RECENT CASE LAW DEVELOPMENTS FOR TEXAS PRACTITIONERS

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RECENT CASE LAW DEVELOPMENTS FOR TEXAS PRACTIONERS

I. INTRODUCTION

Summarized below are selected recent cases of interest to the Texas business law practitioner. This survey only covers opinions issued since the beginning of 2011 and concentrates on Texas Supreme Court opinions and opinions dealing with issues are that are not well-developed or well-settled.

II. CONSTITUTIONALITY OF MARGIN TAX AS APPLIED TO PARTNERSHIP

In re Allcat Claims Serv., L.P., 356 S.W.3d 455 (Tex. 2011).

A natural-person limited partner of a limited partnership challenged the constitutionality of the Texas franchise tax (aka "margin" tax) on the basis that it was an impermissible income tax on the income of the limited partner. The Texas Supreme Court held that the franchise tax was not prohibited by the state constitutional provision requiring a statewide referendum before imposing an income tax on the net income of a natural person.

Article VIII, Section 24 of the Texas Constitution (referred to as the "Bullock Amendment") was adopted by voters in 1993. The Bullock Amendment provided in part that a general law enacted by the legislature that imposed a tax on the net income of natural persons, including a person's share of partnership income, must provide that the portion of the law imposing the tax not take effect until approved by a majority of the registered voters voting in a statewide referendum held on the question of imposing the tax. A decade later, as Texas faced a crisis in how to fund the public school system, one of the proposed solutions offered by the Texas Tax Reform Commission was to increase the number of business forms subject to the franchise tax. In 2006, the Texas Legislature amended Chapter 171 of the Texas Tax Code to expand the scope of the franchise tax to include additional forms of business, and for the first time partnerships were required to pay a franchise tax. These amendments and their application were the subject of this case against the Comptroller and the Attorney General (collectively, the "Comptroller").

Allcat Claims Service, L.P. (the "partnership") was a Texas limited partnership that provided adjusting services to property insurers. John Weakly, the relator, was one of the limited partners. For the 2008 and 2009 tax years, the partnership paid franchise taxes under protest. The partnership and Weakly (collectively "Allcat") filed suit in Travis County and an original proceeding in the Texas Supreme Court seeking an order to refund the portion of the franchise taxes paid that were referable to the partnership's natural-person partners' shares of partnership income, a declaration that the franchise tax was unconstitutional to the extent it taxed partnership income allocable to its natural-person partners, and an injunction directing the Comptroller not to assess, enforce, or collect the franchise tax to the extent it applied to the partnership's income allocated to its natural-person partners.

First, Allcat alleged a facial challenge asserting that the amendment to the franchise tax statute violated the Texas Constitution because the effect of the amendment was to impose a tax on the net incomes of natural persons absent approval in a statewide referendum. The court analyzed whether it had original jurisdiction over the suit and held that it did and that it had the power to issue mandamus. The bill amending the franchise tax provided the Texas Supreme Court exclusive and original jurisdiction over a facial challenge to the constitutionality of the tax and authorized the court to issue injunctive or declaratory relief in connection with the challenge. Mandamus was a proper or necessary process for enforcement of the right.

After determining jurisdiction was proper, the court examined the constitutionality of the new franchise tax. Allcat argued that the franchise tax is an income tax. According to Allcat, the income of a partnership is allocated to each partner according to the partner's partnership interest, and the franchise tax taxes each partner's allocated share of the partnership's income. The Comptroller countered by arguing that Texas has adopted the entity theory of partnership law and that a tax imposed on a limited partnership entity does not constitute a tax on the net income of the partnership's individual partners. The court agreed with the Comptroller. Texas formerly followed the aggregate theory of partnership law under which the partnership was not an entity separate and distinct from its individual partners. When the Texas Uniform Partnership Act was enacted in 1961, Texas adopted the entity theory of partnership law under which the partnership is an entity separate and distinct from its partners. The entity theory was unequivocally embraced in 1993 with the enactment of the Texas Revised Partnership Act, which explicitly stated that a partnership is an entity distinct from its partners. The provision stating that a partnership is an entity distinct from its partners was recodified in the Texas Business Organizations Code. Partnership income thus remains property of the partnership entity until it is distributed, and allocated but undistributed partnership income is not personal income of the partners. The franchise tax imposed on a partnership consequently is not a tax on the income of natural persons. Allcat urged the court to apply the Bullock Amendment to instances in which a natural person's partnership income is taxed "indirectly" by the imposition of the franchise tax. Again, the court reasoned that Texas utilizes the entity theory of partnership law and explained that, while a partner's interest in the partnership represents the right to receive a share of the partnership's income or profits when distributed, individual partners do not own any of the partnership income or profits that remain in the partnership before being distributed to the partners. Texas does not follow the federal flow-through approach for taxing partnerships, which adheres to the aggregate theory of partnership law. The court held that the franchise tax constitutes a tax on the partnership as an entity and does not constitute a tax on the net income of the partnership's natural-person partners within the meaning of the Bullock Amendment.

Allcat also made an "as-applied" challenge to the amendment, arguing that the Comptroller's interpretation and application of the tax violated the constitution under the equal and uniform taxation clause. That is, Allcat alleged that the Comptroller's assessment, enforcement, and collection of the tax violated the constitution. The court concluded that the bill amending the franchise tax did not confer original jurisdiction on the court over challenges as to how the Comptroller assessed, enforced, or otherwise collected the franchise tax. The court also disagreed with Allcat's assertion that Section 22.002(c) of the Government Code gave the court original jurisdiction. In this case, the Tax Code expressly provided which courts had jurisdiction to provide relief in taxpayer challenges (i.e., the district courts of Travis County) and whether those courts were authorized to provide mandamus or other similar relief, and the specific provisions of the Tax Code applied over the general provisions and limitations of the Government Code.

III. DIFFERENCE BETWEEN STANDARD MERGER CLAUSE AND DISCLAIMER OF RELIANCE AS RELATING TO FRAUDULENT INDUCEMENT CLAIM

Italian Cowboy Partners, Ltd. v. Prudential Ins. Co. of Am., 341 S.W.3d 323 (Tex. 2011).

This case involved a dispute over whether a merger clause in a commercial lease resulted in a disclaimer of the plaintiff's reliance on the defendant's representations so as to negate a claim for fraudulent inducement. The Texas Supreme Court discussed the difference between a standard merger clause and a clause disclaiming reliance on representations for purposes of a claim for fraudulent inducement. The court held that the contract at issue contained a standard merger clause that did not negate the element of reliance in a claim for fraudulent inducement. A three-justice dissent argued that the contractual language at issue should be interpreted to disclaim reliance and thus preclude a claim for fraudulent inducement.

The owners and operators of a restaurant terminated the restaurant's lease due to a persistent sewer odor on the premises and sued the landlord and property manager for fraudulent inducement. Before signing the lease, the property management representative who negotiated the lease told the owners that the building was practically new and had no problems. After renovating and opening the restaurant, the owners discovered that the property manager knew that the prior tenant, which also operated a restaurant, encountered problems with a sewer odor and that the property manager had experienced the odor firsthand. The statements made by the property manager during the lease negotiations regarding the condition of the premises were known by the property manager to be false when made and were relied on by the owners when signing the lease. The lease contained provisions in which the tenant acknowledged that neither the landlord nor the landlord's agent made any representations or promises with respect to the premises or lease except as expressly set forth in the lease and that the lease constituted the entire agreement between the parties with respect to the subject matter. The trial court held that this language did not negate the element of reliance on representations required in a claim for fraudulent inducement and found in favor of the restaurant owners. The appellate court reversed and rendered a take-nothing judgment against the owners. The issue on appeal was whether language that amounted to a disclaimer of representations constituted a standard merger clause such that the contract was subject to avoidance on the ground of fraudulent inducement or whether the language also disclaimed reliance on representations, thereby negating a required element of fraudulent inducement.

Case law has long held that agreeing to a merger clause does not waive the right to sue for fraud if a party discovers that representations it relied on before signing the contract were fraudulent. An exception to this rule exists, however, under certain circumstances. When sophisticated parties represented by counsel disclaim reliance on representations about a specific matter, such a disclaimer of reliance may conclusively negate the element of reliance and preclude a claim for fraudulent inducement. *Schlumberger Technology Corp. v. Swanson*, 959 S.W.2d 171 (Tex. 1997). This rule applies to both future and past claims. *Forest Oil Corp. v. McAllen*, 268 S.W.3d 51 (Tex. 2008). Although a contract may almost always be set aside for fraudulent inducement despite the inclusion of a merger clause, it is possible for the terms of a contract to preclude a claim for fraudulent inducement if a clause containing a clear and specific disclaimer of reliance is included. As a result, if a disclaimer of reliance clause is included, a contract may be binding even though it was induced by fraud.

The court examined the lease in this case and found that a plain reading of the contract indicated that the parties merely intended to include the substance of a standard merger clause, which does not disclaim reliance. Furthermore, even if the parties had intended to disclaim reliance, the contract did not do so by clear and unequivocal language. The court compared the language in question with the language in *Schlumberger* and *Forest Oil*. In those cases, the contracts expressly stated that the parties were not relying on any statements or representations of any agent of the parties. The court explained that there was a significant difference between a party disclaiming its *reliance* on certain representations (thus possibly relinquishing the right to pursue a claim such as fraudulent inducement in which reliance is an element) and disclaiming the *fact* that other representations were made. Because the language here only disclaimed the fact of other representations and not the reliance by the parties on specific representations, the language did not negate the reliance element of the owners' claim of fraudulent inducement. In sum, the court held that, unlike a specific disclaimer-of-reliance clause, a standard merger clause such as the one in this case does not by itself bar an action to set aside a contract based on fraudulent inducement.

Three members of the Texas Supreme Court interpreted the contract language differently and argued that a claim for fraudulent inducement by the owners was precluded because the owners disclaimed reliance on representations made outside the lease agreement. The dissent examined the facts in the case and argued that sophisticated parties represented by counsel in a commercial transaction, with full knowledge of the circumstances, without mistake or duress of any kind, should not be allowed to include in a contract a statement of fact (i.e., no other representations were made) and later disavow it. Focusing on the lack of language indicating a disclaimer of reliance by the owners was, according to the dissent, a "poor strawman" used by the majority to find that the parties intended a standard merger clause. The dissent pointed out that a clause stating that no representations had been made and that parties were not relying on representations that had been made is internally inconsistent. According to the dissent, a clear averment that no representations were made other than those contained in the lease was clearer and less equivocal than the language used in *Schlumberger* and *Forest Oil*. The dissent found no explanation by the majority for its preference for a disclaimer of reliance over a disclaimer of representations, and it noted that a footnote in the majority opinion created more confusion by warning that even a clear and unequivocal disclaimer of reliance may not be binding on the parties under certain circumstances such as when the parties have not discussed during their negotiations the substance of the later-alleged misrepresentation.

IV. STOCK OPTION AGREEMENT AS OTHERWISE ENFORCEABLE AGREEMENT ANCILLARY TO COVENANT NOT TO COMPETE

Marsh USA Inc. v. Cook, 354 S.W.3d 764 (Tex. 2011).

This case involved a dispute over the enforceability of a post-employment covenant not to compete. The Texas Supreme Court disapproved of language in *Light v. Centel Cellular Co. of Texas* requiring that the consideration for a covenant not to compete "give rise to" the employer's interest in restraining competition and held that stock options provided an employee in consideration for the covenant not to compete were "reasonably related" to the employer's interest in protecting its goodwill such that the covenant not to compete was ancillary to or part of an otherwise enforceable agreement.

Cook was a long-time employee of Marsh USA Inc. ("Marsh"), a risk management and insurance business. Marsh's parent company Marsh & McLennan Companies, Inc. ("MMC") implemented a plan to provide "valuable," "select" employees the opportunity to become part owners of the company as an incentive to contribute to and benefit from the growth and profitability of MMC. Under the plan, employees would exercise a stock option and acquire a certain number of shares of the company at a discounted price in exchange for signing a non-solicitation agreement. In 2005, Cook exercised the stock option under the plan and signed the non-solicitation agreement that contained the covenant not to compete at issue. The agreement provided that if Cook left the company within three years of exercising the stock option, then for a period of two years he would not solicit or accept business offered by MMC in which Cook was involved within the two years prior to Cook's termination or solicit employees of MMC who reported directly or indirectly to Cook. Furthermore, Cook agreed to keep MMC's confidential information and trade secrets confidential after his employment with Marsh. Less than three years after exercising the stock option and signing the agreement, Cook resigned from Marsh and became employed by a direct competitor of MMC. MMC and Marsh sued Cook for breach of contract, claiming that Cook had violated the agreement by soliciting business and clients of Marsh. Cook sought partial summary judgment on the ground that the agreement constituted an unenforceable contract because it was not ancillary to or part of an otherwise enforceable agreement under *Light v. Centel Cellular Co. of Texas*, 883 S.W.2d 643 (Tex. 1994). The trial court granted Cook's motion for partial summary judgment holding that the agreement was unenforceable as a matter of law. The court of appeals affirmed, holding that the transfer of stock did not give rise to Marsh's interest in restraining Cook from competing as set forth in the *Light* case. Marsh appealed.

The parties agreed that the agreement in this case was governed by the Covenants Not to Compete Act ("the Act"), which is part of Chapter 15 of the Texas Business & Commerce Code. To determine whether the covenant not to compete was valid under the Act, the court had to analyze whether there was an otherwise enforceable agreement between the parties and whether the covenant was ancillary to or part of that agreement. In this case, neither party contested that there was an otherwise enforceable agreement; the question was whether Cook's covenants not to compete were ancillary to or part of the otherwise enforceable agreement. In the *Light* case, the court considered a two-prong approach to determine whether a covenant was "ancillary to or part of" the otherwise enforceable agreement. *Light* required that the consideration given by the employer in the otherwise enforceable agreement must "give rise to" the employer's interest in restraining the employee from competing and the covenant must be designed to enforce the employee's consideration or return promise in the otherwise enforceable agreement. The supreme court focused on the first prong in the *Light* analysis, and noted the "give rise to" language in *Light* narrowed the interests the Act would protect by excluding much of goodwill as a protectable business interest. In contrast to the language used in *Light*, the legislature did not include a requirement in the Act that consideration for the noncompete agreement must give rise to the interest in restraining competition with the employer. Instead, the legislature required a nexus that the noncompete be ancillary to or part of the otherwise enforceable agreement between the parties.

Here, the lower courts held that the covenant not to compete in the agreement signed by Cook was not ancillary to an otherwise enforceable agreement under the *Light* test. Specifically, the courts decided that the covenant not to compete signed by a valued employee for stock options designed to give the employee a greater stake in the company's performance and benefit the company's goodwill was not enforceable as a matter of law because the stock options did not give rise to an interest in restraining competition. However, the supreme court explained that the statute (as well as the pre-statute common law) requires that the covenant not to compete be "part of" or "ancillary to" an otherwise enforceable agreement, and the "give rise to" requirement is inconsistent with the text and purpose of the statute. The court held that consideration for a noncompete agreement that is "reasonably related" to an interest worthy of protection (e.g., trade secrets, confidential information, or goodwill) satisfies the statutorily required nexus between the covenant not to compete and the interests being protected. Also, there was no textual basis for excluding the protection of goodwill from the business interests that a noncompete may protect. The court had previously taken two steps back from *Light's* restrictiveness regarding enforcement of covenants not to compete, and here the court followed this path toward greater enforceability of noncompete agreements by abrogating the *Light* requirement that the consideration for the covenant not to compete must "give rise to" the employer's interest in restraining the employee from competing.

In this case, the stock option Cook exercised fostered the goodwill of the company because it linked the interest of a valuable, long-term employee with the company and its customers in a business in which long-term, personal contact between customers and employees is critical due to the similarity of the product (i.e., insurance) offered by competitors. In turn, Cook became an owner of MMC and likewise had an interest in the success of the company. The agreement prevented Cook from using the company's goodwill to attract customers and employees to competitors. According to the court, a reasonable nexus existed between the covenant not to compete

Cook signed in the agreement and MMC's interest in protecting its business goodwill. That is, the stock options given in consideration for the noncompete agreement were reasonably related to the employer's interest in protecting its goodwill, an intangible but protectable business interest under the Act. Thus, the covenant not to compete was ancillary to or part of an otherwise enforceable agreement Cook and MMC made for Cook to exercise the stock option and become an owner of MMC. The court noted that the hallmark of enforceability is whether the covenant not to compete is reasonable, and the enforceability of such a covenant should not be decided on overly technical disputes as to the standard for whether the covenant is ancillary to an agreement. The court did not decide the reasonableness of the agreement in question as to time, scope of activity, or geography, leaving that determination to the trial court. The court did hold, however, that if the relationship between the otherwise enforceable agreement and the legitimate interest being protected is reasonable, as was the case here, the covenant not to compete is not void on that ground. In addition, the court held that there is no requirement under Texas law that an employee receive consideration (i.e., the stock option) for a noncompete agreement before the employer's interest in protecting its goodwill arises. The court reversed the judgment of the court of appeals and remanded to the trial court for further proceedings consistent with the court's opinion.

One justice concurred in the judgment but emphasized that the law favors robust competition and that restrictions on employee mobility that exist only to stifle competition are *per se* illegal in Texas. The Act allows covenants not to compete when the covenants are reasonable and do not impose a greater restraint than is necessary to protect legitimate business interests. The concurring justice cautioned that the record before the court indicated that the purpose of the covenant not to compete was simply to stifle competition but acknowledged that a fuller record on remand might reveal a less protectionist purpose.

A three-justice dissent agreed that goodwill is a protectable interest under the Act but framed the issue as whether stock options given to an employee can justify a restraint of trade. According to the dissent, equating stock options with goodwill creates a rule by which any financial incentive given to an employee could justify a covenant not to compete because financial incentives could motivate an employee to create goodwill. Employers cannot buy a covenant not to compete, and the dissent argued that the majority's holding allows employers to do just that. The dissent contended that the majority's decision nullifies the rule that covenants not to compete must be ancillary to an exchange of valuable consideration that justifies or necessitates a restraint of trade and creates a rule favoring enforcement of noncompete agreements based on financial incentives. The dissent urged adherence to the doctrine of *stare decisis* in relation to the *Light* requirements and noted that none of the court's decisions since *Light* questioned the rule requiring that the consideration for a covenant not to compete must give rise to an interest in restraining trade.

V. PARENT ENTITIES OF UNFORMED BORROWERS AS THIRD-PARTY BENEFICIARIES OF LOAN COMMITMENT; RECOVERY OF CONSEQUENTIAL DAMAGES FOR BREACH OF LOAN COMMITMENT

Basic Capital Mgmt., Inc. v. Dynex Commercial, Inc., 348 S.W.3d 894 (Tex. 2011).

Corporate owners of entities that were to be formed for the purpose of holding future real estate investments filed suit for breach of contract against the lenders who agreed to provide financing. The entities acting as borrowers were to be formed separately as each real estate investment opportunity arose. The Texas Supreme Court held that the corporate owners of the entities were third-party beneficiaries entitled to enforce the loan commitment and that consequential damages for the lender's breach of the commitment were foreseeable and recoverable.

Basic Capital Management, Inc. ("Basic") managed publicly traded real estate investment trusts in which it also owned stock, including American Realty Trust, Inc. ("ART") and Transcontinental Realty Investors, Inc. ("TCI"). Dynex Commercial, Inc. ("Dynex") provided financing for multi-family and commercial real estate investors. Dynex and TCI negotiated an agreement for Dynex to loan three TCI-owned single-asset, bankruptcy-remote entities ("SABREs", i.e., entities that each own a single asset and whose solvency is independent of affiliates) $37 million to acquire and rehabilitate three commercial buildings in New Orleans if Basic would propose other acceptable SABREs to borrow $160 million over a two-year period. Although not a SABRE, TCI accepted the agreement as the borrower for the New Orleans buildings. The $160 million agreement was between Basic and Dynex and included the requirement that the future SABREs would be owned by ART or TCI. Dynex loaned TCI's three SABREs money to acquire the New Orleans building as well as a $6 million loan presented by Basic under the commitment. Then market rates rose, the commitment became unfavorable to Dynex, and Dynex refused to provide further funding to rehabilitate the New Orleans buildings or to make other loans under the commitment.

Basic, ART, and TCI sued Dynex for breach of the commitment alleging that the breach required the plaintiffs to finance investments through other means at a higher rate when the investments would have qualified for financing through the Dynex commitment. The plaintiffs sought damages for interest paid in excess of what would have been paid under the commitment as well as lost profits from investments for which other financing could not be found. TCI also sued for breach of the New Orleans agreement. The plaintiffs argued that they were the intended beneficiaries of the commitment because their wholly owned subsidiaries would own the properties and borrow the funds advanced by Dynex under the commitment. Dynex contended that the plaintiffs lacked standing because they were not third-party beneficiaries entitled to enforce the commitment and New Orleans loan agreement. The jury found in favor of the plaintiffs, but the trial court granted the lender's post-verdict motions and entered a take-nothing judgment on the plaintiffs' claims holding that the plaintiffs were not a party to or a third-party beneficiary of the commitment and that consequential damages were not reasonably foreseeable when the commitment was made. The appellate court affirmed. The Texas Supreme Court reversed and remanded.

First, the court addressed whether ART and TCI were able to recover for breach of the commitment as third-party beneficiaries. According to the law governing third-party beneficiaries, the fact that a person might receive an incidental benefit from a contract to which he or she is not a party does not give that person a right to enforce the contract. A third party may recover on a contract between other parties only if the parties intended to secure some benefit to that third party and only if the contracting parties entered into the contract directly for the third party's benefit. The court considered the intent of the parties and found that Dynex and Basic intended to benefit ART and TCI. Dynex knew the purpose of the commitment was to secure future financing for the plaintiffs. The commitment expressly required that the borrowers be SABREs in order to provide Dynex more certain recourse to the collateral in the event of default. Realistically, the parties knew a SABRE would not enforce the commitment because a SABRE would not even be created until an investment opportunity arose, and without financing there would be no investment. It was not practical to require the plaintiffs to create inert SABREs for no business purpose other than to sue Dynex in the event of a breach. The court noted that the court of appeals was concerned that the benefit to ART and TCI was indirect in the sense that it flowed through the SABRE-borrowers. The court acknowledged that a corporate parent is not a third-party beneficiary of its subsidiary's contracts merely by virtue of their relationship, but here the transaction was structured to benefit Dynex as well as the parent companies. The SABRE-borrowers provided a mechanism for the plaintiffs to hold investment property in a way that would benefit Dynex by providing greater security.

The court next analyzed whether the plaintiffs were entitled to recover lost profits as consequential damages for breach of the commitment. Consequential damages for breach of contract are available if the damages were reasonably foreseeable at the time the contract was entered into as a probable result of a breach. According to the lower courts, there was no evidence Dynex knew when it made the commitment what specific investments would be proposed or that other financing would not be obtainable. Thus, the lower courts denied recovery of consequential damages. The court again disagreed and stated that Dynex knew the nature of the plaintiff's intended use of the loan proceeds. Dynex discussed with the plaintiffs their intended use of the money Dynex would be providing and negotiated detailed requirements for the loan arrangements. That is, the evidence showed that Dynex clearly knew the purpose of the commitment was to ensure financing of the plaintiffs' real estate investments. In addition, Dynex knew that if market conditions changed and interest rates rose, its breach of the commitment would necessitate that the plaintiffs arrange less favorable financing. Increased costs and lost business were foreseeable results of Dynex's breach of the commitment. Whether lost profits were actually sustained was an issue for the lower court to consider on remand.

VI. INTERPRETATION OF "USE OF LICENSE" FOR FRANCHISE TAX APPORTIONMENT PURPOSES

TGS-NOPEC Geophysical Co. v. Combs, 340 S.W.3d 432 (Tex. 2011).

In this dispute over the application of the Texas franchise tax, the issue was the characterization of a corporation's receipts from the licensing of geophysical and seismic data to customers in Texas for apportionment purposes. If the receipts were from the "use of a license," then the Comptroller correctly assessed additional franchise tax because receipts from the use of a license are sourced according to its place of use; however, if the receipts were from the sale of an intangible asset, then the Comptroller incorrectly assessed the additional taxes because receipts from the sales of intangibles are Texas receipts only if the legal domicile of the payor is Texas. The lower courts held that the Comptroller properly characterized the receipts as being from the use of a license in Texas. The Texas Supreme Court reversed and remanded.

TGS-NOPEC Geophysical Company ("TGS"), a Delaware corporation with its principal place of business in Houston, Texas, gathered, interpreted, and marketed seismic and geophysical data and then licensed the use of that data to its customers. The dispute arose when the Comptroller audited TGS and concluded that additional franchise taxes, penalties, and interest were owed because a significant amount of TGS's receipts should have been characterized as Texas receipts rather than non-Texas receipts, which would have resulted in the franchise tax applying to a larger percentage of TGS's earned surplus and taxable capital under the apportionment formula. (The franchise tax was based on earned surplus or taxable capital for the tax years in issue, but the same apportionment principles addressed in this case apply to the apportionment of margin under the current provisions of the Texas Tax Code.) The contested receipts were revenue that TGS received from licensing its data to customers in Texas. The difference between the characterization as receipts from the use of a license versus receipts from the sale of an intangible was significant because receipts from the use of a license are allocated to Texas if the license is used in Texas whereas receipts from the sale of an intangible sold and used in Texas are not allocated to Texas if the payor's domicile is elsewhere. TGS paid the Comptroller under protest and filed suit. The trial court ruled that the receipts were properly characterized as being from the use of a license in Texas and that TGS owed the additional tax liability but not the penalties and interest. The court of appeals affirmed. The supreme court reversed.

The Texas Supreme Court analyzed whether the act of licensing an intangible asset was the "use of a license" within the meaning of the franchise tax statute. The court of appeals decided that the phrase "use of a license" applied to the use of a license as a transfer mechanism such as that which occurred here when TGS received payments for licensing the use of its data. The Texas Supreme Court came to the opposite conclusion. The court interpreted the Texas Tax Code provision that identifies a taxable entity's gross receipts from business done in this state as the sum of the taxable entity's gross receipts from a list of activities that includes "the use of a patent, copyright, trademark, franchise, or license in this state." If the licensing of data by TGS fell under this "use of a license" category, the receipts were Texas-sourced, but if the receipts were derived from "other business" (e.g., the sale of an intangible), the receipts should be sourced to the customers' domiciles.

The court traced the history of the treatment of receipts from intangibles, including two Comptroller Letter Rulings predating the current version of the sourcing statute. These rulings recognized that receipts from the licensing of seismic data were receipts from the sale of an intangible allocated to the domicile of the payor because the customers used the seismic data rather than the license conveying the data.

Turning to the current statute, the court interpreted the term "license" in a manner similar to the other terms (i.e., "patent," "copyright," "trademark," and "franchise") surrounding it in the statute. When the owners of a patent or copyright convey the limited use of their intellectual property, they do so by granting a license. Revenue received by the patent or copyright owner is from the licensee's use of the underlying patent or copyright, not from the use of a license. Similarly, TGS received revenue from conveying the use of the underlying intellectual property (i.e., the seismic data) rather than from the use of a license. The term "license" in the sourcing statute refers to licenses that are themselves revenue-producing assets analogous to patents and copyrights. It does not refer to or include the transfer mechanism of licensing, which would subsume all intangible assets. If including all intangible assets in the sourcing statute was the legislature's intent, the legislature would not have specifically listed the intangible assets.

Further, the court noted that the Comptroller's own rule contradicted her argument since the rule provides that the "revenue that the *owner* of a trademark, franchise, or license receives is included in Texas receipts to the extent the trademark, franchise, or license is used in Texas." Under this rule, the intangible asset that is "used" must be owned by the revenue recipient. The underlying asset in a licensing transaction meets this standard because it is owned by the licensor, who receives the revenue, but the license resulting from a licensing transaction does not meet this standard because the licensee who uses the intangible asset owns the license. The court also noted that the Comptroller's argument was inconsistent with her rule regarding licensing of software.

Since the receipts of TGS at issue were derived from its customers' use of TGS's seismic data and not the customers' use of a license, allocation of the receipts was governed by the "location of the payor" rule.

VII. LLC VEIL PIERCING

Shook v. Walden, ___ S.W.3d ___, 2012 WL 895946 (Tex. App.—Austin 2012, no pet. h.).

The principal issue in this appeal was the appropriate standard for piercing the veil of a limited liability company before the 2011 amendment to the Business Organizations Code extending the statutory standards governing veil piercing of corporations to LLCs. The court concluded that, assuming veil-piercing principles can be applied to LLCs, a claimant seeking to pierce an LLC's veil with respect to a contractual liability of an LLC must prove (as has long been required by statute when piercing the veil of a corporation) that the person on whom the LLC's liability is to be imposed used the LLC to perpetrate actual fraud for the person's direct personal benefit.

The Waldens entered into two contracts with S & J Endeavors, LLC (the "LLC") under which the LLC would convey a residential lot to the Waldens and construct a residence on the lot. Disputes relating to the construction work arose, and there was a protracted delay in transfer of the title to the lot. The Waldens sued the LLC, and its two members/managers, Shook and Jaehne, asserting numerous tort and contract theories. The jury found that the LLC breached the construction contract, that Shook and Jaehne were liable for the LLC's contractual liabilities on the basis of alter ego and single business enterprise, and that the LLC was operated as a sham. The trial court entered judgment against the LLC, Jaehne, and Shook based on these findings. Shook appealed.

On appeal, the Waldens conceded that the single business enterprise finding could not support a judgment against Shook because the single business enterprise theory that was rejected by the Texas Supreme Court in *SSP Parnters v. Gladstrong Invs. (USA) Corp*. was materially identical to the version submitted to the jury in this case. Thus, the alter ego and sham theories remained as potential bases for the judgment against Shook. Shook did not dispute that the concept of veil piercing applied to an LLC but argued that the Waldens were required to prove that he used the LLC to perpetrate a fraud for his direct personal benefit in order to impose on him the contractual liability of the LLC. The Waldens argued that the common law veil-piercing principles articulated in *Castleberry v. Branscum*, which only required constructive fraud, applied in the absence of any statutory standards in the LLC context.

The court reviewed the development of Texas veil-piercing law going back to the *Castleberry* case. Prior to 1989, Article 2.21 of the Texas Business Corporation Act mandated that the liability of a shareholder of a Texas corporation was limited to the value of the shareholder's shares and did not reference any exception under which a shareholder could be held individually liable for the corporation's obligations. Notwithstanding this statutory language, courts had long held that a corporation's separate existence could be disregarded as a matter of equity in certain circumstances. In 1989, however, the Texas Business Corporation Act ("TBCA") was amended to partially codify and limit judicial application of veil-piercing principles in reaction to the Texas Supreme Court's 1986 decision in *Castleberry*, in which the court stated that piercing the corporate veil on the basis of "sham to perpetrate a fraud" merely required a showing of constructive fraud regardless of whether the underlying claim arose in tort or contract. Article 2.21 of the TBCA was amended in 1989 to provide that a corporation's contractual obligation could not be imposed on a shareholder "on the basis of actual or constructive fraud, or a sham to perpetrate a fraud" except on proof that the shareholder "caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud" on the claimant "for the direct personal benefit of the shareholder." The 1989 amendments also provided that a shareholder had no liability for a contractual obligation of the corporation "on the basis of the failure of the corporation to observe any corporate formality." Article 2.21 was further amended in 1993 and 1997 in several respects, which included broadening the actual fraud requirement to any obligation "relating to or arising from" a corporation's contractual obligation and to claims based on alter ego or any other similar theory.

Meanwhile, as these developments regarding corporate veil piercing were taking place, the legislature authorized the creation of LLCs by passing the Texas Limited Liability Company Act ("TLLCA") in 1991. The TLLCA was later recodified in the Business Organizations Code ("BOC"). Article 4.03 of the TLLCA provided that LLC members and managers were not liable for the debts, obligations, or liabilities of the LLC without mention of veil-piercing principles as an exception. This approach was carried forward in the BOC until the legislature added new Section 101.002 of the BOC in 2011 specifying that the BOC provisions applicable to corporate veil piercing (Sections 21.223 and 21.224) also apply to LLCs, their members, and their managers. Shook acknowledged, however, that the 2011 amendment did not impact this case, which was governed by prior law.

Shook relied upon state and federal decisions that have applied corporate veil-piercing standards to LLCs, but the court of appeals pointed out that courts in those cases have done so without analysis of why the corporate standards apply. The Waldens argued that comparison of the corporate and LLC statutes evidenced a legislative intent that the veil-piercing standards applicable to corporations not apply to LLCs (at least prior to 2011) since the legislature conspicuously omitted from the LLC statute the types of restrictions it imposed in the corporate context. In the absence of any statutory standards for veil-piercing of LLCs, the Waldens reasoned that the equitable principles set forth in *Castleberry* applied. The court of appeals noted that its research had revealed a Wisconsin federal district court decision, in an LLC veil-piercing case governed by Texas law, where the court had essentially employed the same reasoning advanced by the Waldens (noting as an incidental matter that the legislative history of the 2011 amendments to the LLC statutes reflected that the amendments were in part a response to perceived confusion generated by this decision). The court of appeals in this case agreed with the Waldens that the veil-piercing restrictions and limitations in the TBCA did not, as a matter of statutory construction, extend to LLCs at any time relevant to this case and that the veil-piercing remedy in this case would be governed by extra-statutory equitable principles. However, the court stated that it did not automatically follow that proper application of those principles to the LLC must track *Castleberry* as the Waldens presumed.

The court discussed the balancing of competing principles required in the application of veil-piercing principles and concluded that the legislative policy judgments made in the aftermath of *Castleberry* and the balancing of interests must necessarily inform judicial application of equitable veil-piercing principles to LLCs. The court stated that it was following the example set by the Texas Supreme Court in the context of equitable prejudgment interest. In that context, the supreme court overruled prior precedent in deference to legislative policy judgments made and conformed preexisting equitable accrual and compounding methodologies to statutory standards even in cases that the statute did not reach. Although the Waldens stressed that the legislature did not enact a statute to govern veil piercing of LLCs at times relevant to this case, the Waldens offered no reason why the relative equities present with respect to claims to pierce the veil of an LLC with respect to a contract claim would categorically differ from those present in the corporate context. Nor could the court perceive any, and the court concluded that the courts should be guided by the framework provided by the legislature in determining equity with respect to veil-piercing claims against LLCs. The court observed that its conclusion was consistent with the results in other Texas cases although the reasoning was admittedly not made explicit in those cases. The court also noted that a contrary conclusion was not suggested by the fact that the legislature later saw fit to amend the LLC statute to explicitly incorporate the veil-piercing standard prescribed in the corporate statutes.

Deferring to and applying the legislative actual fraud standard governing veil-piercing of corporations required reversal of the judgment against Shook because there were no findings or proof that Shook caused the LLC to be used to perpetrate actual fraud for his direct personal benefit.

VIII. FRAUD, BREACH OF FIDUCIARY DUTY, OPPRESSION, TEXAS SECURITIES ACT CLAIMS IN CONTEXT OF REDEMPTION OF MINORITY OWNER OF LLC

Allen v. Devon Energy Holdings, L.L.C., __ S.W.3d __, 2012 WL 880623 (Tex. App.—Houston [1st Dist.] 2012, no pet. h.).

This case dealt with a dispute arising from the redemption of a minority interest owned by Allen in a closely held limited liability company. Allen alleged that the LLC and Rees-Jones, the LLC's manager and majority owner, fraudulently induced him to redeem his interest. In addition to common law and statutory fraud claims, Allen brought claims for breach of fiduciary duty, shareholder oppression, and violations of the Texas Securities Act. In a lengthy opinion analyzing numerous issues bearing on the various claims, the court held that some, but not all, of the statements relied upon by Allen were actionable, that release and disclaimer provisions in the redemption agreement did not bar Allen's claims based on the actionable statements, that there was a formal fiduciary duty owed by Rees-Jones as the majority member/sole manager of the LLC to Allen as a passive minority member in the context of the redemption of Allen's interest, that Rees-Jones did not conclusively establish that he owed no duty of loyalty to members individually under the terms of the exculpation clause in the LLC's articles of organization, that summary judgment was properly granted on Allen's shareholder oppression claim, that the defendants conclusively established that Allen had certain knowledge that barred his fraud claims relating to the value of the LLC or its assets or the appropriateness of the redemption price, that the defendants did not otherwise disprove justifiable reliance or establish a "knowledge" defense, and that the defendants did not establish that Allen's claims under the Texas Securities Act were barred by limitations or that Allen had no recoverable damages.

The factual backdrop for this case was the redemption of Allen's minority interest in an LLC engaged in natural gas exploration and development. The LLC redeemed Allen's interest in 2004 based on a $138.5 million appraisal of the LLC performed in 2003. In 2006, the LLC was sold for $2.6 billion. The increase in value of the LLC was essentially due to advancements made in horizontal drilling. Allen claimed that Rees-Jones and the LLC made misrepresentations and failed to disclose facts regarding the LLC's future prospects and that he would not have sold his interest in 2004 if he had known these material facts.

<u>Affirmative Defense of Release</u>. The defendants sought summary judgment on the affirmative defense of "release" based on a general mutual release in the redemption agreement as well as a provision in which the parties released each other from claims arising from a determination that the value of Allen's interest was more or less than the redemption price. Although a contractual release may be avoided by proof it was fraudulently induced, the court recognized that the contract itself may preclude a fraudulent inducement claim if it clearly expresses the parties' intent to waive fraudulent inducement claims or disclaims reliance on representations about specific matters in dispute. The court noted that the redemption agreement did not specifically waive fraudulent inducement claims, and the court held that the general release did not amount to a clear expression of intent to waive fraudulent inducement claims as required in order to bar such claims. Further, as discussed later in its opinion, the court rejected the defendants' arguments that "finality" and "independent investigation" clauses in the redemption agreement precluded Allen's fraudulent inducement claims.

<u>Fraud: Actionable and Non-actionable Statements</u>. The court of appeals addressed whether eight alleged statements were actionable as either statements of fact or statements of opinion falling within the exception to the general rule that statements of opinion are not actionable in fraud. The court held that the defendants failed to establish that six statements were non-actionable as a matter of law but that the trial court properly granted summary judgment as to the other two statements relied on by Allen as supporting a fraud claim.

<u>Fraud: Effect of Contractual Releases and Disclaimers on Reliance Element</u>. The defendants sought summary judgment on the ground that the reliance element of Allen's claim was negated as a matter of law by the terms of the redemption agreement and Allen's knowledge of changes in the LLC's value between the redemption offer and its closing. The defendants argued that the redemption agreement's "finality" and "independent investigation" clauses amounted to a clear and unequivocal disclaimer of reliance so as to preclude a fraudulent inducement claim. The "finality" clause provided that the redemption agreement was the "complete and final integration" of the parties' undertakings and superseded all prior agreements and undertakings between the parties. The "independent investigation" clause stated that the redemption price was calculated and agreed to based on specified documents and recognized that intervening events may have increased or decreased the value of Allen's interest; that Allen had the opportunity to obtain additional information; and that Allen had the opportunity to discuss and obtain answers regarding any information relating to the redemption from the LLC, the authors of the documents on which the purchase price was based, and Allen's own advisors. Further, Allen represented in this clause that he based his decision to sell on his own independent due diligence investigation, his own expertise and judgment, and the advice and counsel of his own advisors and consultants. The court held that the "finality" clause was a generic merger clause that did not clearly disclaim reliance. The court held that the "independent investigation" clause did not contain the kind of absolute and all-encompassing language satisfying the clarity requirement as to any fraudulent inducement claim, but the clause did embody a clear and unequivocal intent to bar reliance on representations concerning price, the documents that were the basis for the price, and whether those documents accurately reflected the LLC's value or the value of its assets. Applying this disclaimer to each of the actionable statements asserted by Allen, the court concluded that the agreement clearly and unequivocally disclaimed reliance on representations to the extent they conveyed information about the LLC's value and the suitability of the redemption price but did not clearly and unambiguously disclaim reliance on representations to the extent they conveyed information about the LLC's future prospects in light of drilling technology and other companies' expansion-area endeavors, and all of the actionable statements

related at least in part to the state of drilling technology and other companies' expansion-area endeavors.

Having analyzed the threshold issue of whether the disclaimer was clear and unequivocal, and having found that the agreement was sufficiently clear and unequivocal to disclaim reliance with respect to representations regarding the value of the LLC and its assets or the redemption price, the court turned to an examination of the four remaining *Forest Oil* factors to determine whether the disclaimer of such reliance was enforceable. These factors are: (1) whether the contract was negotiated or boilerplate; (2) whether the complaining party was represented by counsel; (3) whether the parties dealt with each other at arm's length; and (4) the parties' relative knowledge in business matters. The court concluded that the second and fourth of these extrinsic factors favored enforcement, but the defendants did not conclusively establish the first and third factors. The court concluded that a disclaimer is not enforceable when only clarity, sophistication, and representation by counsel are present. Thus, although the agreement was sufficiently clear to disclaim reliance with respect to the value of the LLC and its assets, the defendants were not entitled to a summary judgment that the disclaimer was enforceable because the totality of the circumstances surrounding the agreement did not satisfy the *Forest Oil* test.

<u>Fraud: Justifiable Reliance.</u> The court stated that reliance is an element of fraud by omission and that justifiable reliance was thus an element of Allen's claims for common law fraud and fraud under the Business and Commerce Code. The court noted that reliance is not an element of a claim for fraud under the Texas Securities Act. (The statutory fraud claims were based on Section 27.01 of the Texas Business and Commerce Code and the Texas Securities Act, and the opinion does not contain any discussion indicating that any argument was made regarding the nature of Allen's LLC interest as "real estate or stock in a corporation or joint stock company" under Section 27.01 of the Texas Business and Commerce Code or a "security" under the Texas Securities Act.) The court discussed the defendants' arguments that Allen's reliance was negated by Allen's actual knowledge of the LLC's increased value. The court concluded that the defendants conclusively established that Allen could not have justifiably relied on Rees-Jones's statements regarding expansion-area drilling to the extent the representations purportedly conveyed information about the LLC's value or the redemption price, but the defendants did not conclusively establish that Allen could not have justifiably relied on the statements to the extent they conveyed information regarding the state of drilling technology and expansion-area ventures. Further, the defendants did not conclusively establish that Allen could not have justifiably relied on any of the other actionable statements.

<u>Fiduciary Duty.</u> Based on an alleged fiduciary relationship between Allen and Rees-Jones, Allen alleged that the redemption was a breach of fiduciary duty by Rees-Jones. Allen asserted that Rees-Jones owed Allen a formal fiduciary duty on two bases: (1) a fiduciary duty owed to minority shareholders by a majority shareholder who dominates control over a business, and (2) a fiduciary duty owed by a closely held company's officers and shareholders to a shareholder who is redeeming stock. The court acknowledged that the entity at issue was an LLC, but the court discussed and applied case law addressing closely held corporations because Allen relied on these cases and the LLC was a closely held LLC that operated much like a closely held corporation.

The court noted that the vast majority of intermediate appellate courts in Texas have declined to recognize a formal fiduciary duty by a majority shareholder to a minority shareholder in a closely held corporation while recognizing that an informal fiduciary duty could exist under particular circumstances. Given "this overwhelming weight of authority," the court did not agree with Allen that Texas recognizes a broad formal fiduciary relationship between majority and minority shareholders in closely held companies that would apply to every transaction among them, and the court thus declined to recognize such a fiduciary relationship between members of an LLC on this basis. The court concluded, however, that "there is a formal fiduciary duty when (1) the alleged-fiduciary has a legal right of control and exercises that control by virtue of his status as the majority owner and sole member-manager of a closely-held LLC and (2) either purchases a minority shareholder's interest or causes the LLC to do so through a redemption when the result of the redemption is an increased ownership interest for the majority owner and sole manager." The court noted that the scope of the fiduciary duty is not necessarily the same as for other fiduciary duties, and the court did not decide the scope of the duty. The court based its conclusion on the fact that Rees-Jones had essentially the powers and responsibilities of a general partner, a role in which the law imposes fiduciary obligations. Furthermore, the court relied upon corporate case law applying the "special facts" doctrine and concluded that the "special facts" doctrine supports recognizing a formal fiduciary relationship when an LLC's member-manager communicates a redemption offer to the minority members that may benefit the member-manager individually.

The court also discussed Rees-Jones's fiduciary duty under the LLC's articles of organization. The articles of organization contained a provision largely tracking Section 7.001 of the Texas Business Organizations Code. Since the LLC was an LLC rather than a corporation, the LLC was excepted from the restrictions under Section 7.001 on the limitation and elimination of liability for governing persons, and the court stated that the LLC's members were free under the LLC statute "to expand or eliminate, as between themselves, any and all potential liability of [the LLC's] manager, Rees-Jones, as they saw fit." In the articles, rather than completely eliminate Rees-Jones's potential liability to the LLC or its members, the members eliminated the managerial liability of Rees-Jones except for the categories of liability for which Section 7.001 of the Business Organizations Code does not permit elimination or limitation of liability. One of these categories was expressed in the articles of organization as "a breach of [Rees-Jones's] duty of loyalty to [the LLC] or its members." Allen relied upon this provision in arguing that Rees-Jones owed him a fiduciary duty. Rees-Jones argued that the articles listed the exact duties owed by Rees-Jones as manager and created duties but that the duties ran to the LLC and the members collectively rather than to individual members. The court disagreed with Rees-Jones's argument that the word "members" was intended to refer only to the members as a whole and not to include members individually or in groups of less than all. Furthermore, the court stated that the reference to the LLC or its members was ambiguous at best, thus creating a fact question for the jury. Thus, Rees-Jones did not conclusively establish that he did not owe a duty of loyalty to Allen under the articles, nor did he conclusively establish that his duty of loyalty was not implicated since the redemption resulted in an increase in his ownership percentage and the duty of loyalty places restrictions on a governing person's ability to participate in transactions on behalf of the company when the person has a personal interest in the transaction. The court noted that the LLC did not define or limit Rees-Jones's duty of loyalty in the LLC documents and that the Business Organizations Code does not define the duty of loyalty in the LLC context. The court stated that it typically looks to the common law when the statutes are silent.

<u>Shareholder Oppression.</u> The court of appeals upheld the trial court's summary judgment on Allen's shareholder oppression claim. The court stated that the doctrine of shareholder oppression protects a minority shareholder of a closely held corporation from the improper exercise of majority control, citing the two alternative definitions of shareholder oppression commonly relied upon by Texas courts, i.e., (1) majority shareholders' conduct that substantially defeats the minority's expectations that, objectively viewed, were both reasonable under the circumstances and central to the minority shareholder's decision to join the venture; and (2) burdensome, harsh, or wrongful conduct; a lack of probity and fair dealing in the company's affairs to the prejudice of some members; or a visible departure from the standard of fair dealing and a violation of fair play on which each shareholder is entitled to rely. The court concluded, however, that the alleged "wrongful conduct" of fraud by misrepresentations and omissions and breach of fiduciary duty was not similar to the typical wrongdoing in shareholder oppression cases, i.e., termination of employment, denial of access to books and records, wrongful withholding of dividends, waste of corporate funds, payment of excessive compensation, lock-out from corporate offices, or squeeze-out. Further, the court stated that there is little necessity for the oppression cause of action when the minority shareholder has nondisclosure and breach of fiduciary duty claims. The court noted that it was expressing no opinion as to whether a member of an LLC may assert a claim for shareholder oppression.

<u>Texas Securities Act.</u> Under the Texas Securities Act ("TSA"), a securities buyer is liable to a seller when the buyer makes material misrepresentations or omits material facts necessary to make a statement not misleading. The defendants sought summary judgment on Allen's TSA claims on the basis that Allen had knowledge preventing his recovery and that the claims were barred by the statute of limitations. The court of appeals held that the trial court erred in granting summary judgment on both of these grounds.

The court of appeals rejected the defendants' contention that they conclusively established the statutory defense of Allen's actual knowledge of the untruths or omissions. The court held that Allen's knowledge that the value of the LLC had changed between the valuation in 2003 and the redemption in 2004 did not bar Allen's TSA claims except to the extent the claims related to the value of the LLC and the redemption price, noting that the defendants did not allege that Allen had actual knowledge of the LLC's increased activity in the expansion area, advancements in horizontal drilling, the success of competing wells in the area, and the LLC's future prospects.

The court then discussed whether the TSA statute of limitations barred Allen's TSA claims. Under the TSA, a defrauded seller must bring suit within "five years after the purchase" and within "three years after discovery of the untruth or omission, or after discovery should have been made by the exercise of reasonable diligence." Allen filed suit within three years of the sale of his interest. Thus, the two key issues presented were: (1) when limitations began to run under the TSA; and (2) when Allen's "discovery" of his claim occurred or should have occurred. The defendants argued that the limitations period began on the date Allen discovered or should have discovered the alleged fraud, while Allen argued that it should begin no earlier than the date of the sale. The court held that the five-year repose period ran from the date of the redemption, and the three-year limitations period began on the date Allen discovered or, in the exercise of reasonable diligence, should have discovered the untruths or omissions. Thus, the limitations period could begin to run prior to the plaintiff's injury. Just as the court had held that Allen's actual knowledge of the LLC's increased value did not bar the TSA claims other than claims relating to the value of the LLC or redemption price, Allen's knowledge did not commence limitations on the remaining TSA claims. Further, the court rejected the defendants' argument that various public sources of information were sufficient to conclusively establish that limitations had expired because the defendants failed to establish when Allen should have been aware of any specific information that revealed one or more alleged untruths or omissions.

<u>Common Law and TSA Damages</u>: The court addressed the defendants' argument that Allen had no recoverable damages as a matter of law. The defendants argued that Allen could not recover damages measured by the difference between the value of his interest at the time of the redemption and at the time of the subsequent sale of the company because (1) those damages are too speculative as a matter of law, and (2) the TSA limits his damages to the value of his interest as of the date of the sale. Allen responded that he was entitled to recover such damages based on disgorgement of the increased value received by Rees-Jones, that the damages are not too speculative, and that the damages are recoverable under the TSA as "income." The court first noted that the defendants' summary judgment motion did not address whether Allen could recover the equitable remedy of disgorgement, and the court stated that Allen did not have to prove actual damages with respect to his common law fraud and breach of fiduciary duty claims. In any event, the court concluded that the defendants did not establish that Allen had no recoverable actual damages as a matter of law. The court distinguished the two cases relied upon by the defendants because the plaintiffs in those cases had failed to produce evidence to support their damages model at trial in contrast to the instant case in which Allen bore no evidentiary burden on damages in the face of a traditional summary judgment motion. The court further distinguished one of the cases relied upon by the defendants because it did not address damages recoverable under the causes of action asserted by Allen, i.e., fraud, breach of fiduciary duty, and TSA violations. The court held that "income received by the buyer on the security" recoverable as damages under the TSA does not include the defrauding buyer's proceeds on a subsequent sale because interpreting "income" to refer to dividends and other periodic payments but not profits on a subsequent sale is more logical given the way "income" is used in other subsections of the section of the TSA at issue as well as being more consistent with the way it is used throughout the TSA. Thus, Allen was not entitled to recover the amount paid by the purchaser of the LLC to Rees-Jones for his ownership interest as "income" under the TSA. The court pointed out, however, that the defendants did not conclusively establish that Allen did not have other damages under the TSA, such as distribution income.

IX. FIDUCIARY DUTY OF MANAGER OF DELAWARE LLC, ABSENCE OF FIDUCIARY DUTY OF LIMITED PARTNER OF TEXAS LIMITED PARTNERSHIP, DISCLAIMER OF FIDUCIARY DUTY OF GENERAL PARTNER OF TEXAS LIMITED PARTNERSHIP

Strebel v. Wimberly, __ S.W.3d __, 2012 WL 112253 (Tex. App.—Houston [1st Dist.] 2012, no pet. h.).

This case involved a dispute over the existence and breach of fiduciary duties in a business venture that operated by means of a limited liability company and limited partnership. An individual who was both a minority member of the LLC and a limited partner of the limited partnership sued the individual who was both the controlling member of the LLC and a fellow limited partner to recover withheld profit distributions. The trial court entered a judgment on the jury verdict that found the controlling member breached his fiduciary duties to the minority member. The appellate court reversed and remanded holding: (1) the LLC agreement imposed fiduciary duties on the controlling member, (2) the limited partner relationship by itself did not give rise to a direct fiduciary duty between the individuals, (3) the trial court committed harmful error by commingling valid and invalid theories in instructing the jury that the controlling member had fiduciary duties with respect to operations of both the LLC and the limited partnership, and (4) any withheld profit distributions originated from the operations of the limited partnership in which the controlling member's fiduciary duties had been contractually disclaimed.

In February 2003, John Wimberly and Douglas Strebel went into business together. They formed a limited liability company that came to be known as Black River Capital, LLC (the "LLC"). Strebel had a relationship with the CEO of TXU Energy, and contracts between the LLC and TXU became the focus of the parties' business ventures and the majority of the profits forming the basis of the instant suit. Wimberly, Strebel, and their spouses executed an amended and restated LLC agreement effective January 2004 in which they memorialized terms and provided specifics as to the business. Under the amended agreement, Strebel and Wimberly were the members, with 60% and 40% sharing ratios, respectively; Strebel, Wimberly, and their spouses comprised a board of managers who had to be consulted on certain major decisions; and Strebel was designated as the "Managing Manager and CEO" of the LLC with broad decision making and management powers. In addition, the agreement provided that the managers had fiduciary duties to the LLC and the members equivalent to the fiduciary duties of directors of Delaware corporations, and members had fiduciary duties to the LLC comparable to stockholders of Delaware corporations. Wimberly, Strebel, and their spouses also formed Black River Capital Partners, LP (the "limited partnership") in 2005. Under the limited partnership agreement, the LLC was designated as the general partner with broad authority to control the limited partnership, and Wimberly, Strebel, and their spouses became limited partners who agreed not to act for the limited partnership. The limited partnership agreement provided that the general partner had no duties except those expressly set forth in the agreement, and no provision in the agreement imposed fiduciary duties on the general partner.

In 2007, Wimberly and Strebel had a disagreement regarding the profit distributions related to their business ventures. Wimberly sued Strebel to recover profit distributions Strebel allegedly withheld. Wimberly asserted numerous causes of action contending essentially that Strebel acted in bad faith and breached his fiduciary duties to deprive Wimberly of distributions by retroactively reducing Wimberly's distribution percentages and shifting money from profit to bonuses to reduce funds available for profit distributions. The trial court instructed the jury that Strebel owed Wimberly fiduciary duties based on their relationship as co-owners of the LLC (with Strebel as the majority owner and managing manager) and their relationship as partners in the limited partnership. The jury found that Strebel breached his fiduciary duties to Wimberly. Strebel appealed arguing that he did not owe Wimberly any fiduciary duties and that any acts allegedly depriving Wimberly of distributions were permitted based on the parties' contractual agreements. The court of appeals analyzed the existence and application of fiduciary duties Strebel owed Wimberly.

First, the parties agreed that whether Strebel owed Wimberly fiduciary duties based on their limited liability company relationship depended on the interpretation of the language in the LLC agreement. The LLC agreement was governed by Delaware law. Under the Delaware LLC Act, parties are given broad freedom to contract. The existence and scope of fiduciary duties thus must be determined by reference to the LLC agreement. Here, the LLC agreement stated that managers shall have fiduciary duties to the LLC and the members equivalent to the fiduciary duties of directors of Delaware corporations except as otherwise provided in the agreement. Strebel contended that as the managing manager he owed fiduciary duties to the LLC and its members collectively rather than to Wimberly individually. Wimberly responded that such an interpretation was illogical as it was contrary to the plain meaning of the language of the agreement, which included fiduciary duties to members. Wimberly also asserted that, unless default fiduciary duties are specifically disavowed by contract, Delaware courts have treated LLC members as owing each other the traditional fiduciary duties that directors owe a corporation. The court of appeals sided with Wimberly and held that the trial court correctly interpreted the LLC agreement as imposing fiduciary duties on Strebel as the managing manager to Wimberly as an individual member. The court viewed the reference in the agreement to the duties of corporate directors as describing the type of duties owed, not limiting those to whom the duties are owed. The language of the LLC agreement specified that the managers shall have fiduciary duties to members. Any other interpretation would render the phrase superfluous. Thus, the trial court did not err in instructing the jury that Strebel owed Wimberly fiduciary duties as the managing menber of the LLC.

The parties also agreed that whether Strebel owed Wimberly fiduciary duties based on their limited partnership relationship depended on whether limited partners owe each other fiduciary duties under Texas law. The limited partnership agreement was governed by the Texas Revised Limited Partnership Act ("TRLPA"). The agreement here was silent as to any fiduciary duties owed between and among the limited partners. The trial court instructed the jury that Strebel owed Wimberly fiduciary duties based on their relationship as partners in the limited partnership. Strebel argued on appeal that such an instruction was erroneous because status as a limited partner is insufficient to create fiduciary duties under Texas law, and the limited partnership agreement expressly disclaimed any fiduciary duties owed by the general partner. Wimberly argued that fiduciary duties did exist because the TRLPA specified that in any case not provided for under the TRLPA, the Texas Revised Partnership Act ("TRPA") governed. According to Wimberly, because the TRLPA contained no provisions regarding duties owed by limited partners to each other, the TRPA provision that a partner owes to the partnership and the other partners a duty of loyalty and a duty of care controlled. The court of appeals discussed cases decided by Texas courts of appeals as well as the Fifth Circuit Court of Appeals and concluded that the mere status as a limited partner does not give rise to fiduciary duties despite some broad language in some of the cases to that effect. However, a party's status as a limited partner does not insulate that party from the imposition of fiduciary duties that arise when a limited partner also takes on a nonpassive role by exercising control over the partnership in a way that justifies recognition of such duties or by contract. Thus, entering into an additional relationship or role in which the limited partner controls or manages the limited partnership's affairs may create fiduciary duties to other limited partners. For example, if a limited partner also served as an officer of the limited partnership, then that partner may owe fiduciary duties to the partnership and other limited partners based on the agency relationship without regard to the role as a limited partner. The existence and scope of the fiduciary duties would be defined not by the laws governing limited partners but rather by the relevant laws and contracts governing the role under which the party exercised the authority. In this case, the relationship between Strebel and Wimberly as limited partners in the limited partnership did not give rise to a direct fiduciary duty to each other. The trial court's instruction that Strebel owed Wimberly fiduciary duties as partners in the limited partnership was erroneous. Furthermore, the instructions were erroneous to the extent they conveyed that Strebel owed Wimberly fiduciary duties in Strebel's capacity as the managing manager of the LLC that served as the general partner of the limited partnership because the limited partnership agreement expressly disclaimed any fiduciary duties owed to the limited partners by the general partner itself. The trial court's jury instruction failed to account for the legal effect of this disclaimer. Thus, the trial court wrongly included in its jury instructions the existence of fiduciary duties owed by Strebel to Wimberly in relation to the limited partnership.

Strebel argued that the trial court committed harmful error in the jury instructions by commingling valid and invalid theories. The trial court instructed the jury that Strebel owed Wimberly fiduciary duties based on the LLC agreement, which was correct, and because of the limited partnership relationship, which was incorrect. Because of the commingling, it was impossible to determine if the jury finding that Strebel breached his fiduciary duties was based on a valid or invalid theory. Furthermore, the court of appeals concluded that Wimberly's recovery under the improper jury question failed on causation grounds. The damages alleged by Wimberly were caused by the actions of the limited partnership's general partner (i.e., the LLC) in exercising its exclusive authority to run the limited partnership and Strebel's alleged control of the general partner. Courts have recognized that general partners in a limited partnership owe fiduciary duties to limited partners, but courts have also acknowledged the importance of honoring parties' contractual terms defining the scope of their obligations and agreement, including limiting fiduciary duties that may otherwise exist. Honoring such contractual agreements is especially true in arms-length business transactions in which the parties are sophisticated businessmen represented by counsel, as the parties were here. In this case, there was an express contractual disclaimer in the limited partnership agreement of fiduciary duties owed by the Strebel-controlled general partner to the limited partners, and there was no jury question regarding breaches by the general partner. Because Wimberly sought recovery based on actions that were all taken in Strebel's capacity as managing manager of the general partner, the court held that the waiver of fiduciary duties in the limited partnership agreement foreclosed Wimberly's recovery on his breach of fiduciary duty claim. Applying the fiduciary duties Strebel owed Wimberly in the LLC relationship, as Wimberly urged, would render meaningless the express disclaimer of fiduciary duties in the limited partnership agreement under which the parties were operating. Since Wimberly failed to demonstrate that Strebel took actions that caused Wimberly's lost distribution damages while acting within the scope of any fiduciary duties that existed between the parties (inasmuch as the parties had contractually disclaimed the fiduciary duties related to the actions by Strebel at issue) the judgment, which was based on the jury's finding of breach of fiduciary duty, was reversed. The case was remanded for consideration of alternative liability and damages findings.

X. DOUBLE DERIVATIVE ACTION; SPECIAL RULES FOR DERIVATIVE ACTIONS INVOLVING CLOSELY HELD CORPORATIONS

Webre v. Sneed, ___ S.W.3d ___, 2011 WL 3240520 (Tex. App.—Houston [1st Dist.] 2011, no pet. h.).

This case involved a dispute over the propriety of a double derivative action involving closely held corporations. A shareholder of a closely held holding company brought an action for breach of fiduciary duties and fraud against the officers of the corporation's wholly owned subsidiary. The trial court granted the defendants' plea to the jurisdiction on the basis that the shareholder did not have standing to bring such a suit. The court of appeals reversed and remanded, holding that the shareholder had standing to bring a double derivative action and that the shareholder was not subject to certain statutory requirements, such as the demand requirement, for a derivative action because the corporations were closely held.

Texas United Corporation ("Texas United") and United Salt Corporation ("United Salt") were companies in the business of mining, manufacturing, and selling salt and related activities. Texas United had six shareholders and acted as a holding company for United Salt, its wholly owned subsidiary. Webre was a 24% shareholder in Texas United and served as a director of both companies. Webre filed suit against four individuals who served as directors of both United Salt and Texas United and held various positions as officers of United Salt, Texas United, and related companies (collectively, the "officers"). Webre's dispute with the officers arose from United Salt's acquisition of a salt mining and storage facility in Saltville, Virginia (the "Saltville acquisition"). Webre alleged the officers committed fraud and breached fiduciary duties in connection with the Saltville acquisition by failing to investigate various aspects of the acquisition, making misrepresentations to the United Salt and Texas United boards, and entering into unauthorized contracts. Webre filed suit on behalf of himself, individually, and on behalf of Texas United and United Salt, derivatively. The officers filed pleas to the jurisdiction arguing that Webre lacked standing to bring his suit because he was not a shareholder of United Salt. Texas United and United Salt intervened as defendants, objecting to jurisdiction and seeking dismissal on numerous grounds. The trial court granted the pleas to the jurisdiction and motions to dismiss based on its determination that Webre lacked standing. On appeal, Webre asserted that the trial court erred in finding that he did not have standing to bring his claims.

The central issue in this case was whether Webre, as a shareholder in a parent corporation, had standing to derivatively sue corporate officers of a wholly owned subsidiary corporation. Generally, a corporate officer owes fiduciary duties to the corporation but not to individual shareholders. To recover for wrongs done to a corporation, a shareholder must bring a suit derivatively in the name of the corporation rather than by filing a direct suit in the shareholder's individual capacity. The Texas Business Corporation Act ("TBCA"), which governed this case, and its successor, the Texas Business Organizations Code, provide for shareholder derivative proceedings and set forth numerous procedural requirements. Here, Webre alleged that his suit was brought on behalf of both Texas United and United Salt. Webre alleged that both companies were injured in various respects based on the actions of the officers. Webre argued that the pleas to the jurisdiction and motions to dismiss addressed only his standing to bring suit on behalf of United Salt, but his suit was brought on behalf of both United Salt and Texas United.

It was undisputed that Webre was a shareholder in Texas United, which was a closely held corporation. Thus, he had standing to bring a derivative suit on behalf of Texas United for harm suffered by Texas United. The question presented to the court was whether Webre had standing to bring a suit against the officers on behalf of Texas United's wholly owned subsidiary, United Salt. Webre argued that, as a shareholder of Texas United, which owned all of the shares of United Salt, he also had standing to bring a derivative action on behalf of United Salt. Webre cited *Roadside Stations, Inc. v. 7HBF, Ltd. & Nu-Way Distrb. Co.*, 904 S.W.2d 927 (Tex. App.-Fort Worth 1995, no writ), which held, under a prior version of Article 5.14 of the TBCA, that stockholders of a parent corporation were equitable owners of stock in the subsidiary corporation and that such an equitable ownership interest conferred standing to bring a derivative suit on behalf of the subsidiary. The court agreed with the reasoning in *Roadside*. Although the version of Article 5.14 of the TBCA in effect at the time of *Roadside* allowed "beneficial owners" to file derivative suits, and the version of Article 5.14 governing the instant case allows a "shareholder" to file suit, the court concluded that the applicable version did not exclude "equitable owners," as it stated only that "'shareholder' includes a beneficial owner whose shares are held in a voting trust or by a nominee on the beneficial owner's behalf." The court stated in footnotes that the Business Organizations Code codified the version of Article 5.14 applicable in this case without substantive change. The appellate court also noted that many other jurisdictions have recognized the standing of a shareholder of a parent or holding corporation to bring a suit on behalf of a subsidiary corporation. Such a suit is known as a "double derivative" action because the shareholder effectively maintains the derivative action on behalf of the subsidiary based on the fact that the parent or holding company has derivative rights to the cause of action possessed by the subsidiary. Here, Webre, as a stockholder in Texas United, was also an equitable owner of stock in United Salt because Texas United owned all of the stock in United Salt. Webre thus had standing to bring an action on behalf of United Salt, Texas United's wholly owned subsidiary.

The court of appeals also concluded that the trial court erred in finding that Webre lacked standing to bring suit on a number of other related bases. The court agreed with Webre that Webre's failure to make a pre-suit written demand as generally required by statute did not deprive Webre of standing because Texas United and United Salt both met the definition of a "closely held corporation" (i.e., a corporation with fewer than 35 shareholders that is not listed on a national exchange), and the statute plainly provides that the pre-suit demand requirement does not apply to a closely held corporation.

Next, the court agreed with Webre that estoppel was not a basis to dismiss his suit. The officers argued that Webre was estopped from maintaining the suit because he could not accept the benefit of the Saltville acquisition and simultaneously challenge the transaction. Webre countered arguing that he had not received any benefit from the transaction complained of in the derivative suit and that he had consistently objected to the transaction. Webre and the officers presented conflicting evidence and arguments as to the profitability of the Saltville acquisition, which was an issue that went toward the merits of the litigation and the right to recover. Furthermore, the appellate court stated that quasi-estoppel theories are not proper grounds for attacking subject matter jurisdiction and held that a plea of jurisdiction was an improper method of resolving whether a shareholder was estopped from bringing the action.

The court also rejected challenges to Webre's standing revolving around the business judgment rule. The officers argued that Webre lacked standing to maintain a derivative suit absent pleading and proof of fraud or self-dealing by the board of directors of United Salt because Texas law gives control over business acquisitions and corporate lawsuits to the company's board of directors. The officers also argued that Webre lacked authority from the boards of directors of either United Salt or Texas United to file the suit and that his suit was contrary to the vote of the lawful majority actions of both boards and the other shareholders. The court first agreed with Webre that the trial court could not dismiss his suit for failure to plead and prove fraud. Requiring a plaintiff to prove the merits of the case in order to prove standing is inconsistent with Texas law. Webre alleged that the boards of both United Salt and Texas United made relevant decisions underlying the case based on misrepresentations, fraud, and breach of fiduciary duty. The officers argued that this was not the case and that the boards' actions were lawful and based on sound business judgment, but this dispute was fact-intensive and went to the heart of the merits of the litigation; therefore, the trial court's disposal of the issue as a matter of law was improper. Next, the officers contended that the business judgment rule applied such that Webre lacked standing to bring suit on behalf of Texas United and United Salt because his prosecution of the suit was contrary to the vote of the majority of both boards of directors. The officers relied upon Texas case law analyzing a shareholder's ability to bring suit in the context of a board's rejection of a pre-suit demand. However, as already discussed by the court of appeals in this case, the provisions of the statute that give control to the corporation in a demand-refusal context did not apply here in the context of closely held corporations.

Finally, Webre maintained that the officers' argument that he was not entitled to a direct recovery under the TBCA did not justify the trial court's ruling dismissing the case for lack of standing. The court of appeals analyzed the statutory provisions and agreed with Webre because under the TBCA a shareholder of a closely held corporation could seek a direct recovery if justice required. A determination of whether Webre was entitled to recover directly or whether any recovery ought to be paid to the corporation was not a proper basis for the trial court to deny Webre's standing to bring suit because he had standing regardless of the manner of recovery.

XI. SHAREHOLDER OPPRESSION BASED ON BOARD'S REFUSAL TO MEET WITH PROSPECTIVE PURCHASERS OF MINORITY SHAREHOLDER'S STOCK

Ritchie v. Rupe, 339 S.W.3d 275 (Tex. App.—Dallas 2011, pet. denied, rehearing granted).

A minority shareholder in a closely held corporation sued the corporation and its directors alleging shareholder oppression and violation of her rights to access the books and records of the corporation. The minority shareholder prevailed on her claim that the directors' refusal to meet with potential buyers of her shares was oppressive, and the trial court ordered the corporation to buy back the minority shareholder's shares for an amount equal to the undiscounted fair value of the shares as found by the jury. The court of appeals affirmed the finding of oppression but reversed as to the amount of the buyout, holding that the appropriate remedy in this case was a buyout of the shares at their fair market value (i.e., taking into account appropriate discounts). In addition, the court of appeals held that the minority shareholder was not entitled to an award of attorney's fees because there was no evidence the corporation denied her rights of access to the books and records under the Texas Business Corporation Act.

The plaintiff, trustee of a trust that owned 18% of the stock of a closely held corporation, hired a retired capital fund manager to help her sell the stock to third parties. There were no contractual transfer restrictions on the stock. The directors refused the plaintiff's request to meet with prospective purchasers of the stock, thus making it difficult or impossible as a practical matter for the plaintiff to sell the stock. The plaintiff filed suit alleging oppression, and the trial court concluded as a matter of law that the defendants acted oppressively towards the plaintiff. The trial court ordered the corporation to buy back the plaintiff's shares for the fair value of the shares as found by the jury, and the trial court also awarded the plaintiff attorney's fees based on a finding that the corporation had improperly denied the plaintiff access to the corporation's books and records.

The court of appeals first addressed the defendants' contention that a buyout of the minority shareholder's shares was not an available remedy. The defendants alleged that the only relief available for oppression under Texas law was the appointment of a receiver to rehabilitate the corporation. The court analyzed the corporate receivership statute and explained that receivership was a remedy for shareholder oppression but only as a last resort if less drastic equitable remedies are inadequate. The court interpreted the statute as giving the trial court discretion to fashion equitable remedies such as a buyback for oppression. Furthermore, after looking at the evidence of the value of the corporation, the appellate court rejected the defendants' allegation that the court-ordered buyout of the plaintiff's stock by the corporation was unduly harsh and an abuse of discretion.

Next, the defendants asserted that the trial court's judgment should be reversed because no single majority shareholder existed and because the defendants' alleged conduct was not oppressive. The court rejected the defendants' argument that the absence of a single majority shareholder precluded a shareholder oppression claim since the defendants together controlled over 70 percent of the voting stock and they acted as both the directors and those in control of the corporation. The court then addressed whether the defendants' actions in refusing to meet with potential buyers of the plaintiff's stock amounted to shareholder oppression.

The court discussed two non-exclusive definitions of shareholder oppression: (1) majority shareholders' conduct that substantially defeats the minority's expectations that, objectively viewed, were both reasonable under the circumstances and central to the minority shareholder's decision to join the venture; and (2) burdensome, harsh, or wrongful conduct; a lack of probity and fair dealing in the company's affairs to the prejudice of some members; or a visible departure from the standard of fair dealing and a violation of fair play on which each shareholder is entitled to rely. The court recognized that there is often no ready market for a non-controlling interest in a closely held corporation but stated that a shareholder with unrestricted stock has a "general reasonable expectation" of the freedom to sell the stock to a party of the shareholder's choosing at a mutually acceptable price. Because no ready market exists, shareholders seeking to sell stock to third parties must take action to market that stock, and the court stated that corporate policies that constructively prohibit the shareholder from performing these activities substantially defeat the shareholder's reasonable expectations to market unrestricted stock. Further, standards of fair dealing would include a requirement that the defendants act fairly and reasonably in connection with a shareholder's efforts to sell stock to a third party and not adopt policies that unreasonably restrain or prohibit the sale or transfer of stock or deprive the stock owner of its fair market value. The court acknowledged that a minority shareholder's reasonable expectations must be balanced with the corporation's need to exercise its business judgment, and the court implicitly recognized some of the concerns that would arise in subjecting management to interviews by prospective purchasers of a shareholder's stock, but the court stated that the defendants expressed only a "general and nonspecific fear of litigation" as a justification for their refusal to meet with prospective purchasers of the shareholder's stock. The court stated that the business judgment rule did not apply to the directors' decision in this context, and the court concluded that the flat refusal of the defendants to meet with prospective purchasers was unwarranted.

The defendants also argued that the jury's determination of the stock's fair value as being $7.3 million was erroneous because the trial court submitted the wrong date for valuation and did not allow the jury to apply discounts for lack of marketability and minority status. The appellate court held that the trial court did not submit the wrong date for valuation but did err in not applying discounts for lack of marketability and lack of control. The court held that the appropriate remedy was to provide relief for the injury caused by the oppressive conduct, i.e., to provide for the purchase of the plaintiff's stock for fair market value, which would involve discounts for lack of marketability and minority status. The appellate court remanded for further proceedings to determine the fair market value of the stock.

Finally, the defendants contended that the trial court erred in awarding conditional attorney's fees to the plaintiff. At trial, the plaintiff argued that she was entitled to attorney's fees under the Texas Business Corporation Act on the basis that the corporation withheld its corporate books and records from the plaintiff and her agents and did not allow them to make extracts of the books and records. The jury found in favor of the plaintiff, and the trial court awarded her attorney's fees in the event of an unsuccessful appeal by the appellants. Although the parties had disputes over the logistics of accessing and copying the corporation's books and records, the appellate court reversed the award of attorney's fees because there was no evidence that corporate books and records were withheld from the plaintiff or her agents in violation of the law.

XII. APPLICATION OF MANDATORY ADVANCEMENT OF EXPENSES PROVISION IN BYLAWS

In re Aguilar, 344 S.W.3d 41 (Tex. App.—El Paso 2011, no pet. h.).

In a case of first impression, the court interpreted a mandatory advancement provision in the bylaws of a Texas corporation. Based on the bylaw provision, which tracked the advancement provision in the Texas Business Corporation Act, the court held that the corporation was required to advance reasonable expenses, including attorney's fees, to a director/officer regardless of the individual's conduct (which included alleged breaches of fiduciary duty) in the underlying action brought by the corporation against the individual and regardless of whether it was in the corporation's best interest or whether the individual had the ability to repay the amounts advanced if it was later determined he did not meet the standards for indemnification.

Aguilar, an officer and director of a Texas corporation, was sued by the corporation for conspiracy and breach of fiduciary duties, and Aguilar requested that the corporation advance his defense costs based on a provision of the bylaws providing for advancement. The bylaws contained both indemnification and advancement provisions, and the advancement provision stated that the corporation "shall" advance reasonable expenses to a person named as a defendant in a proceeding after the corporation receives the person's written affirmation of his good faith belief that he has met the standard for indemnification in a written undertaking to repay the amount advanced if it is ultimately determined that indemnification is prohibited. Aguilar made the required written representations, but the corporation's board of directors voted not to advance Aguilar's defense costs. In the absence of Texas cases on advancement under the Texas Business Corporation Act or the Business Organizations Code, the court relied heavily on Delaware case law.

The court first addressed the corporation's argument that Aguilar was not entitled to advancement because of unclean hands. The corporation presented evidence of Aguilar's breach of fiduciary duties, but the court relied upon Delaware cases and held that Aguilar's conduct in the underlying suit, whether referred to as "breach of fiduciary duty" or "unclean hands," was irrelevant to his claim for advancement of his litigation expenses. Although the corporation pointed to a Delaware case in which the court recognized an unclean hands defense, the unclean hands defense in that case involved an officer's conduct with respect to the advancement claim itself (i.e., that the officer deliberately sheltered his assets in anticipation of the litigation to prevent the corporation from obtaining reimbursement for any advanced funds). Here there was no such allegation.

The court next rejected the corporation's argument that the directors could rely on the best interests of the corporation as a basis to deny advancement. The court of appeals found unconvincing a Pennsylvania case in which the court determined that the directors' fiduciary duties to act in the corporation's best interest would trump a mandatory advancement provision. Further, the case had been rejected by the Third Circuit as well as a Pennsylvania court of appeals. Citing cases in which the courts noted that it would not be a breach of fiduciary duty for directors to comply with a mandatory bylaw, the court of appeals held that the corporation could not deny Aguilar advancement on the ground that the corporation now believed advancement not to be in its best interest.

Finally, the corporation argued that advancement was discretionary based on the language of the corporation's bylaws. The first sentence of the indemnification provision stated that "[r]easonable expenses incurred by a person who…is a… named defendant… *shall* be paid or reimbursed by the Corporation…" upon receipt of the specified written undertaking of the person to repay if it is later determined that the standards for indemnification were not met. However, the last sentence of the relevant provision stated that "[t]he written undertaking *may* be accepted without reference to financial ability to make repayment." Viewing the bylaw provision as a whole and based on the commentary to the indemnification provisions of the Model Business Corporation Act on which the Texas statute was based, the court held that the bylaws imposed a mandatory obligation to advance defense costs after it *received* the specified written undertaking. Although the last sentence provided that the written undertaking "may be accepted," it did not condition the corporation's duty to pay on whether it actually *accepted* the undertaking.

The court then addressed the corporation's contention that the advancement provision did not include attorney's fees. The bylaws required the advancement of "reasonable expenses" without defining that term. The court held that "reasonable expenses" included attorney's fees. To exclude attorney's fees from "reasonable expenses" would render the advancement provision insignificant and practically useless in light of the overall purpose of advancement.

XIII. FAILURE OF FRAUDULENT INDUCEMENT CLAIM BASED ON UNENFORCEABILITY OF "BEST EFFORTS" CLAUSE

Kevin M. Ehringer Enters., Inc. v. McData Servs. Corp., 646 F.3d 321 (5th Cir. 2011).

The Fifth Circuit Court of Appeals in this case held that a "best efforts" clause in a contract was too indefinite and vague to provide a basis for enforcement, and a claim for fraudulent inducement based on an alleged breach of the clause coupled with an intent not to perform when the promise was made was unsuccessful as a matter of law.

McData Services Corporation ("McData") contracted to sell two product lines (the "Products") to Kevin M. Ehringer Enterprises, Inc. ("Ehringer") pursuant to an agreement that provided that Ehringer would pay McData a royalty on sales of the Products for a three-year period. McData made various promises in the agreement, including promises to give Ehringer access to its customers, to use its "best efforts" to promote and sell the Products during the three-year period, and not to develop any products that would directly compete with the Products. Additionally, the agreement limited the parties' liability, providing that in no event would either party be liable for lost profits or consequential damages. Ehringer sued McData for breach of contract and fraudulent inducement alleging that McData breached the agreement by competing with the products, failing to use its "best efforts" to promote the products during the three-year period, and failing to provide Ehringer access to McData's customers. Minnesota law governed the breach of contract claim, which resulted in summary judgment granted in favor of McData based on the limitation-of–remedies clause within the agreement. Texas law governed the fraudulent inducement claim, and the district court determined that the limitation-of-remedies clause did not preclude the fraudulent inducement claim. The case thus proceeded to trial on that claim, and the jury found for Ehringer. McData appealed.

Regarding the fraudulent inducement claim, Ehringer alleged McData's promise in the agreement to do an act in the future was fraudulent because McData never intended to perform according to that promise. Generally, parties will not be held liable in tort if the action should only be characterized as breach of contract; however, the legal duty not to fraudulently enter into a contract is separate and independent from the duties established by the contract itself. Thus, a claim for fraudulent inducement will not be barred merely because the damages could be categorized as economic loss related to the contract. To be actionable as fraudulent inducement, a breach must be coupled with a showing that the promisor never intended to perform under the contract.

McData argued that because "best efforts" had no precise meaning either in the agreement or under the law, Ehringer could not prove that McData did not intend to perform, i.e., there was no standard against which to measure the breach and lack of intent to perform. The parties disagreed as to whether Texas or Minnesota law governed the interpretation of the "best efforts" provision. Because Texas law governed the fraud claim, the court applied Texas law to determine whether the "best efforts" clause was sufficiently definite to serve as a benchmark for analyzing McData's intent to perform. The court noted, however, that neither party had shown the outcome would be different under Minnesota law, which the court characterized as less developed on the subject than Texas law.

Under Texas case law, a "best efforts" contract is enforceable if it sets some kind of goal or guideline against which performance may be measured. The court noted an unpublished Texas appellate decision that allowed liability for fraudulent inducement based on a "best efforts" clause where a party promised "to do his best to get [the plaintiff] paid within five days of the next stage's completion." The court characterized that clause as providing a standard by which best efforts could be objectively measured and noted that no Texas case has addressed whether a party can pursue a fraudulent inducement claim based on a promisor's intent not to perform a provision that has no objective measure. In the absence of such case law, the court used the case law addressing enforceability of a "best efforts" clause as a yardstick for analyzing the fraudulent inducement claim. The court examined the language of the "best efforts" provision of the agreement and concluded it did not provide a goal or guideline to measure McData's efforts. The court distinguished a case in which "as promptly as practicable" was held to be an enforceable guideline. The court found nothing in the contract to provide an enforceable guideline for McData's promise to use its "best efforts" to "further the promotion, marketing, licensing, and sale of Products" or to "participate and exploit the Product capabilities at industry trade events." These promises were too indefinite and vague to be enforceable under Texas law. Accordingly, the claim for fraudulent inducement, as a matter of law, could not rest on the alleged breach of the clause coupled with an alleged intent not to perform and should not have been submitted to the jury. The court also noted that there was insufficient evidence of an intent not to perform even assuming Ehringer could bring the fraudulent inducement claim.

XIV. IMPACT OF TEXAS PARTNERSHIP STATUTES ON FIDUCIARY DUTIES OF PARTNERS AND AFFILIATES

In re Jones, 445 B.R. 677 (Bankr. N.D. Tex. 2011).

The bankruptcy court analyzed the current state of Texas law on partner fiduciary duties in the context of a claim that the debtor, who was a director, officer, and majority shareholder of the corporate general partner of a limited partnership, committed a defalcation while acting in a fiduciary capacity, thus incurring a non-dischargeable debt. The court concluded that statutory changes in Texas have expunged the concept of a partner as a *per se* fiduciary, but that the debtor was nevertheless a fiduciary based on his control over the general partner and the partnership. The court analyzed the debtor's conduct and found that it did constitute a defalcation while acting in a fiduciary capacity.

The plaintiff in an adversarial proceeding against a Chapter 7 debtor sought to have her claim against the defendant debtor excepted from discharge under Section 523(a)(4) of the Bankruptcy Code, which excepts from discharge a debt from fraud or defalcation while acting in a fiduciary capacity. Before the debtor's bankruptcy, the plaintiff and her then-husband embarked on a business venture with the debtor. The venture was structured as a limited partnership in which the plaintiff was a limited partner. The general partner was a corporation of which the debtor was a director, president, and 51% shareholder. The plaintiff was also a shareholder in the corporate general partner. The plaintiff claimed that the debtor committed fraud or defalcation while acting in a fiduciary capacity and breached fiduciary duties owed to the corporate general partner, the limited partnership, and the plaintiff as an equity owner of these entities. According to the plaintiff, the debtor treated the limited partnership as his own personal "piggy bank," using limited partnership funds for many personal expenses.

In determining whether the debtor owed a non-dischargeable debt to the plaintiff under Section 523(a)(4) of the Bankruptcy Code, the court first examined whether the debtor was acting in a fiduciary capacity *vis-s-vis* the plaintiff. After noting that the debtor, as an officer and director of the corporate general partner, stood in a fiduciary relationship to the corporation and its shareholders under Texas corporate law, the court proceeded to analyze the nature of the relationship of the corporate general partner to the partnership and the limited partners under Texas partnership law. The court noted that a large amount of common law stands for the proposition that a general partner occupies a fiduciary role with respect to the limited partners, but the court recognized that significant amendments to the Texas partnership statutes in 1994 impact the analysis of fiduciary duties in the partnership context. The court summarized the statutory developments, explaining that the Texas Uniform Partnership Act ("TUPA") only used the term "fiduciary" when referring to a partner's duty to account for any benefit and hold as trustee any profits obtained in connection with the partnership without the consent of other partners, but that case law under TUPA consistently referred to a partner as a fiduciary. In 1994, however, the Texas Revised Partnership Act ("TRPA") rejected the notion of a partner as a trustee and specifically set forth the duties of partners in precise terms. The Official Comments also pointed out that these changes were meant to reign in the loose use of fiduciary concepts. Finally, the Texas Business Organizations Code contains language nearly identical to TRPA. Despite these changes since TUPA, the court noted that very little case law has addressed the significance of the changes. The court pointed out that the Fifth Circuit case of *In re Gupta*, 394 F.3d 347 (5th Cir. 2004), came closest to confronting the significance of the changes. In that case, the Fifth Circuit did not tackle the meaning or ramifications of the new Texas partnership statute with respect to the notion of "fiduciary capacity" under Section 523(a)(4) but did note that partners still owe "special duties to each other," some of which "may rise to the level of a 'fiduciary' for purposes of § 523(a)(4)." A few years later, without mentioning the statutory changes, the Fifth Circuit, in *McBeth v. Carpenter,* 565 F.3d 171 (5th Cir. 2009), held that all partners in a partnership are fiduciaries. Ultimately, the bankruptcy court in this case concluded that the changes in Texas statutory partnership law in recent years expunged the concept of a partner as a *per se* fiduciary but did not eliminate the fiduciary status of a managing general partner because of the control exercised by such a partner. The court reasoned that the new statutory language, which makes clear that a partner is not *per se* a fiduciary, puts partners and partnerships on a parity with shareholders and corporations in that shareholders do not generally owe fiduciary duties to other shareholders. Based on the roles in which fiduciary duties are owed in the corporate context and longstanding case law regarding the fiduciary duties of a managing partner in the partnership context, the court concluded that control is the key to determining whether a partner is a fiduciary. Thus, the court held that Texas case law holding that there is an express trust that satisfies the strict test for "fiduciary capacity" under Section 523(a)(4) is still good law in the context of a managing general partner.

The court then looked at the two-tiered structure of the limited partnership to determine how it affected the fiduciary duties owed by the debtor. As noted above, the debtor was president, a director, and 51% shareholder of the corporate general partner. The court relied on two Fifth Circuit cases, *In re Bennett*, 989 F.2d 779 (5th Cir. 1993) and *McBeth v. Carpenter*, 565 F.3d 171 (5th Cir. 2009), to conclude that the debtor, as manager of the managing general partner, owed fiduciary duties to the partnership and the partners. In *Bennett*, the Fifth Circuit held that the fiduciary obligations imposed on managing partners of a limited partnership under Texas law were sufficient to meet the Section 523(a)(4) test and that the same level of fiduciary duty should apply to the managing partner of a managing partner. *McBeth* was not a Section 523(a)(4) case, but the Fifth Circuit again held that a person or entity acting in complete control of a limited partnership stands in the same fiduciary capacity to the limited partners as a trustee stands to the beneficiary of a trust even in a two-tiered partnership structure. Thus, the court concluded that the debtor owed the plaintiff fiduciary duties through at least two avenues: (1) in his capacity as officer and director of the corporate general partner (since the plaintiff was a shareholder); and (2) in his capacity as the control person/manager of the general partner (since the plaintiff was a limited partner).

The court next analyzed whether the debtor committed a defalcation in a fiduciary capacity, i.e., whether he breached or neglected fiduciary duties, whether he was at least reckless in doing so, and whether a reasonable person in the debtor's position reasonably should have known better. The court described the duties of loyalty and care and the obligation of good faith set forth in TRPA and further noted how cases have described a partner's duties. The court then concluded that the debtor committed defalcations while acting in his fiduciary capacity by repeatedly spending partnership funds for his own personal use and allowing others involved in the business to do the same. The court stated that lack of fraudulent intent and apparent lack of business savvy did not matter because a reasonable person should have known better. The court stated that spending partnership funds for one's lavish lifestyle is not administering the partnership's affairs solely for the benefit of the partnership, nor was the debtor complying with the partnership agreement, abiding by his duty not to misapply funds, acting with utmost good faith, fairness, and honesty, or making full disclosure of matters affecting the partnership.

Finally, the court determined the amount of the "debt" to the plaintiff that had arisen as a result of the debtor's defalcation. The court measured this debt based on the amount of the misappropriated partnership funds. Since the plaintiff primarily contributed "sweat equity" to the limited partnership, loss of partnership investment was not a practical measure. Also, lost profits were not available because the court was unable to calculate them with reasonable certainty. Thus, based on the expert testimony of a team of forensic accountants, the court determined that the debtor misappropriated approximately $1.7 million to the plaintiff's detriment. The court then apportioned this amount based on the plaintiff's partnership interest and deducted a small amount of personal expenses that the plaintiff appeared to have made that were not recorded as a partnership draw. The court also awarded exemplary damages because Texas courts have held that breach of fiduciary duty is a tort for which exemplary damages may be recoverable and there was clear and convincing evidence that the standard for exemplary damages under the Texas Civil Practice and Remedies Code was met. Under the Texas Civil Practice and Remedies Code, exemplary damages may only be awarded if a claimant proves by clear and convincing evidence that the harm to the claimant resulted from actual fraud, malice, or gross negligence. Although the court concluded there was no actual fraud or malice on the part of the debtor, the court found the evidence did establish gross negligence as defined by the statute.