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ARTICLES

Shareholder Oppression and Enhanced Fiduciary Duties

By David E. Lieberman – February 29, 2012

While today’s political buzz phrase, “class warfare,” seems unlikely to spill over into corporate governance jurisprudence, it arguably and only half-facetiously fits in the sizeable body of law addressing shareholder disputes in closely held corporations. In fact, courts, legislatures, and scholars considering the unique characteristics of close corporations have long used a term with similar overtones—“oppression”—to describe exploitive efforts by controlling shareholders to freeze minority shareholders out of the management or profits of a close corporation. Attention to shareholder oppression has spawned enhanced fiduciary duties owed to shareholders in close corporations that have no analogue in the context of publicly traded firms, along with direct common-law and statutory causes of action to enforce them.

Close Corporations Are Different

The advent of enhanced fiduciary duties stems from the courts’ recognition that close corporations, which constitute the overwhelming majority of U.S. businesses, differ materially from public corporations in ways that empower majority shareholders and can leave minority shareholders vulnerable to abuse. Definitions of “close corporation” vary, but the relevant characteristics here are that they are owned by only a small number of shareholders, the shareholders participate actively and substantially in managing the enterprise, and there is no public securities market to trade shares of the corporation’s stock.

Close corporation investors are often tied by family or other personal relationships, and often expect employment by the corporation and a meaningful role in management, as well as financial return on their investment. In contrast, the shareholder investing in a public corporation typically contributes no labor to the enterprise and plays no management role. More important, he can readily liquidate his investment by selling shares in a public securities market if he becomes dissatisfied with the management’s actions. The typical minority close-corporation shareholder is locked into his or her investment. Illiquid, noncontrolling shares are unlikely to attract interest from private investors, and corporate governance documents frequently preclude or restrict a transfer of shares. And, unlike an investor in a general partnership, he or she cannot readily liquidate his or her investment by exercising a statutory right to dissolve the business.

These characteristics, in the context of traditional norms of governance devised to serve publicly traded corporations, often enable opportunistic majority shareholders to marginalize or freeze out minority shareholders. Traditionally, authority to manage and control the corporation vests in the board of directors, and authority to elect board members belongs to those who hold a majority of voting shares. Case law concerning oppression is filled with instances in which majority shareholders in a close corporation garner control by electing themselves, relatives, or other aligned individuals as directors, leaving minority shareholders vulnerable to board decisions

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concerning management, employment, compensation, dividend payments, and other matters material to minority owners.

In addition, although state legislatures have relaxed statutory bars to contractual arrangements that afford protections to minority shareholders or otherwise provide mechanisms to deal with governance disputes, close corporation investors seldom bargain in advance for such safeguards. Employment contracts, buy/sell agreements, supermajority provisions, and meaningful succession planning are rare. Commentators attribute minority owners' frequent failure to negotiate adequate *ex ante* safeguards to many factors, including close family or personal ties to other investors and mutual trust, limited business or legal sophistication, reliance on forms or other expedencies, and the limits of human foresight. An absence of advance planning and contracting often facilitates opportunistic action by those in control.

Squeeze-Outs, Freeze-Outs, and Other Forms of Oppression

A large body of reported decisions illustrates various techniques controlling shareholders have used to freeze minority investors out of meaningful participation in a close corporation. Controlling shareholders are alleged to have improperly withheld dividends or other returns on the minority's investment, improperly terminated employment and management positions and related benefits, or siphoned off disproportionate shares of corporate profits by paying themselves excessive salaries, bonuses, benefits, and perquisites. Others have allegedly committed the corporation to generous contracts with themselves or aligned parties made at less than arm's length—often a lease to use real or intellectual property or a contract to obtain services from a closely affiliated person or entity—or a loan at nonmarket rates. *See* F. Hodge O'Neal & Robert B. Thompson, *O'Neal and Thompson's Oppression of Minority Shareholders and LLC Members*, ch. 3–5 (detailing squeeze techniques and illustrative cases).

In combination with these techniques, controlling shareholders in many contested cases allegedly withhold corporate records and information or physical access to company premises and employees, keeping minority owners in the dark concerning the affairs of the business, its profitability and value, and the benefits enjoyed by those in control. In some instances, after cutting off the minority investor from information, meaningful participation in management, and financial returns, the majority attempts to buy out the minority at an unfairly low price. As some commentators observe, without a market, the minority shareholder may be locked in and frozen out, unable to escape abuses of power simply by selling his or her interest at a fair price.

The Common-Law Response: Enhanced Fiduciary Duties

Courts in many jurisdictions have responded to shareholder oppression by imposing enhanced fiduciary duties in close corporations and granting individual shareholders a direct, common-law action for breach of fiduciary duty when denied a fair share of benefits in the corporation. Two influential Massachusetts Supreme Judicial Court decisions are frequently cited.

In *Donahue v. Rodd Electrotape Co. of New England, Inc.*, 328 N.E.2d 505 (Mass. 1975), the Massachusetts Supreme Judicial Court acknowledged that a minority shareholder, lacking a

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market for his shares, was powerless to challenge dividend and employment decisions by the majority. In light of the nature of close corporations, the court held that the applicable fiduciary duty was not the standard found in corporate law, but the standard existing in partnership law. It held:

Because of the fundamental resemblance of the close corporation to the partnership, the trust and confidence which are essential to this scale and manner of enterprise, and the inherent danger to minority interests in the close corporation, we hold that stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another [i.e., a duty of] the “utmost good faith and loyalty.” Stockholders in close corporations must discharge their management and stockholder responsibilities in conformity with this strict good faith standard. They may not act out of avarice, expediency or self-interest in derogation of their duty of loyalty to the other stockholders and to the corporation.

We contrast this strict good faith standard with the somewhat less stringent standard of fiduciary duty to which directors and stockholders of all corporations must adhere in the discharge of their corporate responsibilities.

328 N.E.2d at 515–16 (internal citations omitted).

A year later, the same court refined its analysis in *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657 (Mass. 1976). It held that a close-corporation shareholder could not be frozen out from participating in the business absent a legitimate business reason. The court tempered its strict good-faith standard by imposing a balancing test centered on whether controlling defendants can show that the challenged conduct was narrowly tailored to further a legitimate business purpose.

Courts in many other jurisdictions have imposed similarly enhanced, partnership-like fiduciary duties on directors, officers, and at least some shareholders of close corporations. The advent of special fiduciary duties has materially altered the rights and duties of close corporate shareholders and has afforded new remedies. *See, e.g., Galbreath v. Scott*, 433 So. 2d 454, 456–57 (Ala. 1983); *Hagshenas v. Gaylord*, 557 N.E.2d 316 (Ill. App. Ct. 1990). Courts finding breaches of fiduciary duties in a close corporation have, for example, ordered corporations to employ minority shareholders who have no employment agreement, have ordered buyouts of minority owners’ stock without either contractual or statutory requirement, have barred controlling shareholders from selling their shares, or have forced selling shareholders to share a control premium.

The law concerning fiduciary duties in close corporations continues to evolve, and there is pointed scholarly disagreement concerning the extent to which the doctrine articulated in Massachusetts is accepted or represents the majority rule, as it is often characterized. *Compare* Robert B. Thompson, “The Shareholder’s Cause of Action for Oppression,” 48 *Bus. Law.* 699,

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729 (1993) (noting “widespread judicial acceptance of the philosophy that applying an enhanced fiduciary duty in close corporations is beneficial”), with Mary Siegel, “Fiduciary Duty Myths in Close Corporate Law,” 29 *Del. J. Corp. L.* 377, 386 (2004) (“Delaware’s minority rule has garnered support from an ever-increasing number of states” and “many state courts have either yet to consider or decide their position on this topic.”).

Important variations occur from jurisdiction to jurisdiction and from case to case. Reported decisions differ concerning the scope and limits of the enhanced fiduciary duties, including whether they apply to all shareholders or only to those in control, whether they apply to all actions or only to those taken in a corporate capacity, and whether they apply to all closely held corporations or only to statutory close corporations.

Courts in “minority jurisdictions,” including Maine, Maryland, and, notably, Delaware, reject the principle that different rules apply to close corporations or that all shareholders in a close corporation, like all partners in a partnership, owe fiduciary duties to each other. Rather, they hold that, as with publicly traded corporations, only controlling shareholders owe fiduciary duties and only if acting in their corporate capacities. Under these authorities, controlling shareholders’ duties require them only to act in the best interest of the corporation, not in the best interest of other shareholders. They reason that the governing corporation statute allows shareholders to contract for their own protection and identifies no special duties owed to minority shareholders. *See, e.g., Nixon v. Blackwell*, 626 A.2d 1366, 1379 (Del. 1993).

Under the generally applicable corporate rules, moreover, courts do not measure fiduciary duties by the strict standard that exists among general partners. Rather, they apply either the business-judgment rule or the entire-fairness test. Here, however, in practice, the distinction between the majority and minority rules may begin to blur. When controlling shareholders oppress minority shareholders, courts are likely to find conflicts of interest sufficient to ignore the highly deferential business-judgment rule in lieu of the entire-fairness test, which requires a showing of “utmost good faith” and the “most scrupulous inherent fairness of the bargain.”

The Statutory Response: Direct Actions for Shareholder Oppression

In a development that parallels the advent of enhanced common-law fiduciary duties, legislatures in most states have, since the late 1970s, substantially broadened corporate dissolution statutes to provide a broad array of remedies to individual close corporation shareholders who establish oppression or other statutory grounds. Some commentators characterize the advent of the statutory cause of action and the direct common-law action for breach of enhanced fiduciary duties as two sides of the same coin—in other words, twin manifestations of the emergent minority shareholder’s cause of action for oppression. *See, e.g.,* Douglas K. Moll, “Minority Oppression & the Limited Liability Company: Learning (or Not) from Close Corporation History,” 40 *Wake Forest L. Rev.* 883, 895 (2006); Douglas K. Moll, “Shareholder Oppression & Dividend Policy in the Close Corporation,” 60 *Wash. & Lee L. Rev.* 841, 852 (2003). It is indeed difficult in practice to distinguish judicial definitions of oppression in close corporations from breaches of the enhanced common-law fiduciary duties imposed in that context.



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Under the expanded dissolution statutes, courts are authorized to grant a number of remedies short of dissolution when a close corporation shareholder establishes that a controlling director, officer, or shareholder has engaged in illegality, fraud, misapplication of assets, waste, or oppression. A deadlock between shareholders or directors may also trigger statutory relief. Many statutes specify a nonexhaustive menu of available remedies, including compulsory declaration of dividends, appointment of a receiver, or a court-ordered buyout of the minority shareholder at a fair price. More robust statutes, as in Illinois, identify additional remedies, such as cancellation or alteration of any provision of the articles of incorporation, bylaws, or a corporate resolution; directing or prohibiting specific acts by the corporation or control persons; removing officers or directors; requiring an accounting; or damage awards. In other states, such as California, the statute specifies no particular remedies but authorizes a court to provide any equitable relief that it deems appropriate. For an overview of the advent of the statutory remedy, *see* Charles W. Murdock, “The Evolution of Effective Remedies for Minority Shareholders and Its Impact Upon Valuation of Minority Shares,” 65 *Notre Dame L. Rev.* 425 (1990).

While expanded-dissolution statutes provide remedies for oppression, they seldom define the term. Here, the statutory and common-law actions sometimes coalesce. Some courts left with the task define oppression with express reference to the enhanced fiduciary duty of good faith and fair dealing owed among shareholders in a close corporation. Others define oppression as “burdensome, harsh, and wrongful conduct” that deviates materially from the “standards of fair dealing on which every shareholder who entrusts his money to a corporation is entitled to rely.” Perhaps the most widely used approach defines oppression as the frustration of the reasonable expectations of the shareholders. The definitions are not mutually exclusive, and it is unclear that they yield different results when applied to specific facts. Among other illustrations, courts will likely find oppression where minority shareholders employed by a corporation and actively involved in running the business are excluded from participation after dissension among the shareholders.

Direct Rights of Action

Alongside the advent of statutory and common-law rights of action for oppression of shareholders in close corporations, courts have modified their analyses of whether a shareholder’s claim for breach of fiduciary duty may be brought as a direct action or if it must instead be brought as a derivative suit in the name of the corporation. The distinction is important because treatment as a derivative action may impose a number of procedural impediments that effectively preclude a minority shareholder from controlling his or her claim or recovery.

Traditionally, a shareholder’s challenge to a control person’s diversion of corporate assets to himself or herself was deemed derivative because the injury is common to all shareholders and to the corporation. A direct action required a separate and distinct injury to the complaining individual shareholders. But many courts recognize that the derivative-direct distinction ill suits the circumstances of a close corporation and increasingly permit close-corporation minority



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shareholders to bring direct, individual causes of action for oppression, whether statutory or under the common law. Claims that would be deemed derivative in the context of a public corporation, including actions alleging improper diversion of assets in favor of controlling shareholders, are often treated as direct.

Conclusion

While “class warfare” perhaps overstates the issue, sharp conflict abounds among owners over the controls and profits of close corporations, often engendering minority shareholder claims of oppression. Courts and state legislatures have responded, recognizing the distinctive forces that operate in close corporations and fashioning common-law and statutory protections that provide a direct shareholder cause of action for oppression.

The practicing lawyer representing a close corporation or its owners is well served to understand the common-law fiduciary duties and statutory rights and obligations in the governing jurisdiction, and to apprise his or her clients. Although the doctrines are not new, they continue to evolve, and material variations exist between the common-law and statutory remedies, from jurisdiction to jurisdiction, and even from case to case.

Fortunately, a great deal of ground work has been laid. Shareholder oppression is the subject of excellent legal scholarship. This overview recommends and relies heavily on each the cited journal articles and the cited treatise devoted to shareholder oppression. Litigation over close corporation governance disputes exacts substantial costs on its participants and the businesses they own. In the author’s experience, optimal, rational resolutions are more readily achieved when negotiated by parties who better understand their respective rights and remedies, as well as the realities and limitations of litigation.

Keywords: litigation, business torts, shareholder oppression, close corporations, enhanced fiduciary duties

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Defending Against Breach of Fiduciary Duty in Bankruptcy

By Jeffrey Baddeley – February 29, 2012

“Victory has a thousand fathers; failure is an orphan.” The quote is attributed to John F. Kennedy in the wake of the failed Bay of Pigs invasion, though it appears to have been first used by Count Galeazzo Ciano, son-in-law of Benito Mussolini. The sentiment aptly characterizes the plight of directors and officers of bankrupt companies.

When a company files for bankruptcy, creditors and their counsel often look for scapegoats. Wiser directors or more capable managers would have avoided the economic calamity that now confronts the disappointed creditor constituency. The increasing reality in Chapter 11 bankruptcy cases is that very few companies emerge from bankruptcy intact. Sales of substantially all of a debtor’s assets under Bankruptcy Code Section 363 have become an overwhelmingly common approach to Chapter 11 “reorganization” cases. David Dragatt, “363(b) Sales: News, Views and Increased Use,” and cases cited therein, 18th Annual Southwest Bankruptcy Conference. Often the corporate debtor’s claims against its directors and officers, usually arising out of whatever actions put the debtor into bankruptcy, constitute a significant asset of the bankruptcy estate.

Moreover, the claims against directors and officers are often pursued by a trust established for the benefit of the unsecured creditors. Those trustees and their constituents are more likely to have a hostile view of managers’ conduct. Therefore, lawyers representing corporate officers and directors must understand the duties of officers and directors when the company is in financial difficulty and the impact a bankruptcy filing may have on otherwise available defenses and protections.

The Fiduciary Duties of Directors and Officers

Outside of bankruptcy, officers and directors owe duties of care and loyalty to the corporations they serve. Case law now seems to hold that the duty of good faith, once thought to be an independent duty, is subsumed in the duty of loyalty or the duty of care. See *In re Citigroup, Inc. S’holder Derivative Litig.*, 964 A.2d 106, 122 (Del. Ch. 2009).

Duty of Loyalty

Officers and directors owe undivided and unqualified loyalty to the corporation they serve. *Pepper v. Litton*, 308 U.S. 295 (1939). Thus, they must act in good faith and with the reasonable belief that an action taken is in the best interest of the corporation. They cannot personally profit at the expense of the corporation or place their personal concerns ahead of those of the corporation. Corporate directors and officers may be seen as trustees for the benefit of shareholders or as their agents. Most “breach-of-loyalty” cases involve a claim that a director’s conflict of interest led the company to enter into a contract that benefited the director, rather than the company. See, e.g., *Cede & Co. v. Technicolor*, 634 A.2d 345 (Del. 1993). “[A] director is considered interested where he or she will receive a personal financial benefit from a transaction

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that is not equally shared by the stockholders.” *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993).

Claims for breach of the duty of loyalty are not limited to cases of conflict of interest. Delaware courts have held that the

fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.

Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006). To hold a disinterested director liable for a breach of loyalty under Delaware law (such as for indolence in monitoring the company’s affairs), the plaintiff must make a strong showing of misconduct. *In re Lear Corp. S’holder Litig.*, 967 A.2d 640 (Del. Ch. 2008).

Duty of Care

Officers and directors of a corporation must exercise the care that a careful and prudent person would use in similar circumstances and consider all material information reasonably available to them. A breach of the duty of care, without allegations of self-dealing or breach of loyalty, “is possibly the most difficult theory in corporation law upon which a plaintiff might have to win a judgment.” *In re Caremark Int’l, Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996). Only a sustained or systematic failure of the board to exercise oversight will establish the lack of good faith necessary to hold directors liable.

Delaware courts have identified three categories of bad-faith corporate fiduciary conduct: subjective bad faith, motivated by actual intent to do harm; lack of due care, consisting of actions taken without malice, but as the product of gross negligence; and a conscious disregard of the director’s duties, such as acting with a purpose other than the corporation’s best interest, or failing to act in the face of a known duty to act. *Brehm v. Eisner (In re Walt Disney Co. Derivative Litig.)*, 906 A.2d 27 (Del. 2006). The Delaware Supreme Court has rejected the notion that gross negligence, without more, is a breach of the duty to act in good faith.

Business-Judgment Rule

The business-judgment rule protects directors and officers from a claim for breach of the duty of due care. The business-judgment rule is not a substantive rule of law; instead, it creates a presumption “that in making a business decision the director of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company.” *In re Healthco Int’l, Inc.*, 208 B.R. 288, 306 (Bankr. D. Mass. 1997). To raise a reasonable doubt that the directors’ actions are protected by the business-judgment rule, the plaintiff must allege specific facts that would disprove “(1) that the directors are disinterested

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and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.” *Aronson v. Lewis*, 473 A.2d 805, 809 (Del. 1984).

To obtain the protections of the business-judgment rule, the officer or director must diligently and reasonably inform himself or herself of all relevant facts and cannot passively approve important transactions without undertaking any examination of the facts. *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985), *overruled on other grounds*, *Gantler v. Stephans*, 965 A.2d 695 (Del. 2009). A board that meets regularly, hires reputable advisors, and informs itself about the company’s affairs is likely to be protected by the business-judgment rule. *See In re Lear*, 967 A.2d at 655.

Entering the “Zone of Insolvency”

The foregoing rules seemed well established and widely accepted until the Delaware Chancery Court’s decision in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 17 Del. J. Corp. L. 1099, 1991 WL 277613, at *34 (Del. Ch. 1991). There, Chancellor Allen appeared to expand the directors’ duties to protect not only the corporation, but also its creditors, saying, “At least when the corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residual risk bearers, but owes its duty to the corporate enterprise.”

The language of *Credit Lyonnais* led to considerable confusion as to the duties and liabilities of directors in the “zone of insolvency.” Courts held that directors are trustees or “quasi-trustees” for an insolvent corporation’s creditors. Under this “trust-fund” theory, the corporate assets are held in trust for the benefit of creditors, and therefore the directors and officers have duties analogous to those of a trustee—to preserve the assets for the benefit of creditors. Dianne F. Coffino & Charles H. Jeanfreau, “Delaware Hits the Brakes: The Effect of *Gheewalla* and *Trenwick* on Creditor Claims,” 17 *Norton J. Bankr. L. & Prac.* 63.

Courts have also wrestled with the question of when the zone of insolvency arises. A company may be operating in the zone of insolvency when it is not yet technically insolvent, but is nevertheless experiencing financial difficulties. There are two generally accepted tests for determining insolvency. Under the “balance-sheet test,” a debtor is insolvent when the sum of its debts exceeds the fair value of its property. Under the “equitable-insolvency test,” a debtor is insolvent if it lacks sufficient property to pay debts as they mature. Determining when a corporation is in the zone of insolvency became more art than science—leaving boards, officers, and their counsel confused as to when their duties began to expand.

Not surprisingly, the notion that the duties of officers and directors had changed in an undefined zone of insolvency led to a variety of different interpretations. After several years, however, the courts in Delaware and elsewhere began to question the validity of the theory. A series of Delaware cases beginning in 2004 began to prune back the reach of the zone-of-insolvency cases that emerged after *Credit Lyonnais*. The current consensus is that the substantive duties of

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directors and officers do not change, regardless of the solvency of the company or its imminent insolvency.

In *Production Resources Group, LLC v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004), a judgment creditor sought the appointment of a receiver because of alleged wrongdoing by the judgment debtor's management. The creditor alleged breach of fiduciary duties. The Delaware Chancery Court discussed the concept of fiduciary duties in the vicinity of insolvency and the rights of creditors to sue for breach of fiduciary duties.

The *Production Resources* court recognized that *Credit Lyonnais* had given rise to the notion that new duties arose in the "zone of insolvency." That interpretation was incorrect, according to *Production Resources*, which said:

The *Credit Lyonnais* decision's holding and spirit clearly emphasized that directors would be protected by the business judgment rule if they, in good faith, pursued a less risky business strategy precisely because they feared that a more risky strategy might render the firm unable to meet its legal obligations to creditors and other constituencies.

863 A.2d at 788.

Even though the *Production Resources* court did not reject the idea that directors owe existing duties to creditors in the zone of insolvency, it did state that

even in the case of an insolvent firm, poor decisions that lead to a loss of corporate assets and are alleged to be breaches of equitable fiduciary duties remain harms to the corporate entity itself. . . . *The reason for this bears repeating—the fact of insolvency does not change the primary object of the director's concern, which is the firm itself.* The firm's insolvency simply makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value and logically gives them standing to pursue claims to rectify that injury.

Id. at 792 (emphasis added). *Production Resources* thus made clear that the duties of officers and directors do not change when the company is insolvent or in danger of insolvency. And the protections of the business-judgment rule still apply to officers and directors of insolvent companies.

The retrenchment continued with *Trenwick America Litigation Trust v. Ernst & Young, LLP*, 906 A.2d 168 (Del. Ch. 2006). In *Trenwick*, a liquidating trust of an insolvent insurance company sued the parent company's directors for breach of fiduciary duties, claiming that they had followed an imprudent strategy of acquiring operating subsidiaries and had underestimated their potential claims exposure. That exposure ultimately led to the company's insolvency. Among other causes of action, the plaintiff pled "deepening insolvency."

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The Delaware Chancery Court rejected the deepening-insolvency cause of action under Delaware law. In doing so, the court emphasized that fiduciaries of an insolvent corporation have no fiduciary duty to choose a conservative approach over an aggressive approach if both are reasonable under the circumstances:

The incantation of the word insolvency, or even more amorphously, the words zone of insolvency should not declare open season on corporate fiduciaries. Directors are expected to seek profit for stockholders, even at risk of failure. With the prospect of profit often comes the potential for defeat.

....

Even when the firm is insolvent, directors are free to pursue value maximizing strategies, while recognizing that the firm's creditors have become its residual claimants and the advancement of their best interests has become the firm's principal objective.

Id. at 174–75 .

After *Trenwick*, corporate counsel had pretty clear direction, at least in Delaware: The tort of deepening insolvency does not exist under Delaware law.

If the board of an insolvent corporation, acting with due diligence and good faith, pursues a business strategy that it believes will increase the corporation's value but that also involves the incurrance of additional debt, it does not become a guarantor of that strategy's success. That the strategy results in continued insolvency and an even more insolvent entity does not in itself give rise to a cause of action. Rather, in such a scenario, the directors are protected by the business-judgment rule. To conclude otherwise would fundamentally transform Delaware law.

The rejection of an independent cause of action for deepening insolvency does not absolve directors of insolvent corporations of responsibility. Rather, it remits plaintiffs to the contents of their traditional toolkit, which contains, among other things, causes of action for breach of fiduciary duty and for fraud.

Production Resources and *Trenwick* left at least one open question: Can creditors bring direct causes for breach of fiduciary duties, or can they only sue for derivative injury to the corporation itself? That question was answered in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007). There, the Delaware Supreme Court rejected direct claims by creditors in blunt language:

To recognize a new right for creditors to bring fiduciary claims against those directors would create a conflict between those directors' duty to maximize the value of an insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors. Directors of insolvent

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corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation.

930 A.2d at 102–3.

So, for a brief moment, the advice to a board was clear, at least under Delaware law: Directors have the benefit of the business-judgment rule; creditors cannot bring direct causes of action; and rational business judgments, even decisions that turn out poorly, are covered under the business-judgment rule. Given the general deference to Delaware law and the rulings of Delaware courts in matters of corporate governance, commentators began to proclaim the death of deepening insolvency. *See, e.g., Coffino & Jeanfreau, supra.*

Not So Fast

A recent case demonstrates the tenacity of the deepening-insolvency theory. In [*Official Committee of Unsecured Creditors v. Baldwin \(In re Lemington Home for the Aged\)*](#), 659 F.3d 282 (3d Cir. 2011), the Third Circuit announced that while deepening insolvency may not be a viable cause of action under Delaware law, it is a viable cause of action under Pennsylvania law; directors owe fiduciary duties to the creditors of an insolvent entity; and the business-judgment rule can be overcome by evidence of simple negligence, not only gross negligence. The Third Circuit's holding, which vacated the district court's order of summary judgment in favor of the company's directors and officers, highlights several key differences between Pennsylvania law and Delaware law pertaining to fiduciary duties, the business-judgment rule, and deepening insolvency. Nevertheless, this decision is likely to revive the debate over the zone of insolvency and the progeny of *Credit Lyonnais*.

Background

In April 2005, Lemington Home filed a voluntary Chapter 11 petition in the Bankruptcy Court for the Western District of Pennsylvania with a goal of transferring Lemington Home's principal charitable asset to an affiliate whose board was composed of Lemington Home's directors. In November 2005, the Bankruptcy Court granted the creditors committee's motion to commence an adversary proceeding in the district court against Lemington Home's directors and officers.

In its complaint, the committee asserted claims against the directors and officers for breach of the fiduciary duties of care and loyalty and for deepening insolvency. The district court granted the directors' and officers' motion for summary judgment, finding that the business-judgment rule precluded the committee's claims of breach and the committee would be unable to show the fraud necessary to support a claim of deepening insolvency.

On appeal, the Third Circuit vacated the district court order and remanded the case for trial. The Third Circuit held that the district court had improperly relied on *Aronson*, which held that director liability could only be premised on gross negligence. 473 A.2d at 812. "Pennsylvania, however, recognizes directors' and officers' liability for *negligent* breach of fiduciary duty." *In re Lemington Home*, 659 F.3d at 292 n.5 (citation omitted).

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The Third Circuit also held that officers and directors owed fiduciary duties “not only to the corporation and its shareholders, but to the creditors of an insolvent entity.” *Id.* at 290, citing *Citigroup Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims*, 160 F.3d 982, 987–88 (3d Cir. 1998). The Third Circuit’s ruling is diametrically opposed to the *Gheewalla* decision. While *Gheewalla* holds that creditors have only derivative claims against directors and officers, *Lemington Home* holds that directors owe direct duties to creditors.

This holding is disturbing, particularly because it relies on *Citigroup Venture Capital* as support. In *Citicorp Venture Capital*, the challenged conduct occurred after the bankruptcy filing. No one seriously disputes that debtors (and their directors and officers) owe fiduciary duties to creditors after a bankruptcy filing. It is far less clear, however, that such duties are owed prior to the filing. The *Lemington Home* court’s decision, relying on inapposite case law, has given new life to a discredited legal theory.

But the *Lemington Home* court was not finished. The court first announced a lower standard of liability for directors and officers, and unduly broadened the scope of directors’ fiduciary duties. Then, finding that a cause of action for deepening insolvency “has not been formally recognized by Pennsylvania state courts,” the Third Circuit held that its prior decision in *In re Lafferty*, 267 F.3d 340 (3d Cir. 2001), compelled a holding that deepening insolvency was a viable cause of action under Pennsylvania law. The Third Circuit acknowledged the growing judicial and scholarly criticism of deepening insolvency, but found that even “if our precedent is erroneous . . . it can only be overturned by this Court *en banc*.” *In re Lemington Home*, 659 F.3d at 294 n.6.

Under Pennsylvania law, deepening insolvency is defined as “an injury to [a debtor’s] corporate property from the fraudulent expansion of a corporate debt and prolongation of corporate life.” *Id.* A plaintiff must show that the directors’ actions were fraudulent, not merely negligent. In *Lemington Home*, the district court had ruled that the committee would not be able to show the necessary fraud to support a deepening-insolvency claim. The Third Circuit, considering the evidence in the light most favorable to the committee as the nonmoving party, disagreed.

The Third Circuit held that fraud is “anything calculated to deceive, whether by single act or combination, or by suppression of truth” and that the committee had raised a genuine issue of material fact for a finding of fraud, which made summary judgment inappropriate. The facts that might support a finding of fraud included that the directors had delayed the filing of bankruptcy for three months, commingled Lemington Home’s funds with related entities’ funds, let the company continue to do business with vendors despite its insolvency, and transferred some of Lemington Home’s assets to related entities post-petition. The committee therefore had sufficient evidence to bring a claim that the directors knew that Lemington Home was insolvent, that they planned on filing for bankruptcy, and that their actions would cause further insolvency, but they nevertheless failed to inform its creditors of Lemington Home’s insolvency.



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Although these facts are arguably consistent with a claim of fraud, the Third Circuit's ruling may be further proof that "bad facts make bad law." It is troubling, however, that the court held that "suppression of truth" is the equivalent of fraud in the context of insolvency. That language implies that a debtor that is—insolvent? approaching insolvency? in the zone of insolvency?—owes a fiduciary duty to its creditors to advise those creditors of its financial problems. That kind of candor seems inconsistent with the directors' duty to preserve value for the corporation and its shareholders.

Directors and officers are often faced with difficult decisions, and awkward communications with vendors and other creditors. Life will not be any easier for them if they are legally obligated to refrain from "suppressing the truth." The Third Circuit has announced an unrealistic standard of conduct that may give rise to further confusion in a difficult and unsettled area of law.

The *Lemington Home* decision may have limited impact. After all, far fewer corporations are governed by Pennsylvania law than by Delaware law. It is worth remembering, however, that courts may not find Delaware cases—or Delaware statutes—controlling in deciding issues of director and officer liability.

Keywords: litigation, business torts, director and officer liability, breach of fiduciary duty

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Revival of the Adverse Domination Doctrine

By Michael White and Nathan Viavant – February 29, 2012

The death spiral of a corporation or a bank can often be a long one. All the while, the directors and officers may be taking steps to prop up the failing institution. As a result, the discovery of misconduct may be delayed for years and, in many instances, may not occur until after the statute of limitations has expired. The current economic crises and resulting litigation aptly demonstrate the problems and solutions to pursuing claims against directors and officers in such circumstances.

Since the consequences of the current financial crisis began to become clear at the end of 2007, the Federal Deposit Insurance Corporation (FDIC) has closed hundreds of banking institutions, and it will likely close hundreds more in the near future. One recent article put the total number of banks that have disappeared since 2007 by failure, merger, or acquisition at roughly 1,000, with 865 banks still on the FDIC's "problem" list at the end of June 2011. Victoria McGrane, "FDIC's Latest Closings: Its Own Offices," *Wall St. J.*, Oct. 3, 2011. FDIC bank closures have often been followed by allegations of nonfeasance, malfeasance, and even fraudulent lending and banking practices attributable to bank directors and have resulted in claims by the FDIC against the bank's directors. Most of the claims available are based on alleged violations of state law and are subject to state statutes of limitation as short as two years.

Historical Development of the Doctrine of Adverse Domination

During a previous financial crisis, the savings and loan turmoil of the 1980s, the Resolution Trust Corporation (RTC), predecessor to the FDIC, successfully relied on the doctrine of adverse domination to revive otherwise stale state-law claims for breach of fiduciary duties. What is the likelihood such claims can succeed in the current political, economic, and legal climate? The answer may be found in the reincarnation of the doctrine of adverse domination. This doctrine allows courts to decline to enforce state statutes of limitation that would otherwise bar claims against bank directors for breaches of fiduciary duties.

In general, a statute of limitation for breach of fiduciary duty against the directors of a corporation begins to run from the time of their wrongful acts. What happens, however, when one or more of those directors exercises control or influence to prevent the discovery or pursuit of the claims? While the answer to this question has been determined to be one of state law, federal courts ruling under state law have developed and applied the doctrine of adverse domination in a way that may continue to open the door to otherwise stale claims.

Most often, the doctrine is described as "merely a corollary of . . . [the] discovery rule, applied in the corporate context," *RTC v. Farmer*, 865 F. Supp. 1143, 1154 n.11 (E.D. Pa. 1994) (citing *In re Lloyd Securities*, 153 B.R. 677, 685 (E.D. Pa. 1993)), to toll the statute of limitations while a corporate plaintiff continues under the domination of the wrongdoers; in other words, until they cease to be directors. As a practical matter, many courts find that where the agents of the



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corporation who know of the injury are themselves the wrongdoers, the corporation cannot “discover” knowledge known only to its offending agents:

It is the “inherently unknowable” character of the injury that is the critical factor that governs the applicability of the discovery rule A corporate plaintiff does not have “knowledge” of an injury to itself until those individuals who control it know of the injury and are willing to act on that knowledge.

Id. at 1155.

As a result, the adverse domination rule “presumes that actual notice will not be available until the corporate plaintiff is no longer under the control of the erring directors.” *Hecht v. RTC*, 333 Md. 324, 635 A.2d 394, 405 (Md. 1994).

Courts also often apply the related rationale of equitable estoppel. Under these principles, courts seek to prevent the culpable directors from benefiting from their lack of action on behalf of the corporation:

Is it logical to assume that the directors, in whom the bank has entrusted the discretion to sue, would authorize the initiation of an action against themselves for their own improprieties? To permit bank directors who control and dominate the affairs of a bank to benefit from their own inaction by finding that, as a matter of law, limitations run from the moment of their commission of improprieties, is a result which justice could not tolerate.

FDIC v. Bird, 516 F. Supp. 647, 651 (D.P.R. 1981).

Under either of these rationales, the doctrine will not apply if other non-culpable directors or the shareholders have actual knowledge of the culpable director’s misconduct. *Int’l Rys. of Cent. Am. v. United Fruit Co.*, 373 F.2d 408, 414 (2d Cir. 1967).

Learning from Past Lessons

Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) in 1989 to respond to the 1980s’ savings and loan debacle. The FIRREA established the RTC and gave it the power to pursue claims against directors and officers. The RTC typically filed suit against the directors and officers in federal court, and, as a result, much of the jurisprudence on the doctrine involves federal courts interpreting and applying state statutes of limitation. The federal courts did not, however, create the doctrine from whole cloth. The doctrine is often traced back to the 1967 case of *International Railways of Central America v. United Fruit Co.*, in which the court ruled that

a plaintiff who seeks to toll the statute [of limitations] on the basis of domination of a corporation has the burden of showing a full, complete and exclusive control in the directors or officers charged. . . . This principle must mean at least that once the facts

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giving rise to possible liability are known, the plaintiff must effectively negate the possibility that an informed stockholder or director could have induced the corporation to sue.

373 F.2d at 414.

With these principles as building blocks, the RTC filed hundreds of lawsuits on behalf of failed institutions against the institutions' directors and officers. The RTC faced a difficult challenge, however, because the defendants often asserted that the applicable state statutes of limitation had run by the time the RTC was able to investigate and prosecute the claims. To get around this problem, the RTC often successfully invoked the doctrine of adverse domination, relying on its two related principles that knowledge of the wrongdoing should not be imputed to the corporation for so long as the offending directors and officers were in control and that the corporation could not discover and act upon the wrongdoing so as to trigger the running of the statute of limitation until those directors and officers were ousted.

Over the ensuing years, most courts that have considered the doctrine have embraced it, although they have done so to varying degrees and with differing rationales. They have differed on the degree of domination of the board required for the corporation to claim tolling under the doctrine, the burden of proof as to domination, and the degree of culpability that the plaintiff must allege against the directors. State interpretations of the common-law discovery rule, the imputation of corporate knowledge, and the application of the discovery rule in negligence cases also can bear on how the state court will apply the doctrine of adverse domination.

Application of the Doctrine Throughout the Country

Before discussing the differences in application of the doctrine, it should be noted that a few courts have either rejected the doctrine outright or refused to evolve discovery-rule or equitable-estoppel doctrines into a formal recognition of adverse domination. *See RTC v. Armbruster*, 52 F.3d 748, 751–52 (8th Cir. 1995); *RTC v. Artley*, 28 F.3d 1099 (11th Cir. 1994); *FDIC v. Cocks*, 7 F.3d 396 (4th Cir. 1993); *RTC v. Everhart*, 37 F.3d 151, 155 (4th Cir. 1994). As explained by one federal court ruling under Virginia law, the doctrine of equitable estoppel was sufficient, without embracing adverse domination, to “hold that a statute of limitations is tolled until a person intentionally misled by a putative defendant could reasonably discover the wrongdoing and bring action to redress it.” *Cocks*, 7 F.3d at 402. As this decision suggests, whether or not a court will embrace adverse domination under the laws of a given state depends, in part, on whether there exists an independent state discovery rule recognizing tolling and the nature of the state's doctrine of equitable estoppel.

While a majority of state high courts and federal circuits interpreting state law have recognized the doctrine of adverse domination—as stated by West Virginia's highest court, “Indeed, the adverse domination doctrine appears to be well settled law in many states, and it has been generally accepted by federal courts to be the law of states that have not yet explicitly ruled on the subject themselves,” *Clark v. Milam*, 452 S.E.2d 714 (W. Va. 1994) (citing cases)—they

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have embraced a variety of standards in doing so. As a result, divisions have emerged on a number of issues that are essential to understanding the application of adverse domination in varying jurisdictions, including the level of control required to prove domination, the degree of culpability required, and the burden of proof. *FDIC v. Dawson*, 4 F.3d 1303, 1309 (5th Cir. 1993).

How Much Control Is Required to Demonstrate Domination?

As the name suggests, adverse domination requires that the company, through its board members, be “dominated” by culpable wrongdoers. Courts disagree, however, as to the level of board domination required to toll a statute of limitations. Courts recognizing adverse domination generally apply either the “complete domination test” (sometimes referred to as the “single disinterested director” test) or, more commonly, the “majority domination test” to determine whether the wrongdoers sufficiently dominate the corporation to invoke adverse domination. Under the complete domination test, the plaintiff must prove that no informed director was capable of suing or willing to do so. As explained by one court, a plaintiff has the burden to show “a full, complete and exclusive control in the directors or officers charged.” *Farmers & Merchants Nat’l Bank v. Bryan*, 902 F.2d 1520, 1523 (10th Cir. 1990); *see also RTC v. Farmer*, 865 F. Supp. 1143, 1157 (“[T]he plaintiff must negate the possibility that an informed person or persons could have induced the corporation to initiate suit.”). This test presents a high bar to the plaintiff, and a number of courts have explained the practical problem with such a high standard. As one court described it, “this rule is considered *harder* to satisfy than the majority version [of the adverse domination doctrine] because it relies on no presumption of domination,” even after a plaintiff has shown that a majority of directors were culpable. *FDIC v. Henderson*, 61 F.3d 421, 427 (5th Cir. 1995).

In contrast, the majority test requires a plaintiff to “show only that a majority of the board members were wrongdoers during the period the plaintiff seeks to toll the statute.” *Dawson*, 4 F.3d at 1310 (finding that the majority rule, “a more prophylactic approach,” would apply under Texas law). This standard presents a much more manageable burden to a plaintiff seeking to toll a statute of limitations. Under the majority test, even courts applying a “narrow” interpretation of adverse domination have held that, while the plaintiff must show that a majority of directors was culpable, “it is not necessary to sue a majority of the board to obtain a finding of adverse domination.” *Henderson*, 61 F.3d at 426. Decisions on adverse domination have identified no specific element of state law predicate to a choice between the complete domination and majority domination standards. However, the practical considerations of meeting the high standard of the complete domination test and the reality of board domination have prompted most courts to favor the majority domination standard. As the Oregon Supreme Court stated, “We conclude that the ‘disinterested majority’ version of the [adverse domination] doctrine more closely mirrors human nature.” *FDIC v. Smith*, 980 P.2d 141, 148 (Or. 1999). As another court explained:

As long as the majority of the board of directors are culpable they may continue to operate the association and control it in an effort to prevent action from being taken

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against them. While they retain control they can dominate the non-culpable directors and control the most likely sources of information and funding necessary to pursue the rights of the association. As a result it may be extremely difficult, if not impossible, for the corporation to discover and pursue its rights while the wrongdoers retain control.

Dawson, 4 F.3d at 1310.

What Level of Misconduct Must Be Shown to Trigger the Doctrine?

Congress amended the FIRREA in 1994 to toll state statutes of limitation for claims of “fraud, intentional misconduct resulting in unjust enrichment, or intentional misconduct resulting in substantial loss to the institution.” 18 U.S.C. § 1821(d)(14)(C). Even before that amendment, some state courts set the bar at fraudulent or intentional misconduct. *See, e.g., RTC v. Farmer*, 865 F. Supp. 1143, 1157 (E.D. Pa. 1994).

Whether lesser degrees of culpability will also toll state statutes of limitation is a matter of state law. *See, e.g., RTC v. Acton*, 49 F.3d 1086, 1090 (5th Cir. 1995). Accordingly, the standards applied vary depending on applicable state law. At least one court has found that the degree of culpability is irrelevant and that the statute of limitations is tolled because the plaintiffs cannot determine the cause of action. *See Clark v. Milam*, 452 S.E.2d 714, 719 (W. Va. 1994) (“[R]egardless of whether the alleged wrongdoing was intentional or merely negligent, the knowledge of officers’ and directors’ wrongdoing cannot be imputed to the corporation because those officers’ and directors’ control over the corporation prevents it from learning of the misconduct that is injuring it.”) Some courts apply the doctrine to claims of simple negligence. They often do so by analogizing to how courts use the discovery rule in other claims grounded in negligence, such as medical malpractice. *See, e.g., RTC v. Scaletty*, 891 P.2d 1110, 1117 (Kan. 1995); *RTC v. Hecht*, 818 F. Supp. 894 (D. Md. 1992). While one might imagine that the business-judgment rule could shield directors against claims of mere negligence, directors of financial institutions in particular are generally responsible for a higher standard of care. *See, e.g., Norma Hildenbrand*, “D&O Liability: Expansion via Regulation,” 111 *Banking L.J.* 365, 379 (1994).

Other courts require some affirmative showing of misconduct, particularly where FIRREA claims are at issue, or suggest a minimum requirement of gross negligence. *FDIC v. Jackson*, 133 F.3d 694, 699 (9th Cir. 1998) (“Because applying the adverse domination doctrine to negligent conduct is more consistent with its past approach, we hold that the Arizona Supreme Court would find that, at a minimum, gross negligence, rather than merely fraud or intentional misconduct, tolls the statute of limitations.”).

Who Has the Burden to Prove Adverse Domination?

Under the complete domination test and the majority test, the plaintiff has the burden of proving adverse domination. *See, e.g., FDIC v. Dawson*, 4 F.3d 1303, 1311 (5th Cir. 1993). In the last decades, however, courts have begun applying tests that combine the level of domination with the burden of proof. *See, e.g., FDIC v. Smith*, 980 P.2d, 141, 147–48 (Or. 1999); *Wilson v. Paine*,



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288 S.W.3d 284, 288 (Ky. 2009). Courts embracing the complete domination test, for example, apply a “single disinterested director” version of the doctrine in which “a plaintiff has the burden of showing that the culpable directors had full, complete, and exclusive control of the corporation, and must negate the possibility that an informed director could have induced the corporation to sue.” *Smith*, 980 P.2d at 145 (citations omitted).

Courts applying a majority test regarding the level of corporate domination now apply a “disinterested majority” version of the doctrine, which initially places the burden on the plaintiff to show that a majority of the board is culpable. *Dawson*, 4 F.3d at 1310; *Wilson*, 288 S.W.3d at 288 (“A majority of jurisdictions follow the disinterested majority test, whereby a plaintiff is required to show that a majority of the board members were wrongdoers during the period the plaintiff seeks to toll the statute of limitations.”). Once the plaintiff has met its burden under this standard, the burden shifts to the defendant to prove that some member of the board was willing and able to sue on behalf of the corporation. *See, e.g., FDIC v. Henderson*, 61 F.3d 421, 426 (5th Cir. 1995) (“Proof that a majority of the board is actively and purposefully engaged in the wrongdoing reverses the presumption that informed directors will induce the corporation to sue culpable ones and thereby establishes that the institutions are dominated by directors adverse to the claims in question.”); *Hecht v. RTC*, 635 A.2d 394, 406 (Md. 1994); *RTC v. Scaletty*, 891 P.2d 1110, 1113 (Kan. 1995); *RTC v. Grant*, 901 P.2d 807, 816 (Okla. 1995). The Oregon Supreme Court, for example, favors the majority test/disinterested majority burden of proof, saying, “Because a board composed of a majority of culpable directors will rarely, if ever, facilitate the assertion of claims against its members, it is appropriate that those directors bear the burden of proving otherwise.” *Smith*, 980 P.2d at 148.

The Potential for Broader Application of the Adverse Domination Doctrine

While this article has explored the contours of the adverse domination doctrine in the context of actions involving financial institutions, the doctrine is not necessarily limited to that arena. The rationales supporting the doctrine apply with equal force to private actions, as demonstrated by the *International Railways* case credited with first enunciating the doctrine. If the facts and the equities warrant relief from the time bar of an applicable statute of limitations, the doctrine of adverse domination can be an effective tool to overcome that bar and allow a claim to be heard. *See, e.g., Safecard Servs., Inc. v. Halmos*, 912 P.2d 1132 (Wyo. 1996).

Keywords: litigation, business torts, adverse domination doctrine, misconduct, statute of limitations

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Supreme Court Examines the Fiduciary Exception to Privilege

By David Dodds – February 29, 2012

The attorney-client privilege is one of the oldest and most venerable privileges under the common law. However, the privilege is not absolute, and many courts have recognized an exception to the privilege in the context of certain fiduciary relationships. Originally grounded in the common law of trusts, the “fiduciary exception” to the attorney-client privilege permits the beneficiaries of a trust to obtain privileged communications where the trustee obtains legal advice related to the exercise of his fiduciary duties in connection with the administration of the trust. The fiduciary exception has since been applied by courts to other fiduciary relationships beyond the traditional trust context—for example, fiduciary relationships in the Employee Retirement Income Security Act (ERISA) and corporate shareholder contexts.

Against this backdrop, the U.S. Supreme Court issued its recent opinion in *United States v. Jicarilla Apache Nation*, 564 U.S. ___, 131 S. Ct. 2313 (2011), holding that the fiduciary exception to the attorney-client privilege does not apply to the U.S. government’s administration of Indian trusts. Although the specific holding in the *Jicarilla* decision has limited application, the Supreme Court’s analysis is instructive with respect to the application of the fiduciary exception to other types of fiduciary relationships.

Background

The *Jicarilla* case involved a breach-of-trust action by an Indian tribe against the federal government for alleged mismanagement of funds held in trust for the tribe. The government withheld certain documents from production on the basis of the attorney-client privilege. The tribe moved to compel the government to produce the withheld documents. The lower courts held that the common-law fiduciary exception to the attorney-client privilege applied to require production. The Supreme Court reversed and held that the fiduciary exception did not apply in this context.

Analysis

The Supreme Court acknowledged that some state courts—including in Texas and in California—have “altogether rejected the notion that the attorney-client privilege is subject to a fiduciary exception.” However, neither party in *Jicarilla* disputed the existence of a common-law fiduciary exception, and therefore the Court assumed that such an exception exists. The Court commented that American courts began adopting the fiduciary exception by the 1970s, noting the Fifth Circuit’s opinion in *Garner v. Wolfenbarger*, 430 F.2d 1093 (5th Cir. 1970), which allowed shareholders, on a showing of “good cause,” to discover legal advice given to corporate management.

The Supreme Court in *Jicarilla* identified two reasons for applying the common-law fiduciary exception, based on the leading case of *Riggs National Bank of Washington, D.C. v. Zimmer*, 355

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A.2d 709 (Del. Ch. 1976). First, the court in *Riggs* explained that the trustees had obtained the legal advice at issue as “mere representative[s]” of the beneficiaries because the trustees had a fiduciary obligation to act in the beneficiaries’ interest when administering the trust. For this reason, the beneficiaries were the “real clients” of the attorney who had advised the trustees on trust-related matters, and therefore the attorney-client privilege belonged to the beneficiaries rather than the trustees. As described in *Jicarilla*, the court in *Riggs* based its “real client” determination on several factors, including whether there was a reason for the trustees to seek legal advice in a personal rather than a representative capacity, whether the legal advice was intended for any purpose other than to benefit the trust, and whether the attorney had been paid out of trust assets. Second, the court in *Riggs* concluded that the trustees’ fiduciary duty to furnish trust-related information to the beneficiaries outweighed the trustees’ interest in the attorney-client privilege.

In *Jicarilla*, the Supreme Court held that, unlike a private trust under the common law, the statutory Indian trust at issue was derived from the unique position of the U.S. government as a sovereign and was governed by federal statutes. These statutes, and the regulations promulgated under them, established the fiduciary relationship and defined the contours of the government’s fiduciary responsibilities. Thus, the Indian tribe was required to identify a right conferred by statute or regulation to obtain otherwise privileged information from the government against its wishes. In this statutory context, the court found that the two features justifying the fiduciary exception—the beneficiary’s status as the real “client” and a trustee’s common-law duty to disclose information about the trust—were absent in the general trust relationship between the United States and the Indian people.

As to the first feature, the Court held that the United States did not obtain legal advice as a “mere representative” of the tribe, nor was the tribe the “real client” for whom the advice was intended. Although the source of payment of legal fees is not usually determinative of client status, the Court found it significant that the government’s attorneys were paid out of congressional appropriations at no cost to the tribe, and that these attorneys were paid to render advice regarding the government’s statutory obligations. This payment structure confirmed the Court’s view that the government sought legal advice in its sovereign capacity rather than as a conventional fiduciary of the tribe. The Court concluded that the government’s sovereign interest in the administration of Indian trusts is distinct and independent from the interests of tribes who may benefit from the trusts. Thus, the government’s request for legal advice related to the administration of the trusts was in a “personal” rather than a fiduciary capacity. Moreover, the government had too many potential competing legal concerns to allow for a case-by-case inquiry into whether the purpose of each communication with counsel triggered the fiduciary exception.

As to the second feature, the Court concluded that the United States does not have the same common-law disclosure obligations as a private trustee. The government had already complied with the specific disclosure requirements enumerated in the trust-creating statute. The Court held that the common law of trusts did not override these specific statutory requirements. The Court



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declined to construe the statute to include a general common-law duty to disclose all information related to the administration of Indian trusts.

Implications of the *Jicarilla* decision

The *Jicarilla* decision is instructive as to the applicability and contours of the fiduciary exception to the attorney-client privilege. Trustees and other fiduciaries should expect that the decision will be cited by beneficiaries seeking to compel the production of privileged communications between fiduciaries and their counsel.

As a threshold matter, the Court's recognition that the fiduciary exception has not been recognized in some states demonstrates a potential issue as to which privilege law applies. In federal cases, counsel should consider whether federal or state privilege law applies. *See* Fed. R. Evid. 501. Assuming state privilege law applies, counsel should consult applicable choice-of-law principles in determining which state's privilege law should apply.

The *Jicarilla* decision also illustrates the application of the two criteria traditionally required for the fiduciary exception to apply—the beneficiary's status as the "real client" and the trustee's duty to disclose trust-related information to the beneficiary. To the extent a particular relationship does not satisfy these two criteria, courts following the analysis in *Jicarilla* would likely hold that the fiduciary exception does not apply.

Keywords: litigation, business torts, fiduciary exception, attorney-client privilege, Supreme Court

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Reasonableness Standard Versus Business-Judgment Rule

By Mark Nichols – February 29, 2012

Collecting homeowners' association fees from unit owners in foreclosure, fixing leaky roofs from hurricane damage, and hiring a new landscaper. These are just a few examples of the many decisions that a condominium association's board of directors must consider on a regular basis. The condominium association is the governing body of a community, with duties ranging from promulgating and enforcing rules and regulations to handling financial matters such as the collection of dues. *See Matter of Levandusky v. One Fifth Ave. Apartment Corp.*, 75 N.Y.2d 530, 536 (N.Y. 1990); *Papalexiou v. Tower W. Condo.*, 401 A.2d 280, 285 (N.J. Super. 1979). Those brave few who volunteer to serve on the association's board should always remember that it is nearly universally accepted that they owe a fiduciary duty to all of the association's members. *See, e.g., Bd. of Managers of Weathersfield Condo. Ass'n v. Schaumburg Ltd. P'ship*, 717 N.E.2d 429, 436 (Ill. App. 1999); *Bd. of Managers of Fairways at North Hills Condo. v. Fairway at North Hills*, 603 N.Y.S.2d 867, 870 (1993); *Schwarzmann v. Ass'n of Apartment Owners*, 655 P.2d 1177 (Wash. 1982). *But see Smith v. Ridgeview Homeowner's Ass'n*, 2011 WL 1743787, at *3 (Minn. Ct. App. 2011) (holding the governing body of a condominium association owes a duty to members as a whole as opposed to individual unit owners); *Office One, Inc. v. Lopez*, 769 N.E.2d 749 (Mass. 2002) (holding that members of the governing board of a condominium association, in their capacity as trustees, owe no fiduciary duty to individual unit owners).

When a disgruntled condominium unit owner challenges the board's decision through litigation, under what standard will the board's action be governed? The answer depends on the jurisdiction, and even then, the answer is not entirely clear. Most jurisdictions apply one of two standards: reasonableness or business judgment. Under the reasonableness standard, the condominium association's board of directors must demonstrate its decision was reasonable, thus requiring the court to conduct a fact-intensive inquiry into the substantive and procedural decision-making process. *See, e.g., Bolandz v. 1230-1250 Twenty-Third Street Condo. Unit Owners Ass'n*, 849 A.2d 1010, 1014–15 (D.C. 2004). On the other hand, the business-judgment rule gives deference to the decision made by a condominium association's board of directors absent a showing of fraud, bad faith, incompetence, or a variety of other factors varying by jurisdiction. *See, e.g., Micheve, LLC v. Wyndham Place at Freehold Condo. Ass'n*, 885 A.2d 35, 39 (N.J. App. Div. 2005) (finding the business-judgment rule afforded when the board's actions authorized by statute or its own bylaws, and when the decision is not fraudulent, self-dealing, or unconscionable); *Black v. Fox Hills N. Cmty. Ass'n*, 599 A.2d 1228, 1231–32 (Md. App. 1992) (holding the business-judgment rule precludes the judicial review of a condominium association's board of directors absent fraud or bad faith).

While courts try to distinguish their decisions to neatly fit under one of the two standards, the history of cases involving decisions of condominium association boards of directors proves the

two concepts to be anything but neatly distinguished. In fact, case law shows “reasonableness” and “business judgment” in the context of condominium associations to be more like overlapping circles on a Venn diagram than two separate, distinct standards.

Origin of the Reasonableness and Business-Judgment Confusion

One of the earliest cases to consider the standard for reviewing a decision of a condominium association’s board of directors is *Hidden Harbour Estates, Inc. v. Norman (Hidden Harbour I)*, 309 So. 2d 180 (Fla. 4th Dist. Ct. App. 1975). In *Hidden Harbour I*, the association’s board of directors adopted a rule, subsequently ratified by the vote of unit owners, prohibiting alcoholic beverages from the clubhouse and adjacent areas. *Id.* at 181. The trial court granted a permanent injunction prohibiting the association from enforcing the rule because the action engaged in by the board constituted a nuisance. The Fourth District reversed, concluding the association can adopt rules passing the test of “reasonableness,” and each case must be reviewed based on the particular facts and circumstances. *Id.* at 181–82. The Fourth District held the same standard in *Hidden Harbour Estates, Inc. v. Basso (Hidden Harbour II)*, 393 So. 2d 637 (Fla. 4th Dist. Ct. App. 1981). In *Hidden Harbour II*, the association’s board of directors denied the association members the right to drill a well next to their mobile home unit. *Id.* at 638. The members drilled the well anyway, and the trial court denied injunctive relief to Hidden Harbour. On appeal, the Fourth District held the board of directors must demonstrate “reasonableness” when the validity of promulgated rules is challenged or when a board refuses an owner’s action where the board has the power to grant or deny the action. *Id.* at 640. Because Hidden Harbour failed to demonstrate its decision to deny the drilling of a well was reasonably related to its concerns, the Fourth District affirmed the trial court’s ruling.

In between *Hidden Harbour I* and *II*, the Superior Court in New Jersey decided *Papalexidou v. Tower West Condominium*, 401 A.2d 280 (N.J. Super. 1979). In *Papalexidou*, the board of directors for Tower West Condominium voted to levy an assessment of \$100,000 to pay overdue bills and repair leaks in the roof. *Id.* at 284. All but seven unit owners paid the special assessment. The remaining unit owners secured an injunction restraining the association from asserting a lien or imposing other sanctions on the nonpaying owners. *Id.* at 282. In beginning its analysis, the court cited *Hidden Harbour I* for the “test of reasonableness.” *Id.* at 285. The court also cited *Ryan v. Baptiste*, 565 S.W.2d 196, 198 (Mo. Ct. App. 1976), in which the Missouri Court of Appeals considered the reasonableness of a board’s actions by weighing the rights of objecting owners against the rights of the entire residential community.

The *Papalexidou* court inexplicably transitioned from the “reasonableness” rules of *Hidden Harbour I* and *Ryan* to a discussion of the business-judgment rule. The court defined the business-judgment rule to require a showing of fraud or lack of good faith before a board’s decisions can be questioned. *Id.* at 285–86. The court held fraud, self-dealing, or unconscionable conduct must be evidenced before a court will review authorized conduct of directors. *Id.* at 286; *see also Comm. for a Better Twin Rivers v. Twin Rivers Homeowners’ Ass’n*, 929 A.2d 1060, 1074 (N.J. 2007). In declining the invitation to review the board’s decision, the court found no

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fraud, lack of good faith, self-dealing, dishonesty, or incompetence in the decision-making process. *Id.* at 286–87.

The only link between the “reasonableness” discussion and the “business judgment” holding is the court’s explanation that, while directors are not expected to be perfect, “[a]ll that is required is that the persons in such positions act reasonably and in good faith in carrying out their duties.” *Id.* at 286. Without rejecting the holdings of *Hidden Harbour I* or *Ryan*, the court did no analysis of the particular facts and circumstances nor any balancing test of the objecting owners’ rights versus the rights of the community at large. Left unclear by the court’s decision is whether there remains an argument to be made that boards’ decisions can be overturned by showing unreasonableness.

In an oft-cited and arguably clearer opinion, the New York Court of Appeals addressed the issue of “reasonableness” versus “business judgment” head-on in *Matter of Levandusky v. One Fifth Avenue Apartment Corp.*, 75 N.Y.2d 530 (N.Y. 1990). In accordance with an agreement the board and Levandusky executed, the board of directors for the condominium cooperative issued a stop-work order to prevent Levandusky from moving a steam riser pipe in violation of Levandusky’s proprietary lease. *Id.* at 533–34. The supreme court initially granted Levandusky’s petition to set the stop-work order aside and held the board’s decision to stop the renovations was “arbitrary and capricious.” *Id.* at 535. On rehearing, the supreme court withdrew its decision, holding it was “precluded by the business judgment rule from reviewing the board’s determination.” *Id.* On appeal, a majority of justices in the appellate division agreed with the original supreme court decision, while two justices dissented and agreed the board’s actions were not subject to judicial review under the business-judgment rule.

After a thorough discussion about the role a cooperative or condominium association board of directors plays in governing the affairs of the respective community, and the unit owners’ rights they tacitly relinquished by agreeing to be regulated by the rules and regulations, the court of appeals held the appropriate standard of review for a board’s decisions is analogous to the business-judgment rule. *Id.* at 536–37. “So long as the board acts for the purposes of the cooperative, within the scope of its authority and in good faith, courts will not substitute their judgment for the board.” *Id.* at 538; *see also Yusin v. Saddle Lakes Home Owners Ass’n*, 73 A.D.3d 1168, 1170–71 (N.Y. App. Div. 2010). The court further supported its opinion by citing other cases inside and outside of its jurisdiction (including *Papalexiou*) applying the business-judgment rule to cooperative and condominium boards. *Id.* at 537.

The court of appeals then took the extra step the court in *Papalexiou* did not take by explicitly rejecting the “reasonableness” test. *Id.* at 538. The court recognized the “reasonableness” standard and business-judgment rule have a lot in common, but pointed out the two biggest differences. *Id.* at 539. First, the business-judgment rule places the burden on the objecting unit owner to demonstrate the breach of fiduciary duty, whereas the reasonableness standard places the burden on the board to show the decision was reasonable. And, second, citing *Hidden Harbour II*, the reasonableness standard requires the court to independently evaluate the board’s

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decision. The court of appeals, therefore, decided the more appropriate standard was the one of limited judicial review.

New York is one of the few jurisdictions in which an appellate court went the extra mile to explain what the reasonableness standard is, what the business-judgment rule is, and why one is more beneficial than the other. Most other jurisdictions fail to provide a clear statement of the standard to be applied. The court selects one of the standards without a thorough review of the other and, in skipping this part of the process, conflates the two. It is understandably difficult to separate them, as the analysis in *Levandusky* illustrates. But a review of opinions from around the country demonstrates some courts are not just conflating them, but also perhaps mislabeling them.

Does the Business-Judgment Rule Require Finding Reasonableness?

As discussed in *Papalexiou* and *Levandusky*, the business-judgment rule restricts a court's ability to review the substance of a decision made by the condominium association's board of directors. Some courts looked to stay in line with these early cases on point. The Court of Special Appeals of Maryland cited *Papalexiou* in adopting Maryland's business-judgment rule, requiring the court to give deference to a board's decision absent bad faith or fraud. *Black v. Fox Hills N. Cmty. Ass'n*, 599 A.2d 1228, 1231–32 (Md. App. 1992). The Superior Court of Massachusetts adopted the business-judgment rule discussed in *Levandusky* and held trustees of the condominium trust were not liable for actions "taken in good faith and in the exercise of business judgment in the lawful and legitimate furtherance" of the unit owner's interests. *Pederzani v. Guerriere*, 1995 WL 1146832, at *1 (Mass. Super. Ct. 1995). The Superior Court of Connecticut also adopted the business-judgment rule as enumerated in *Levandusky*. *Powder Farm Park Ass'n v. SKF Leader Hill, LLC*, 2008 WL 4853332, at *4 (Conn. Super. Ct. 2008).

Another one of the leading cases applying the business-judgment rule to condominium associations is *Lamden v. La Jolla Clubdominium Homeowners Ass'n*, 980 P.2d 940 (Cal. 1999). In *Lamden*, the Supreme Court of California reviewed several of its past cases in which actions of a condominium association were at issue. *Id.* at 947–49. The court looked to its then recent opinion in *Nahrstedt v. Lakeside Village Condominium Ass'n*, 878 P.2d 1275 (Cal. 1994), wherein it concluded that "courts will uphold decisions made by the governing board of an owners association so long as they represent good faith efforts to further the purposes of the common interest development, are consistent with the development's governing documents, and comply with public policy." *Lamden*, 980 P.2d at 950. Staying in line with its holding in *Nahrstedt*, the court in *Lamden* concluded the board's decisions should be given deference when the board is acting on reasonable investigation, in good faith with regard to the best interests of the association and its members, and exercises discretion within the scope of its authority under relevant statutes, covenants, and restrictions.

Other courts have relied on legal treatises and their own body of case law to allow condominium associations the deference afforded by the business-judgment rule. The Court of Appeals in South Carolina reviews conduct of directors under the business-judgment rule and will not

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disturb their actions absent a showing of incompetence, dishonesty, or bad faith. *See Goddard v. Fairways Dev. Gen. P'ship*, 426 S.E.2d 828, 832 (S.C. Ct. App. 1993). An Illinois Appellate Court applied its corporate business-judgment rule to a derivative suit brought by unit owners on behalf of the condominium association. *Davis v. Dyson*, 900 N.E.2d 698 (Ill. App. Ct. 2008). The *Davis* court makes its analysis of the business-judgment rule based on the holding in *Stamp v. Touche Ross & Co.*, 636 N.E.2d 616 (Ill. App. 1993). The *Stamp* court concluded the business judgment of directors would not be interfered with absent bad faith, fraud, illegality, or overreaching. *Id.* at 621. In affirming the rule from *Stamp*, the court also noted that, for a board to get the benefit of the business-judgment rule, exercise of due care is a prerequisite. *Davis*, 900 N.E.2d at 714. Because the plaintiffs in *Davis* alleged “inexcusable unawareness or inattention” as well as illegality, they alleged enough to survive the business-judgment rule challenge at the pleadings stage. *Id.* at 715–16.

The Supreme Court of Washington in *Riss v. Angel* discusses condominium directors’ fiduciary duty to “exercise ordinary care in performing their duties and to act reasonably and in good faith.” 934 P.2d 669, 680–81 (Wash. 1997). The court appears to conflate the two differing standards by stating the duty as such, and by concluding “whether or not the business judgment rule should be applied to property owners associations, the decisions of these associations must be reasonable.” *Id.* at 681. Quoting its business-judgment rule from prior decisions, the court stated it will not disturb the directors’ judgment absent a showing of fraud, dishonesty, or incompetence, but that “reasonable care” is also required, and good faith is insufficient because the standard requires the directors to act as reasonably prudent people in like situations would act.

The business-judgment rule quoted by the Supreme Court of Washington reflects the “pure” business-judgment rule approach. But does this approach support its conclusion? The court concludes the rule does not “exonerate the homeowners for their unreasonable decision to reject Plaintiffs’ proposal.” Why was the decision unreasonable? Because it was an unreasonable decision-making process. *Id.* at 679. Although the court refers to a “reasonable decision” in several places in the opinion, Washington does appear to adhere to the “pure” business-judgment rule.

Florida is perhaps the most difficult state to understand whether its courts apply the business-judgment rule. As discussed earlier, one of the first cases on point as to the issue of the appropriate standard of review for condominium associations is *Hidden Harbour I*. In a recent decision by the Fourth District Court of Appeal in Florida, the court in *Hollywood Towers Condominium Ass’n v. Hampton* cited numerous cases holding the business-judgment rule to be the appropriate standard of review. 40 So. 3d 784, 787 (Fla. 4th Dist. Ct. App. 2010) (citing *Garcia v. Crescent Plaza Condo. Ass’n*, 813 So. 2d 975 (Fla. 2d Dist. Ct. App. 2002); *Farrington v. Casa Solana Condo. Ass’n*, 517 So. 2d 70, 72 (Fla. 3d Dist. Ct. App. 1987); *Tiffany Plaza Condo. Ass’n v. Spencer*, 416 So. 2d 823, 826 (Fla. 2d Dist. Ct. App. 1982)). When deciding on the appropriate business-judgment review test, the court adopted the two-prong test

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in *Lamden*, stating the decision must be within the association's scope of authority and must be reasonable, meaning not arbitrary, capricious, or in bad faith.

But how did the Florida courts transition from the reasonableness standard to the business-judgment rule? Arguably, they never did. In *Farrington*, the Third District Court found support for its decision to support the business-judgment rule. One case was *Papalexou*, a business-judgment rule case. Another is *Hidden Harbour I*, a case oft-cited for the reasonableness standard. Indeed, many courts outside of Florida have used Florida cases to support their position that the reasonableness standard is the appropriate standard. See *Barclay Square Condo. Ass'n v. Grenier*, 899 A.2d 991, 996–97 (N.H. 2006) (citing *Hidden Harbour I*); *Hutchens v. Bella Vista Vill. Prop. Owners' Ass'n*, 110 S.W.3d 325, 330 (Ark. Ct. App. 2003) (citing *Scudder v. Greenbrier C. Condo. Ass'n*, 663 So. 2d 1362, 1369 (Fla. 4th Dist. Ct. App. 1995)). In Florida, therefore, there appears to be authority to support both the reasonableness standard and the business-judgment rule as appropriate standards of review.

Reasonableness Standard Isn't Far from Business-Judgment Rule

Many other jurisdictions adhere to the “reasonableness” standard when reviewing the decisions of a condominium association's board of directors. Conceptually, as discussed in *Levandusky*, the reasonableness standard is going to have a significant amount of overlap with the business-judgment rule. Can there be a scenario where an action taken or decision reached by a condominium association's board of directors is both reasonable and done arbitrarily, capriciously, incompetently, or in bad faith? But one would expect if a court intends to employ a reasonableness standard, there should be some difference between reasonableness and the business-judgment rule. When looking at the specific standards the courts use, however, it seems clear that the reasonableness standard hardly varies, if at all, from the business-judgment rule.

For example, an Arkansas Court of Appeal in *Hutchens v. Bella Vista Village Property Owners' Ass'n* held the power of the governing body for a condominium association is limited by the “reasonableness” test, requiring a determination of whether action is unreasonable, arbitrary, capricious, or discriminatory. 110 S.W.3d 325, 330 (Ark. Ct. App. 2003). The Supreme Court of North Dakota also employs the same reasonableness test. See *Buckingham v. Weston Vill. Homeowners Ass'n*, 571 N.W.2d 842, 845–46 (N.D. 1997); see also *Barclay Square Condo. Ass'n v. Grenier*, 899 A.2d 991, 996–97 (N.H. 2006) (finding the amendment at issue “is reasonable and not arbitrary or capricious”). On its face, this standard is the business-judgment rule, almost exactly as defined in Florida, California, New York, and New Jersey, with an additional “unreasonable” defense. Yet neither jurisdiction proposes what “unreasonable” means. Is it procedurally unreasonable, thus making the actual standard the business-judgment rule, since the court does not question the substance of the decision? Or is it substantively unreasonable, thus making the test the more traditional reasonableness standard?

Both *Hutchens* and *Buckingham* cite the Ohio Court of Appeals case *Bluffs of Wildwood Homeowners' Ass'n v. Dinkel*, 644 N.E.2d 1100, 1102 (Ohio App. 1994), in describing the “reasonableness” test in Ohio. One of the cases cited in *Dinkel* sheds some light on Ohio's

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reasonableness standard. In *River Terrace Condominium Ass'n v. Lewis*, the First District Court of Appeal in Ohio stated, when reviewing a decision by the association's board of directors, "the trial court does not substitute its judgment for that of the board of managers or weigh the various elements and considerations to be taken into account as though the court were acting *de novo*." 514 N.E.2d 732, 737 (1st Dist. Ct. App. Ohio 1986). In so holding, the court applied a three-part test of reasonableness, looking at whether the decision was arbitrary or capricious, whether the decision was nondiscriminatory and even-handed, and whether the decision was made in good faith for the common welfare of the owners and occupants. The reasonableness standard in Ohio, and by extension in Arkansas and North Dakota, appears to be, for all intents and purposes, the business-judgment rule.

Perhaps the purest "reasonableness" standard can be found in Washington, D.C. On a case of first impression, in *Johnson v. Hobson*, the D.C. Court of Appeals reviewed a condominium association board's decision to have cars without valid license plates or registration towed from the premises. 505 A.2d 1313, 1314–15 (D.C. App. 1986). Citing *Hidden Harbour I* and *Ryan* (like the court in *Papalexioiu*), as well as *Holleman v. Mission Trace Homeowners' Ass'n*, 556 S.W.2d 632, 636 (Tex. Civ. App. 1977), the court adopted the reasonableness standard. *Id.* at 1317. In a footnote, the court specifically declined to adopt the business-judgment rule as adopted in *Papalexioiu*. *Id.* at 1317 n.7.

The court's analysis went through both the substantive and procedural aspects of applying the reasonableness standard. *Id.* at 1317–18. For substantive reasonableness, the court looks at whether the action taken was within the powers granted to the board by statute or condominium documents; whether the substance bears a relationship to the "health, happiness and enjoyment of life" for owners; and whether the substance has an unfair or disproportionate impact on select unit owners. As for procedural reasonableness, the court should review whether owners had notice the board could regulate the topic at issue and whether the board failed to follow the procedures mandated by the condominium documents. *Id.* at 1318. The D.C. Court of Appeals definitively affirmed the reasonableness standard, the decision to not adopt the business-judgment rule, and the analysis of *Johnson* in *Bolandz v. 1230-1250 Twenty-Third Street Condominium Unit Owners Ass'n*, 849 A.2d 1010, 1014–15 (D.C. 2004). The court in *Bolandz* left no doubt about the inquiry to make when utilizing a reasonableness standard, citing the quoted language *Johnson* used from *Hidden Harbour I*, "[E]ach case must be considered on the peculiar facts and circumstances thereto appertaining." *Id.* at 1015.

Other jurisdictions that have elected to apply a version of the reasonableness standard go so far as to explain how the business-judgment rule is properly incorporated. The Supreme Court of Alaska, in upholding the condominium rule at issue, held the reasonableness standard was "supported by case law and commentary." *O'Buck v. Cottonwood Vill. Condo. Ass'n*, 750 P.2d 813, 817 (Alaska 1988) (citing *Hidden Harbour I* and *Johnson*). In a footnote, the court additionally stated that applying the business-judgment rule advocated by the condominium association, while favored by commentary and with good authority, would make little to any

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difference in this case because “the rule at issue measures up to any standard of reasonableness.” *Id.* at 817 n.4. The language in the footnote left some question as to whether the Supreme Court of Alaska would adopt the business-judgment rule in the future because the court elected not to take the association’s invitation to make the business-judgment rule the law. Little doubt remains as evidenced by the holding in *Bennett v. Weimar*, 975 P.2d 691, 696–97 (Alaska 1999). The Supreme Court of Alaska, this time forced with the argument of reasonableness versus business judgment (as applied in *Papalexidou*), stayed with its holding in *O’Buck* in favor of the reasonableness standard. *Id.* at 697. The court continues to leave itself an “out” for ruling on the business-judgment rule by not taking a firm position and once again stating, “[T]he rule at issue measures up to any standard of reasonableness.”

The Restatement Attempts to Balance the Two

The Court of Appeals of Arizona dealt with the reasonableness standard versus business-judgment rule debate by following a third option. In *Tierra Ranchos Homeowners Ass’n v. Kitchukov*, the association advocated for the business-judgment rule of *Lamden* while the unit owner argued Arizona case law did not allow for judicial deference to condominium associations. 165 P.3d 173, 177–78 (Ariz. App. 2007). Because the court found this case of reviewing the decision of a condominium association’s board of directors to be a case of first impression, Arizona law mandated the court look to the appropriate Restatement for guidance. *Id.* at 179. Under the *Restatement (Third) of Property: Servitudes (2000)*, a unit owner challenging an action by the association must show the association breached its duty to treat members fairly or its duty to act reasonably in the exercise of its discretionary powers. When challenging a discretionary action, the unit owner also has the burden of proving the breach of duty has caused, or threatens to cause, injury to the member individually or to the interests of the common-interest community. Finding the *Restatement’s* approach to be well-reasoned, the Arizona court adopted it. *Id.* at 180.

The court discussed the *Restatement* commentary as it related to the reasonableness standard and business-judgment rule. *Id.* at 179. The *Restatement* does not adopt the business-judgment rule because it provides “too little protection against careless or risky management,” but balances the protection taken away from the association by now requiring the unit owner to establish the board’s action was unreasonable, as opposed to putting the burden on the association to prove its actions were reasonable. *Id.* at 179–80. What the *Restatement* sees as balancing between the two standards may ultimately be very detrimental to the unit owner. Is the burden of proving unreasonableness a fair burden to put on one unit owner? Can one unit owner ever prove a board’s decision was unreasonable as to all unit owners? In a condominium development of nearly 1,000 units, what sort of time and expense will a unit owner have to endure to prove his or her case? Ultimately, more case law will need to be developed to conclude how effective the third *Restatement* option really is.

Conclusion

A review of the case law shows three approaches to reviewing the validity of an action



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challenging the decision of a condominium association's board of directors. The two most readily recognizable approaches, the reasonableness standard and the business-judgment rule, share so many characteristics that defenses of one are almost certainly defenses to the other. The minority approach, as prescribed by the *Restatement (Third) of Property: Servitudes (2000)*, attempts to be a hybrid between the two majority approaches, but may only create an undue burden on the challenging unit owner as opposed to clarifying the standard. When reviewing a decision by a condominium association's board of directors, a lawyer should probably allege all substantive and procedural flaws in the association's decision-making process to avoid missing a successful defense to any of the above standards.

Keywords: litigation, business torts, reasonableness standard, business-judgment rule, condominium association board of directors

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NEWS & DEVELOPMENTS

Golf Course Visitors Considered Interstate Commerce

With a panel composed of Circuit Judges Jacques L. Weiner, Jr., Edith Brown Clement, and Jennifer Elrod, the Fifth Circuit Court of Appeals considered an appeal concerning the interstate commerce element of a valid claim under the Sherman Act. [*Gulf Coast Hotel-Motel Assoc. v. Mississippi Gulf Coast Golf Course*](#), No. 10-60844, 2011 WL 4446002 (5th Cir. (Miss.) Sept. 27, 2011).

Ultimately, the Fifth Circuit Court of Appeals concluded that the plaintiff's complaint sufficiently stated a claim under the Sherman Act to confer federal subject-matter jurisdiction and that the alleged misconduct by the defendants could not be said to have an insignificant impact on interstate commerce. Therefore, the Fifth Circuit found the district court erred in dismissing the case and reversed and remanded for further proceedings.

Keywords: litigation, business torts, Fifth Circuit, subject-matter jurisdiction, interstate commerce

—*Sofia Adrogué, P.C., Looper, Reed & McGraw, P.C., Houston, Texas*

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Appeal of Denial of Motion to Compel Isn't an Automatic Stay

With a panel composed of Circuit Judges W. Eugene Davis, Jerry E. Smith, and Edward C. Prado, the Fifth Circuit Court of Appeals considered the district court's denial of a motion to compel arbitration and held that appeal does not result in an automatic stay. *Weingarten Realty Investors v. Miller*, No. 11-20676, 2011 WL 5142183 (5th Cir. (Tex.) Nov. 1, 2011). The plaintiff realty firm and the defendant's company created a joint venture in which the plaintiff loaned the joint venture money under a loan agreement between the plaintiff and the joint venture. The loan agreement contained an arbitration clause. The defendant did not sign the loan agreement individually, but did sign the third-party guarantee in which he and his company guaranteed half of the loan. There was no arbitration clause in the guarantee.

Keywords: litigation, business torts, Fifth Circuit, arbitration

—*Sofia Adrogué, P.C., Looper, Reed & McGraw, P.C., Houston, Texas*

» [Read the Case Note](#)

Fifth Circuit Hears Purchase-and-Sale Agreement Case

With a panel composed of Circuit Judges W. Eugene Davis, Edward C. Prado, and Priscilla Owen, the Fifth Circuit Court of Appeals heard an appeal concerning a purchase-and-sale



Business Torts Litigation

FROM THE SECTION OF LITIGATION BUSINESS TORTS LITIGATION COMMITTEE

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agreement and asserted claims for breach of contract, promissory estoppel, and negligent and fraudulent misrepresentation. *LHC Nashua Partnership, Ltd. v. PDNED Sagamore Nashua, LLC et al.*, No. 10-20331, 2011 WL 4471133 (5th Cir. (Tex.) Sept. 28, 2011) The litigation arose out of a contract between the parties in which the defendant agreed to transfer its rights to buy a shopping mall property from a third party to the plaintiff. The plaintiff alleged that, based on representations made by the defendant, the plaintiff expected to be able to lease the property to a specific home-improvement store. The store then refused to enter into a lease, and instead purchased the property from the defendant.

Keywords: litigation, business torts, purchase-and-sale agreements, Fifth Circuit

—*Sofia Adrogué, P.C., Looper, Reed & McGraw, P.C., Houston, Texas*

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