v. Sidhu,* 964 A.2d 1262, 1274 (Del. Ch. 2008). The Delaware Supreme Court held that the mere fact that a director is grossly negligent in breaching his duty of care does not automatically mean that he has acted in bad faith (a finding of bad faith would preclude a director from obtaining the protection of an exculpatory clause under

DGCL § 102(b)(7)). *Disney*, 906 A.2d at 64-67. Under Delaware law, the intentional dereliction of duty or the conscious disregard for one's responsibilities constitute bad faith, which also results in the breach of the duty of loyalty. *McPadden*, 964 A.2d at 1274. Such conduct would therefore preclude a director from benefitting from any exculpatory clause under exceptions outlined in the Delaware exculpation statute.

Thus, Delaware has established clear rules for practitioners that guide them in drafting exculpatory clauses for corporations, and the vast majority of Delaware corporations have such clauses. *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 752 (Del. 2005). The Delaware caselaw and exculpation statute are in line with each other and as evidenced in the *Disney* case, they make logical sense when applied together.

Although it is not clear under Texas law that non-financial industry directors are liable for grossly negligent breaches of the fiduciary duty of care, it would be prudent for the Texas practitioner to draft an exculpatory clause as if that were the case so that a corporation's directors are protected in the instance that in the future Texas courts do decide to follow the precedent set by other jurisdictions and hold directors liable for grossly negligent conduct.

H) The Clause

Because the Delaware exculpation statute is so similar to that of Texas, it may be useful to use a Delaware corporation's exculpatory clause as a guide. The following is an exculpatory clause that is similar to one used in a Delaware corporation:

> To the fullest extent permitted by Texas Business Organization Code or as it may hereafter be amended, no director of the Corporation shall be personally liable to the Corporation or its stockholders for monetary damages for breach of the fiduciary duty of care.

VIII. EXCULPATION AND PARTNERSHIPS

The liability of a governing person in a general partnership may be limited or restricted to the extent permitted under Chapter 152. TBOC § 7.001(d). The liability of a governing person in a limited partnership may be limited or restricted to the extent permitted under Chapters 153 and 152 (where applicable to limited partnerships). Id.

Limited partnerships are governed by Chapter 153 of the TBOC. However, in cases not provided for by Chapter 153, the provisions of Chapter 152 governing general partnerships apply.

A) Partner Duties

A partner owes to the partnership, the other partners, and a transferee of a deceased partner's partnership interest: (1) a duty of loyalty; and (2) a duty of care. TBOC § 152.204(a). Additionally, a partner shall discharge the partner's duties to the partnership and the other partners, and exercise any rights and powers in the conduct or winding up of the partnership business (1) in good faith; and (2) in a manner the partner reasonably believes to be in the best interest of the partnership. TBOC § 152.204(b).

Importantly, the TBOC expressly provides that a partner does not violate a duty merely because his conduct furthers his own interest. TBOC § 152.204(c). Additionally, the Code states that a partner is not a trustee and is not held to the standards of a trustee. TBOC § 152.204(d).

B) Limitation or Exculpation of Partner Liability

When a Trustee breaches a fiduciary duty, even if he is exculpated from liability and does not have to pay monetary damages, the Trust Code still provides other non-monetary remedies for the trustee's actions. The trustee can be removed, forced to provide an accounting, or a host of other remedies.

However, in the partnership context, monetary liability is the primary deterrent to keep a partner from breaching his fiduciary duties. Thus, it would make little sense for a person to agree to exculpate his prospective partner from monetary damages for breaches of fiduciary duty committed by that partner when he has little other recourse against such partner. It makes more sense for the partners to define or carve out in their partnership agreement what they agree constitutes a breach of fiduciary duty. The Texas Legislature has allowed for partners to do just that in their partnership agreement.

The partnership agreement governs the relations of the partners and between the partners and the partnership, and the Code only fills the gaps to the extent the partnership agreement does not otherwise provide. TBOC § 152.002. However, the Code explicitly prohibits a partnership agreement and the partners from doing the following:

1) Eliminating the duty of loyalty. However, the partners by agreement may identify specific types of activities or categories of activities that do not violate the duty of loyalty if the types or categories are not "manifestly unreasonable."

2) Eliminate the duty of care. However, the partners by agreement may determine the standards by which the performance of the obligation is to be

measured if the standards are not "manifestly unreasonable."

3) Eliminate the obligations of good faith under § 152.204(b), except that the partners by agreement may determine the standards by which the performance of the obligation is to be measured if the standards are not "manifestly unreasonable." TBOC § 152.002.

Thus, while the TBOC does not allow either a general partnership or a limited partnership to exculpate the partners for breaches of the duty of loyalty or of care, or to eliminate the obligation of good faith, the TBOC does allow the partners to better define in their partnership agreement what those duties entail, as long as the provisions are not "manifestly unreasonable."

C) Duty of Loyalty

Notice that the statute allows the partners to identify activities "that do not violate the duty of loyalty." This is not permitting a partnership agreement to limit or eliminate liability of a partner who breaches the duty of loyalty related to certain activities. Rather, it is allowing the partnership agreement to declare some activity is not a breach of the duty of loyalty. The difference is significant. In declaring that some activity is not a breach of the duty of loyalty, when a partner acts in such defined manner, it is an absolute defense that such activity did not give rise to the duty of loyalty. However, an exculpatory clause is in the nature of an affirmative defense. *Emerald Partners v. Berlin,* 787 A.2d 85, 91 (Del. 2001); *Gesoff v. IIC Industries, inc.,* 902 A.2d 1130, 1164 (Del. Ch. 2006). If the partnership agreement were allowed to exculpate or limit the partner's liability for taking such action, then a trial could ensue and a jury could determine such partner was guilty of such breach of the duty of loyalty, but the exculpatory clause would ultimately protect the partner from liability for monetary damages.

If used thoughtfully, § 152.002 can be of more assistance to the partners than would a typical exculpatory clause.

D) Duty of Care

A partner's duty of care is to act in the conduct and winding up of the partnership business with the care of an ordinarily prudent person would exercise in similar circumstances. TBOC § 152.206. An error in judgment does not by itself constitute a breach of the duty of care, and a partner is presumed to satisfy the duty of care if the partner acts on an informed basis, in good faith, and in a manner the partner reasonably believes to be in the best interest of the partnership. Id.

While the TBOC defines the duty of care for a partner in § 152.206, it fails to define the applicable standard of care. Is a partner liable for gross negligence, or only for fraud, as may be the case in the context of corporate directors?

There is very little case law on the issue of standard of care for the duty of care in the partnership context, and most of the case law is several decades old. Thus, the old case law applied to former versions of the partnership statutes. The case law that is on point holds that mere negligence in the management of the affairs of a general partnership does not give rise to a cause of action. *Ferguson v. Williams*, 670 S.W.2d 327, 331 (Tex. App.—Austin 1984, writ ref'd n.r.e.). Thus, it appears that in order to be liable for a breach of the duty of care, a person must be at least grossly negligent.

Given the uncertainty of the case law, § 115.002 has provided an opportunity for the partners to define the standard for themselves. Whether such standard is "manifestly unreasonable" will be up to a court to decide. To uphold the provision, it is important that both parties to the partnership agreement are aware of the provision, so the provision should be made conspicuous and explicit.

Since there is so little caselaw in the partnership area of the law on the standard for the duty of care, practitioners should look to other areas of the law for guidance. It seems reasonable that a partnership agreement could exculpate partners for acts committed in gross negligence (as apparently allowed for corporate directors), but not committed fraudulently, in bad faith, intentionally, or with reckless indifference to the interest of the partnership.

IX. EXCULPATION AND LIMITED LIABILITY COMPANIES

A) Duties

The Code does not define or expressly impose fiduciary duties on managers or members of an LLC. However, by referring to fiduciary duties in § 101.401, it implicitly recognizes that such duties exist. Thus, it has generally been assumed that managers in a manager managed LLC and members in a member-managed LLC owe fiduciary duties similar to those of corporate directors.

The Delaware Limited Liability Company Act, from which the Texas version was inspired, expressly emphasizes the policy of giving maximum effect to principles of freedom of contract and enforceability of LLC agreements. Delaware LLC Act § 18-1101(b). Although the Texas version of the LLC Act does not expressly state this policy, the legislative history of the LLC Act indicates that this was the intent of the Texas Legislature, as well. This intent to recognize or emphasize the principles of freedom of contract appears to be unique to LLC's.

B) Exculpation and Limitation of Liability

According to § 7.001(d), the liability of a governing person in a limited liability company may be limited or restricted to the extent permitted under § 101.401.

TBOC § 101.401 provides that a LLC company agreement may expand or restrict any duties, including fiduciary duties, and related liabilities that a member, manager, officer, or other person has to the company or to a member or manager of the company. TBOC § 101.401.

This provision essentially leaves it to the courts to determine to what extent and which duties and liabilities may be eliminated or limited as a matter of public policy.

There are two possibilities as to how courts will interpret this statute. The first is that courts may simply look to the restrictions placed on exculpatory clauses by caselaw and statutes for other forms of business entities.

The second possibility is that courts may follow the reasoning of the Texas supreme court in *Texas Commerce Bank, N.A. v. Grizzle*, 96 S.W.3d 240 (Tex. 2002), where the court essentially held that unless the Texas Legislature explicitly limits what can be exculpated, there are no limits on exculpatory clauses. *Id.* at 249-250 (holding that the State's public policy is reflected in its statutes, and that because the Trust Code did not expressly limit exculpatory clauses by prohibiting exculpating a trustee for self-dealing, then a trustee could be exculpated for self-dealing).

While there is a persuasive argument that courts will follow the *Grizzle* reasoning, practitioners must also remember that the Texas Legislature reacted to the *Grizzle* ruling by revising the Trust Code and expressly putting statutory limits on exculpatory clauses. *See* above discussion of *Grizzle* and Tex. Trust Code § 114.007 (2006). However, there is a difference between Trust law and LLC law. In Trust law, there was already a long established precedent of caselaw holding that there were limits to exculpatory clauses for trustees. See *Langford v. Shamburger,* 417 S.W.2d 438 (Tex. Civ. App.—Fort Worth 1967, writ ref'd n.r.e.); *McLendon v. McLendon,* 862 S.W.2d 662, 676 (Tex. App.—Dallas 1993, writ denied); *Grider v. Boston Co.,* 773 S.W.2d 338, 343 (Tex. App.—Dallas 1989, writ denied); *InterFirst Bank of Dallas, N.A. v. Risser,* 739 S.W.2d 882, 899 (Tex. App.—Texarkana 1987, no writ). The *Grizzle* case turned those cases on their heads. In the LLC arena, there is no such caselaw precedent.

However, it could be argued that the same public policy reasons for establishing *some* limits on exculpatory clauses, such as prohibiting the exculpation of liability for fraud, are necessary.

Therefore, to avoid the controversy that might arise if an exculpatory clause tests the limits and attempts to exculpate fraud or breaches of duty committed in bad faith, the prudent practice would be to follow the guidelines set in other areas of the law and exculpate governing persons in the LLC for gross negligence, but not for bad faith, fraud, or acts committed intentionally or with reckless indifference to the interest of the LLC.

C) The Clause

Exculpation of Members. In carrying out their duties hereunder, the Members shall not be liable to the Company or to any other Member for their good faith actions, or failure to act, or for any errors of judgment, or for any act or omission believed in good faith to be within the scope of authority conferred by this Agreement, but only for their own willful misconduct in the performance of their obligations under this Agreement. Actions or omissions taken in reliance upon the advice of legal counsel as being within the scope of authority conferred by this Agreement shall be conclusive evidence of such good faith; however, good faith may be determined without obtaining such advice. *McConnell v. Hunt Sports Enterprises* (1999), 132 Ohio App.3d 657, 692, 725 N.E.2d 1193, 1217.

CONCLUSION

As demonstrated above, there are many options available to protect fiduciaries, no matter what capacity in which they serve. The exculpatory clause is one of the more powerful tools at a drafter's disposal. However, the courts and the Legislature have restricted the ability to exculpate fiduciaries to some degree, depending upon the type of fiduciary. While the law is different for each type of fiduciary, generally, public policy tends to prohibit the exculpation of fiduciaries for acts committed in bad faith or fraudulently.

Finally, it is important that practitioners do not draft boilerplate exculpatory clauses without an eye toward their particular client's and the beneficiary's circumstances. In many circumstances, an exculpatory clause will not be appropriate, and may result in unintended consequences if improvidently used.