

**RECENT CASE LAW DEVELOPMENTS
FOR TEXAS BUSINESS LAW PRACTITIONERS**

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CHAPTER 1

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RECENT CASE LAW DEVELOPMENTS FOR TEXAS PRACTITIONERS

I. INTRODUCTION

Summarized below are selected recent cases of interest to the Texas business law practitioner. This survey covers opinions issued since the beginning of 2012 and concentrates on Texas Supreme Court opinions and opinions dealing with “hot topics” or issues that are not well-developed or well-settled. A couple of significant opinions issued by courts of appeals in 2011 are pending before the Texas Supreme Court, and they are noted at the end of the paper. In addition, one recent unpublished bankruptcy court opinion is noted because it analyzes the nature and extent of an LLC managing member’s duties to the LLC and the other members, which is a question that has not been the subject of a great deal of analysis in the Texas case law.

II. RELATIONSHIP OF POWERS OF NONPROFIT CORPORATION TO AFFILIATION WITH HIERARCHICAL CHURCH

Masterson v. Diocese of Northwest Texas, ___ S.W.3d ___, 2013 WL 4608632 (Tex. 2013).

In this dispute between the Episcopal Diocese of Northwest Texas and a local church over the possession and control of local church property, the Texas Supreme Court determined that Texas courts should follow the “neutral principles of law” methodology, under which courts decide non-ecclesiastical issues such as property ownership based on the same neutral principles of state law applicable to other entities, while deferring to religious entities’ decisions on ecclesiastical and church polity questions. The local church in this case was incorporated under the Texas Nonprofit Corporation Act. Due to doctrinal differences with The Episcopal Church of the United States (TEC), members of the local church voted to withdraw from the Diocese and TEC and, in furtherance of severing these relationships, amended the bylaws and articles of incorporation of the church.

One of the issues addressed by the court in this opinion was whether the local church’s corporate powers were restricted by its affiliation with TEC. TEC’s constitution and rules required parish corporations to remain part of and subject to TEC’s authority, and the local church’s bylaws confirmed that it was a constituent part of the Diocese and TEC and that the local church acceded to, recognized, and adopted the general constitution and canons of TEC. However, the members of the local church voted to

amend the bylaws to remove or change provisions referring to and adopting canons and constitutions of the Diocese and TEC. The court held that, “[a]bsent specific, lawful provisions in a corporation’s articles of incorporation or bylaws otherwise, whether and how a corporation’s directors or those entitled to control its affairs can change its articles of incorporation and bylaws are secular, not ecclesiastical matters.” The Diocese argued that Section 3.009 of the Texas Business Organizations Code requires the articles of incorporation of the local church to state that the corporation is member-managed in order for the corporation to be governed by its local members. The court stated that this argument was unpersuasive to the extent it related to whether an outside entity had authority to control the corporation. Even if the corporation were not member-managed, the TEC or Diocese would not be able to appoint or control its management absent provisions in the corporate documents to that effect. Furthermore, when the local church was incorporated in 1974, the Texas Nonprofit Corporation Act provided that the power to amend the bylaws was vested in the members, if any, but could be delegated by the members to the board of directors. The current statute sets forth a different default rule as to who is authorized to amend the bylaws, but the court stated that neither the current nor the former version of the statute empowered an external entity to amend the bylaws absent specific, lawful provisions in the corporate documents.

The majority stated that the dissenting justices’ argument that the local church could not amend its articles of incorporation and bylaws to omit references to TEC and the Diocese because it would circumvent an ecclesiastical decision made by a higher authority within a hierarchical church was in substance application of the deference methodology despite the dissent’s agreement that the neutral principles methodology applies. According to the majority, the dissent’s approach would subject the corporate decision makers and parish members who were qualified to vote under the bylaws to the dictates of persons not identified in corporate governing documents as having the right to make, control, or override corporate decisions. The majority stated that the dissent’s argument ignored the fact that the local church was incorporated under secular Texas corporation law that dictates how and when corporate articles of incorporation and bylaws can be amended and the effect of such amendments. The majority pointed out that the dissent did not identify any requirement in the corporate documents that amendments must be approved by the Diocese or TEC,

or any Texas law precluding the corporation from amending its articles or bylaws to delete references to the Diocese or TEC. In fact, the articles of incorporation and bylaws specified that qualified parish members were entitled to elect the vestry and amend the bylaws.

The court also analyzed the rights of the Diocese and TEC with respect to real property held in the name of the corporation. Three reasons were advanced in favor of TEC's right to possession of the property. The first argument was that the decision of the Bishop of the Diocese that the continuing local church consisted of the faction of the local church that was loyal to the Diocese and TEC settled the question of who was entitled to the property under deference principles and that the corporation had no rights in the property other than holding title as trustee for the loyal faction, the Diocese, and TEC. The second argument was that the corporation's initial adoption of the constitutions and canons of the Diocese and TEC in the corporation's articles of incorporation and bylaws was irrevocable under neutral law principles. The third argument was that the corporation accepted donations based on its having agreed to the constitutions and canons of the Diocese and TEC and that the corporation could not obtain the right to own and possess the property by unilaterally changing its articles of incorporation and bylaws.

With regard to the first argument, the court stated that the neutral principles of law approach adopted by the court led to the conclusion that the corporation owned the property under the deeds that conveyed title to the corporation because the deeds expressed no trust or limitation on the title. The court recognized that the Bishop's decision as to ecclesiastical matters, i.e., which faction of believers was the "true" church recognized by the Diocese and TEC, was entitled to deference. However, the Bishop's decisions as to secular legal questions, i.e., the validity of amendments to the articles of incorporation and bylaws under Texas law and the issue of property ownership under the circumstances in this case, were not entitled to deference because of the court's adoption of the neutral principles of law approach.

With regard to the second and third arguments, the court pointed out that the Diocese and TEC did not argue that the articles of incorporation, bylaws, and statutory law precluded amendments revoking the relationship with the Diocese and TEC. Under Section 2.102 of the Business Organizations Code, a religious organization may choose to organize as a domestic nonprofit organization and acquire, own, hold, mortgage, and dispose of property for the use and

benefit of and in trust for another organization, but the power to do so is a different question from whether the organization has actually done so. The court did not read United States Supreme Court case law as establishing substantive property and trust law that state courts must apply to church property disputes, and the court found no Texas law that precluded the corporation from revoking trusts actually or allegedly placed on the property. The majority disagreed with the dissent's conclusion that a particular TEC canon (the "Dennis Canon") created an irrevocable trust in favor of the Diocese and TEC. Even assuming a trust was created by the Dennis Canon and the corporation's bylaws and actions, which the majority expressly refrained from deciding, the majority concluded that the Dennis Canon did not contain language making the trust expressly irrevocable, as required by Section 112.051 of the Texas Property Code.

III. CONSTITUTIONALITY OF MARGIN TAX

In re Nestle USA, Inc., 387 S.W.3d 610 (Tex. 2012).

The petitioner argued in this original proceeding that the current franchise tax (a/k/a "margin" tax) bears no reasonable relation to the value of the privilege of doing business in Texas and thus violates the Texas Constitution's equal and uniform taxation mandate, the Fourteenth Amendment's Equal Protection and Due Process guarantees, and the U.S. Constitution's Commerce Clause. The Texas Supreme Court concluded these challenges were without merit. (This is the second case in which the Texas Supreme Court has addressed a challenge to the constitutionality of the margin tax. In 2011, in *In re Allcat Claims Services, 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 on the basis that it was an impermissible income tax on the income of the limited partner. The 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.)

The court traced the history of the Texas franchise tax and described the various approaches taken from the first franchise tax enacted in 1893 through the most recent restructuring of the tax in 2006 (with a few amendments since). The court described the current method of calculating the franchise tax, under which a tax rate of 1%, or .5% for entities primarily engaged in retail or wholesale trade, is applied to "taxable margin." Taxable margin is

calculated by subtracting one of three general deductions from total revenue and applying an apportionment factor based on the percentage of the entity's gross receipts from Texas business. Total revenue is income reported to the IRS with certain deductions, limitations, and exceptions. The three general deductions from which a taxpayer may choose are cost of goods sold, compensation, and 30% of total revenue. There are discounts for small businesses, and a taxpayer with no more than \$10 million total revenue may choose a rate of .575% of total revenue with none of the otherwise available general deductions.

In the 2006 legislation revising the franchise tax, the legislature gave the supreme court original, exclusive jurisdiction over a challenge to the constitutionality of the legislation, and Nestle USA, Inc. ("Nestle") initiated this challenge to the franchise tax pursuant to this provision. Although Nestle's business in Texas is confined to wholesale and retail activities, its manufacturing business in other states subjects it to the 1% tax rate rather than the lower .5% rate applicable to wholesalers and retailers because a taxpayer's retail/wholesale revenue must exceed revenue for other business and must come mostly from the sale of products produced by others to qualify for the lower rate. Additionally, Nestle and its affiliates are required to report as a group and must together choose one general deduction that produces a less advantageous result than if the entities were allowed to report separately and could choose the most beneficial deduction for each. Nestle also receives no benefit from other franchise tax deductions and exemptions applicable to other businesses. Nestle argued that the franchise tax bears no reasonable relationship to its object, the privilege of doing business in Texas, because of its many deductions and exemptions, and treats similarly situated businesses differently. For these reasons, Nestle asserted that the franchise tax violates the Texas Constitution's Equal and Uniform Clause and the Fourteenth Amendment's Equal Protection and Due Process guarantees. In addition, Nestle argued that the tax discriminates against interstate commerce in violation of the Commerce Clause of the U.S. Constitution because the tax is higher for taxpayers whose manufacturing business is outside Texas. After concluding that it had original jurisdiction over all of Nestle's arguments (unlike some of the arguments made in *In re Allcat Claims Services, L.P.*, in which various other challenges to the constitutionality of the franchise tax were made), the court turned to each of Nestle's challenges.

With respect to the Equal and Uniform challenge, the court looked at the Equal and Uniform

Clause in the several Texas Constitutions over the years and discussed how exemptions from property taxes and classifications for purposes of occupation taxes are consistent with the Equal and Uniform Clause. The court characterized a franchise tax as similar to an occupation tax and concluded that classifications to assure equality and uniformity in occupation taxes are equally necessary for franchise taxes. The court acknowledged that the differentiations made in the application of the franchise tax have increased in complexity over the years but stated that their nature as classifications to assist in achieving equality and uniformity has not. The court also noted that constitutions in other states with similar tax uniformity provisions have been interpreted to allow classifications in taxes on the privilege of doing business.

Having concluded that the Equal and Uniform Clause permits classifications in the franchise tax, the court proceeded to consider what limitations are imposed on the legislature in providing such classifications. The court agreed with Nestle that a classification in a tax must be related to the object of the tax, but the court stated that the legislature must have discretion in structuring tax laws, especially when the object of the tax, such as occupations or the privilege of doing business in Texas, is not easily or precisely valued. Thus, the presumption of constitutional validity of legislation is especially strong with respect to tax statutes. With this in mind, the court addressed Nestle's attacks on various classifications in the current franchise tax, such as payments included and excluded in the compensation deduction, treatment of a Texas wholesale and retail business that also has out-of-state manufacturing business, the group filing required of affiliated entities, and certain exclusions from cost of goods sold. However, the court found reasons for each of the items Nestle criticized as a departure from uniformity. Nestle did not challenge each and every deduction and exemption but argued that the myriad exemptions and special deductions were arbitrary and not reasonably related to the privilege of doing business in Texas. Based on the examples cited by Nestle, the court disagreed and concluded that the structuring of the tax was reasonably related to its object.

Nestle conceded, and the court agreed, that failure of its challenge based on the Equal and Uniform Clause foreclosed its Equal Protection challenge. The Equal and Uniform Clause is stricter than the Equal Protection Clause of the Fourteenth Amendment. Having concluded that the legislature had a rational basis for structuring the franchise tax as it did, the

court held that it did not violate the Equal Protection Clause.

The Due Process Clause requires that the taxing power exerted by the state bear a fiscal relation to protections, opportunities, and benefits provided by the state. Having already concluded that the classifications in the franchise tax are reasonably related to the privilege of doing business in Texas, the court stated that its analysis was similar to that of the United States Supreme Court in a case in which a company complained that it paid more franchise tax because of its manufacturing outside Texas even though it did no manufacturing in Texas. The Supreme Court held in that case that the franchise tax did not violate Due Process because the use by a unitary business of property outside the state in correlation with property within the state necessarily affects the value of the privilege within the state. For the same reasons, the court concluded that Nestle's Due Process challenge failed.

In its Commerce Clause challenge, Nestle claimed that the manufacturing rate discriminates against interstate commerce and is not fairly related to the services provided by Texas. The court concluded that the manufacturing rate does not discriminate against interstate commerce because the difference in rate stemmed solely from differences in the nature of businesses and not from the locations of their activities. In-state manufacturing companies pay the same rate as Nestle, and out-of-state companies that only engage in wholesaling and retailing qualify for the lower rate. The court also concluded that the manufacturing rate is fairly related to services provided in Texas. The franchise tax need not precisely align the tax rate with the value of the privilege; it is enough that manufacturing outside the state will often increase the value of doing business within the state.

Justice Willett dissented, joined by Justice Lehrmann, arguing that the court lacked original mandamus jurisdiction in taxpayer constitutional challenges like this one.

IV. SUFFICIENCY OF EQUITABLE TITLE THROUGH WHOLLY OWNED LLCs FOR PURPOSES OF AD VALOREM TAX EXEMPTION PROVIDED TO COMMUNITY HOUSING DEVELOPMENT ORGANIZATION

AHF—Arbors at Huntsville I, LLC v. Walker County Appraisal District, __ S.W.3d __, 2012 WL 2052948 (Tex. 2012).

Two LLCs that owned low-income housing apartment complexes asserted that the housing

complexes met the statutory requirements for exemption from ad valorem taxation available to a community housing development organization ("CHDO") under Section 11.182 of the Texas Tax Code. The principal issue addressed in this opinion was whether a CHDO must have legal title to property to qualify for the exemption, and the Texas Supreme Court held that equitable title is sufficient.

The sole member of each of the two LLCs in this case was a nonprofit corporation exempt from federal income taxation under Section 501(c)(3) and certified as a CHDO by the Texas Department of Housing and Community Affairs. Section 11.182(b) of the Texas Tax Code provides a tax exemption to an organization on "property it owns" if it is organized as a CHDO and "owns the property for the purpose of" providing low- or moderate-income housing without profit. The LLCs argued that their apartments were exempt because ownership, within the meaning of the statute, includes equitable title, which the LLCs' sole member, a certified CHDO, held by virtue of its complete control of the LLCs. The appraisal district argued that ownership means legal title, and that the LLCs were not entitled to an exemption since there was no evidence they themselves were CHDOs. The court looked to Section 11.182(e) of the Tax Code as an indication that ownership in subsection (b) included equitable title. Section 11.182(e) allows property "owned by a limited partnership" to be tax-exempt in certain instances if 100% of its general partner is controlled by a CHDO meeting the requirements of subsection (b). The court was unconvinced that limited partnerships are the one exception to subsection (b)'s requirement of legal ownership by a CHDO and saw no reason to distinguish between a general partner's control of a limited partnership and other types of corporate control over related entities, such as the CHDO's complete ownership of its subsidiary LLCs in this case. The court characterized the purpose of subsection (e) as limiting exemptions for limited partnerships to those in which the CHDO wholly owns the general partner rather than as carving out an exception for non-CHDO limited partnerships. The court observed that this construction acknowledges the realities of the commercial housing industry, in which lenders often require that property be purchased by a single-asset entity. The court also noted that tiered ownership allows greater flexibility for investors, encouraging the involvement of private funds in developing low-income housing consistent with the purpose in creating the concept of CHDOs. The court rejected several arguments made by the appraisal district, including an argument that entities that are

separate for purposes of imposing liability should not be treated as one for purposes of qualifying for tax exemptions. The court pointed out that federal tax law disregards the separate identity of some entities (e.g., the LLCs in this case, which are disregarded as separate entities from their owner), and the court stated that there was no reason why Section 11.182 should not do the same. The court discussed five cases in which courts of appeals adopted varying constructions of Section 11.182. The court agreed with the reasoning in *TRQ Captain's Landing v. Galveston Central Appraisal District*, 212 S.W.3d 726 (Tex. App.–Houston [1st Dist.] 2006, pet. granted, appeal abated), in which the court of appeals upheld an exemption for a limited partnership that was wholly owned by an LLC whose only member was a CHDO. Applying the rule that a CHDO's equitable ownership of property qualifies for an exemption under Section 11.182 to the facts in the instant case, the court concluded that the CHDO had complete control over the LLCs and equitable title to the property—the power to compel the transfer of legal title. The court acknowledged that each of the LLCs had managers, who were the governing authority of the entities, but concluded that the member CHDO had complete control over the LLCs because managers serve at the pleasure of the members. The court noted that it was not addressing and expressed no view on numerous other issues raised by the parties, including the appraisal district's arguments that the LLCs were not charitable organizations, that their apartments were not used for low- and moderate-income housing, and that other requirements of Section 11.182 and of federal law were not met.

Justice Willett dissented from the majority's opinion, pointing out that the companies were asking the court to pierce the corporate veil that they themselves created. He argued that Texas law respects corporate formalities and usually limits piercing to circumstances of fraud or other malfeasance. He pointed out that the legal and business communities would be astounded if taxing authorities could routinely look to the parent to pay taxes on property of a subsidiary, and the granting of a tax exemption to a subsidiary struck Justice Willett as equally untenable. Justice Willett viewed the legislature's failure to provide a provision similar to the one provided for limited partnerships in Section 11.182(e) as reason enough to disagree with the majority. Though he found it unnecessary to consider why the legislature would treat the two entities differently, he pointed out various differences between limited partnerships and LLCs that might provide plausible reasons for drawing

a statutory distinction. In sum, Justice Willett stated that he would respect what he viewed as the legislature's policy choice to treat LLCs and limited partnerships differently.

V. EFFECT OF STATEMENTS OF INTENT TO DISSOLVE PARTNERSHIP

Buck v. Palmer, 381 S.W.3d 525 (Tex. 2012) (per curiam).

The issue addressed in this case was whether a partner's letter and other statements to his co-partner expressing a desire to discontinue their joint venture conclusively established an immediate dissolution of the partnership at that time under the Texas Uniform Partnership Act. The court of appeals affirmed a summary judgment on the basis that the partnership was dissolved by the "express will" of a partner, but the Texas Supreme Court concluded that there was a genuine issue of material fact as to whether the statements at issue were intended to dissolve the partnership.

Buck and Palmer were partners in a joint venture to build a marina and yacht club. The venture borrowed over \$7 million, guaranteed by Buck and Palmer. The venture failed after a series of major storms damaged the marina, and litigation by creditors seeking repayment ensued. At the time of the litigation, Buck and Palmer each owned a 20% interest in the venture, and a corporation owned an 80% interest. The litigation culminated in a settlement under which the venture's debt was reduced to a \$600,000 note and the corporation's 80% interest was transferred to Palmer. After the settlement, the value of the property rose to an estimated value of \$4 million.

In 1997, Palmer sued Buck for breach of an oral agreement to transfer Buck's partnership interest to Palmer in exchange for release from the venture's indebtedness following the settlement. Buck denied the existence of the contract and sought a determination of the fair value of his interest. Palmer argued that Buck had relinquished his interest even absent the oral contract because Buck expressed his will to dissolve the partnership on several occasions between 1993 and 1995. Palmer principally relied on a 1995 letter in which Buck wrote to Palmer that Buck had no intention of embarking on the land development scenario with Palmer. Relying on the letter as evidence that the venture was dissolved on that date, Palmer argued that Buck was entitled only to a distribution according to the value of Buck's interest at that time, which Palmer argued was no greater than zero in view of the venture's indebtedness. The trial

court granted Palmer's motion for summary judgment, and the court of appeals affirmed, reasoning that Buck's statements to Palmer in 1995 were conclusive evidence of dissolution at that time.

The Texas Supreme Court applied the now expired Texas Uniform Partnership Act, which provided that dissolution is caused "by the express will" of any partner ceasing to be associated with the continued operation of the partnership. The court concluded that the 1995 letter might be some evidence that the partnership was dissolved, but the court viewed other evidence presented by Buck as creating a genuine issue of material fact as to his intent. Specifically, the court pointed to the fact that the settlement agreement signed by Palmer in the venture's litigation with its creditors after the alleged dissolution listed Buck as a 20% owner. Also, an amended joint venture agreement adopted after the alleged dissolution showed Buck as an owner, and Buck's affidavit testimony stated that he did not intend to dissolve the venture. Based on this evidence, the court stated that reasonable jurors could differ as to whether Buck intended to dissolve the partnership, merely expressed a desire to relinquish his interest in the future, or simply engaged in hyperbole due to his frustration with the venture's performance. Thus, the court reversed and remanded the case.

VI. INTERPRETATION OF AGREEMENT REGARDING TRANSFER OF LIMITED PARTNERSHIP INTEREST

Milner v. Milner, 361 S.W.3d 615 (Tex. 2012).

This case involved the interpretation of a mediated settlement agreement ("MSA") requiring a husband to transfer to his wife all of his "beneficial interest and record title in and to" a limited partnership in connection with their divorce. The parties disagreed as to whether the MSA required the wife to be substituted as a limited partner, and the Texas Supreme Court concluded that the MSA was ambiguous and that there was a fact question as to the intent of the parties requiring remand to the trial court for the mediator to resolve the issue.

Vicki Milner entered into an MSA with her husband, Jack Milner, in their divorce proceeding. The MSA provided that Jack agreed to transfer to Vicki all of his "beneficial interest and record title in and to" a limited partnership and its LLC general partner subject to existing liabilities and the partnership agreement. Vicki agreed to substitute herself for Jack by assuming the outstanding liabilities of both entities. The exhibits to the MSA contained documents for all the partners to sign consenting to the transfer of Jack's limited

partnership interest as well as his interest in the LLC general partner. There were three limited partners, Jack, Jack's brother, and a third individual, Michael Hill. Jack and Vicki signed the consent document on the day they entered the MSA, but the other partners did not sign it that day. Jack's brother signed the consent a few days later but then sold his interest to Hill a few days after signing the consent. The draft divorce decree proposed by Jack differed from the MSA in that it did not refer to any required consent of partners and simply contained an assignment of interest for Jack to execute. Vicki asserted that it was her understanding that the MSA was contingent on the consent of all partners to the transfer. Vicki withdrew her consent to the MSA based on this discrepancy, and Jack reasserted his motion that the court enter his previously filed draft of the divorce decree. The trial court signed the decree, which merely provided for the assignment of Jack's partnership interest and did not mention the consent requirement or contain additional signature lines for the other partners. Arguing that the divorce decree did not properly reflect the MSA, Vicki filed a motion for a new trial, which was denied. The consent issue was important because the partnership agreement did not require the consent of the partners for Jack to merely assign his interest to Vicki, but consent of all the partners was required for her to become a substituted limited partner. Hill never signed the exhibits to the MSA, thus preventing Vicki from obtaining the consent required for her to become a limited partner. Because the rights of a limited partner are greater than an assignee, the distinction had a potential impact on the value of the transferred interest. The court of appeals concluded that the trial court abused its discretion by not setting aside the MSA because there was no meeting of the minds regarding the nature of the transferred interest in the limited partnership.

The Texas Supreme Court examined the language of the MSA and concluded that it was ambiguous as to whether it required Vicki's substitution as a limited partner. Thus, there was a fact question as to the parties' intent requiring remand of the case to the trial court for the mediator to resolve the ambiguity. The court noted that Jack plainly agreed to transfer his "beneficial interest and record title" in the partnership and LLC, but the MSA did not explain what this entailed. The phrase was not defined in either the MSA or the partnership agreement, and the court cited various dictionary definitions and case law addressing these terms. The court pointed out that the term "beneficial ownership interest" used in the title of the MSA exhibits does not appear in the legal

dictionary and is not clearly defined in Texas law. The court concluded that the references in the MSA to both “beneficial interest and record title” and “beneficial ownership,” standing alone, were consistent with either an assignment of the partnership interest or transfer of full limited partnership rights. The court examined the provisions of the partnership agreement, which recognized that a person acquiring a partnership interest could do so by substitution as a full partner or by assignment. The partnership agreement characterized an ownership transfer as either an authorized transfer, one to which all partners consented, or an unauthorized transfer, which the partnership agreement contemplated would typically result from death, divorce, or incompetency of a partner. The partnership agreement specifically addressed divorce of a partner by providing that a former spouse would not be considered a substituted partner or have any voting rights or rights relative to the operation or management of the partnership except as provided in the agreement or the Texas Revised Limited Partnership Act. The court explained that the partnership agreement permitted a former spouse, like any other person, to be substituted as a partner if all other partners consented, which consent could be withheld or granted in the sole discretion of the partners. Jack argued that the parties intended no more than an unauthorized assignment of his partnership interest due to the absence of an express requirement or contingency in the MSA that the consent of the other partners be obtained. The supreme court did not agree that the absence of such an express provision clearly confirmed the parties’ intent. The court pointed out that the MSA might have used the term “assignee,” which was defined in the partnership agreement with reference to the Texas Revised Limited Partnership Act, rather than “beneficial interest and record title” if the intention was merely to assign Jack’s partnership interest. The supreme court also pointed out that the phrase “beneficial interest and record title” was used in the partnership agreement when referring to what could only be transferred by unanimous consent. The court stated that references in the MSA to “beneficial interest and record title” and the consent requirement in the partnership agreement along with the inclusion of consent forms to be signed by the other partners suggested the admission of a substitute partner rather than a mere assignment. In sum, the court concluded that the question of what Jack promised to deliver was not clear and that the parties’ intent was a question of fact.

A dissent by Justice Johnson joined by Justices Green and Willett argued that the language of the MSA

was unambiguous and required only that Jack transfer his interest and sign the consent. Like the majority, the dissenting justices discussed the relationship of the MSA to the partnership agreement and the terminology used therein, but the dissent concluded that the only reasonable construction of the MSA was that Jack and Vicki agreed that Jack’s transfer of his interests were subject to the partnership agreement provisions requiring consent of all partners to admit Vicki as a limited partner and that the MSA did not compel Jack to obtain the consent of other partners or imply an unexpressed material contingency that Vicki be admitted as a limited partner.

VII. OPPRESSION OF LLC MEMBER OR ASSIGNEE; RIGHTS OF ASSIGNEE OF LLC MEMBERSHIP INTEREST IN DIVORCE

Kohanim v. Katoli, __ S.W.3d __, 2013 WL 3943078 (Tex. App.—El Paso 2013, pet. filed).

The plaintiff, an assignee of a 50% membership interest in an LLC by virtue of being awarded her husband’s 50% membership interest in a divorce, sued the remaining 50% member of the LLC, asserting various causes of action. The court of appeals discussed the limited rights of the plaintiff as an assignee who had not been admitted as a member but affirmed the trial court’s award of damages to the plaintiff based on oppressive acts of the remaining 50% member. Some of the plaintiff’s causes of action failed because they depended upon the existence of a fiduciary duty on the part of the remaining member, and the trial court refused to find that the plaintiff was owed a fiduciary duty by the remaining member. The court of appeals found it unnecessary to determine whether the trial court erred in declaring that a member agreement with buy-sell provisions was void or inapplicable to the plaintiff because the remaining member failed to comply with the buyout provisions, and the trial court’s declaration in this regard did not impact the judgment.

In 1996, Jacob Kohanim (“Jacob”) and Mike Khosravikatosi (“Mike”) formed an LLC to purchase and hold real property on which a corporation owned by them operated a restaurant. Jacob and Mike were the managers and each owned a 50% interest in the LLC. The member agreement contained transfer restrictions that provided the LLC and the other member the opportunity to purchase a member’s interest in the event of a proposed sale of the interest or a transfer to a member’s spouse in a divorce. In 2003, Mike’s wife, Parvenah, filed for divorce, and the divorce court issued temporary orders prohibiting Mike

and Parvenah from transferring assets. During the pendency of the divorce, Mike purported to transfer a 5% interest in the LLC to Jacob. In 2005, the divorce decree was entered. In the divorce decree, the district court found the transfer was void because it was an attempt to transfer community property in violation of the court's order enjoining such a transfer. The divorce decree further awarded to Parvenah "[o]ne hundred percent (100%) of the husband's interest" in the LLC, "which interest is equivalent to a fifty percent (50%) interest in such company." The decree required the husband to execute and deliver to the wife's attorney a stock transfer certificate and/or assignment of interest. Before the divorce decree was entered, Jacob closed an LLC bank account and transferred \$160,000 in the account to the restaurant's bank account as a "payment to owner." After the divorce decree was entered, Parvenah's attorney raised with Jacob the issue of the \$160,000 payment and demanded a meeting for an accounting and to discuss management of the LLC. The following month, Jacob advised Parvenah that he intended to start the process of determining the value of the LLC for purposes of the buyout provision in the member agreement. Jacob never consented to Parvenah's admission as a member. At the end of 2005, Jacob's attorney informed Parvenah that she had no right to vote at an upcoming meeting regarding Jacob's compensation and that Jacob intended to vote his 55% interest in favor of a \$50,000 payment to him as compensation for his services in 2005. Jacob received the \$50,000 payment over Parvenah's objections. In 2006, Parvenah sued Jacob and the LLC, seeking a declaration of her rights with respect to the LLC and the validity of the member agreement and asserting claims based on constructive fraud, breach of fiduciary duty, oppression, waste, gross mismanagement and abuse of control, and unjust enrichment. The trial court appointed a receiver for the LLC and ordered the receiver to sell the LLC's assets. The trial court eventually approved a sale of the LLC's property for \$1,300,100. The trial court's final judgment contained findings as to the amount of assets held by the receiver and how the assets should be divided based on the court's finding that Jacob and Parvenah each held a 50% beneficial interest in the assets. The trial court also found that Jacob, with malice and intent to defraud, engaged in wrongful acts and omissions that damaged Parvenah by decreasing the value of Parvenah's interest in the LLC, and the trial court awarded Parvenah actual and punitive damages based on the wrongful acts and omissions. Jacob appealed on numerous issues but did not challenge the trial court's division of the LLC's assets.

The court of appeals sustained Jacob's challenge to Parvenah's recovery for breach of fiduciary duty. Although the trial court's conclusions of law stated that Jacob owed a fiduciary duty to the LLC and breached that duty, the trial court did not make Parvenah's requested findings that Jacob owed Parvenah a fiduciary duty or that he breached that duty. Thus, the court of appeals held that Parvenah could not recover for her breach of fiduciary duty cause of action.

The court of appeals also held that Parvenah could not recover on her fraud and constructive fraud claims. She failed to plead a cause of action for actual fraud, and the court concluded the issue of actual fraud was not tried by consent. With respect to Parvenah's constructive fraud claim, the court of appeals held that Parvenah could not recover because constructive fraud is premised upon the existence of a breach of fiduciary duty, and the trial court refused to find that Jacob owed Parvenah a fiduciary duty and that he breached that duty.

The court of appeals rejected Jacob's challenge to the legal sufficiency of the evidence to support Parvenah's oppression claim. The court of appeals stated that "a member oppression claim may exist when: (1) a majority shareholder's conduct 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; or (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 standards of fair dealing, and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely." Jacob contended that an oppression claim can only be asserted by a minority member or shareholder, and Jacob conceded that Parvenah owned a 50% interest. The court of appeals rejected the argument that only a minority owner may assert an oppression claim because the Texas Business Organizations Code provides for a receivership based on oppression by the directors or "those in control" of the entity. The court of appeals went on to examine whether there was any evidence of oppressive acts. Jacob argued that there was no evidence that he oppressed Parvenah's rights by refusing to allow her to participate in management given that she was not a member. The court explained that a membership interest is personal property and that Mike's 50% membership interest was community property awarded in its entirety to Parvenah under the divorce decree. Mike executed a document transferring and assigning

the membership interest to Parvenah as required by the divorce decree, but the assignment of the interest did not include the right to participate in management under the Texas Business Organizations Code. Under the statute, the right to participate in management is not community property, and assignment of a membership interest does not entitle the assignee to participate in the management and affairs of the LLC, become a member, or exercise any rights of a member. An assignee is entitled to become a member only with the approval of all of the members, and Jacob never consented to Parvenah becoming a member. Thus, she did not have any right to participate in the management of the LLC. Jacob next contended that there was no evidence that he oppressed Parvenah's rights by failing to make distributions to her. The LLC's regulations (i.e., company agreement) provided for quarterly distributions to members of "available cash" provided available cash was not needed for reasonable working capital reserves. The Texas Business Organizations Code provides that an assignee is entitled to receive any distribution the assignor is entitled to receive to the extent the distribution is assigned. Because the district court awarded the entire community interest to Parvenah, she had a right to receive distributions. The district court found that Jacob paid himself for services that were not performed and that he failed to make any distributions to Mike or Parvenah even though \$250,000 in undistributed profits had accumulated since the mortgage on the LLC's property was paid off. The court of appeals concluded this was some evidence supporting the trial court's finding that Jacob failed to make profit distributions. The court also agreed that the established facts demonstrated that Jacob engaged in wrongful conduct and exhibited a lack of fair dealing to the prejudice of Parvenah.

The court of appeals agreed with Jacob's challenge to the trial court's finding on Parvenah's unjust enrichment claim. The trial court found that Jacob wrongfully utilized funds and assets of the LLC for his own use and unilaterally obligated the LLC to pay himself for management services that were not performed at all or were performed in a manner that damaged the LLC. A claim for unjust enrichment on these facts belonged to the LLC rather than Parvenah.

The court next addressed Jacob's challenge to the legal sufficiency of the evidence to support the actual and punitive damages award. Because the court of appeals sustained Jacob's challenges to Parvenah's other causes of action, the only viable cause of action to support a damage award was the shareholder/member oppression claim. The court of appeals stated that the standard of review on this issue

was not the traditional sufficiency analysis as asserted by Jacob, but rather was abuse of discretion because the receivership provision of the Texas Business Organizations Code that provides for an oppression action authorizes a court to fashion an equitable remedy if the acts of those in control of an entity are oppressive. The court of appeals concluded that the trial court's methodology for finding actual damages was not an abuse of discretion. The trial court calculated Parvenah's damages by calculating the difference between the value of the LLC's assets at the time of the trial court's judgment in this case and the value of the LLC at the time of the divorce, increased by the amount taken from the LLC's bank account by Jacob before the divorce decree. The court of appeals rejected Jacob's argument that the trial court erred by adding back the amount taken from the LLC's bank account prior to the divorce. Because Jacob's removal of the LLC's funds reduced the value of Parvenah's interest, the court of appeals concluded the trial court did not err by adding that amount back into the value of the LLC. Next the court of appeals rejected the argument that the member agreement required the LLC to be valued as of the date of the divorce petition. The court of appeals stated that the trial court found that the member agreement did not apply to Parvenah. Assuming it applied to Parvenah, the court of appeals stated that it was inapplicable here because Jacob did not comply with the provision addressing a buyout on divorce by intervening in the divorce proceeding to enforce the provision. Mike had agreed to the intervention, but Jacob did not do so. Jacob next argued that the LLC regulations provided that the valuation of Parvenah's interest must be based on book value because the regulations contained a provision for purchase of a member's interest at book value or appraised value on request of a party who deems the book value to vary from market value by more than 20%. The provision of the regulations relied upon by Jacob addressed death, dissolution, retirement, or bankruptcy of a member. The court stated that the provision did not address how damages are calculated in a lawsuit based on oppression, and the court relied on other case law in which the court in an oppression action concluded that it was not an abuse of discretion to order a buyout for fair value when a buy-sell agreement provided for redemption at book value. The court of appeals pointed out that receivership is one remedy for shareholder/member oppression and that the trial court ordered a receivership and authorized a sale of the LLC's assets. Jacob did not complain concerning the receivership or sale. However, the court concluded that Parvenah was not limited to a recovery

of her proportionate share of the sale proceeds and that courts have equitable powers to fashion appropriate remedies for oppressive conduct, including a buyout. Here, the court concluded that sufficient evidence supported the values found by the trial court and that Jacob did not argue, and the court of appeals did not perceive, that the trial court's methodology constituted an abuse of discretion. The court of appeals sustained Jacob's challenge to punitive damages because the only causes of action that could support a punitive damages award were actual fraud and breach of fiduciary duty.

Finally, the court concluded that Jacob's challenges to the trial court's declarations that the member agreement was void or inapplicable to Parvenah did not impact the judgment given that: Jacob did not challenge the declaration that Parvenah owned a 50% interest or the 50/50 allocation of the LLC's assets; the court of appeals sustained Jacob's contentions that an award of damages could not be based on Parvenah's breach of fiduciary duty, constructive fraud, and unjust enrichment claims; and attorney's fees under the Declaratory Judgment Act were supported by the unchallenged declarations of the trial court.

VIII. DEFINITION OF NONPROFIT ASSOCIATION UNDER TEXAS UNIFORM UNINCORPORATED NONPROFIT ASSOCIATION ACT (TUUNAA); LIMITED LIABILITY OF MEMBER OF NONPROFIT ASSOCIATION UNDER TUUNAA

MT Falkin Investments, L.L.C. v. Chisholm Trail Elks Lodge No. 2659, 400 S.W.3d 658 (Tex. App.—Austin 2013, pet. filed).

The court of appeals held that an unincorporated nonprofit association, the members of which were six nonprofit organizations and the purpose of which was to conduct a shared charitable bingo association, was a nonprofit association governed by Chapter 252 of the Texas Business Organizations Code rather than a general partnership. The court went on to hold that Chapter 252 abrogates the common-law rule that a member is personally liable for a contract of an unincorporated nonprofit association when the member has assented to or ratified the contract.

The lessor under a commercial lease agreement with the Williamson County Charitable Bingo Association ("WCCBA") sued a lodge that was a member of WCCBA, alleging that the lodge was liable for the breach of the lease. WCCBA's restated articles of organization recited that WCCBA was an

unincorporated nonprofit association with up to six members, who must also be nonprofit organizations. The articles stated that the purpose of the association was to conduct a shared charitable bingo operation. The plaintiff asserted that WCCBA was a general partnership governed by Chapter 152 of the Texas Business Organizations Code ("BOC") rather than an unincorporated nonprofit association governed by Chapter 252 of the BOC (i.e., the Texas Uniform Unincorporated Nonprofit Association Act or "TUUNAA") as determined by the trial court by summary judgment. The plaintiff argued that WCCBA had many of the characteristics that would indicate the formation of a partnership and that there was thus a fact question about whether WCCBA was a partnership. The court of appeals stated that unincorporated nonprofit associations commonly exhibit some characteristics of a partnership. The summary judgment evidence established that WCCBA operated for a common, nonprofit purpose and thus was an unincorporated nonprofit association as defined by TUUNAA. The argument that WCCBA has many characteristics of a partnership and could also be classified as a partnership was without merit insofar as establishing liability under Chapter 152 of the BOC. Because WCCBA qualified as an unincorporated nonprofit association, it was governed solely by TUUNAA.

The court went on to conclude that TUUNAA abrogated the common law such that a member of an unincorporated nonprofit association is not liable for the association's contract merely because the member assented to or ratified the contract. The court discussed the common law of unincorporated nonprofit associations in Texas, under which an unincorporated nonprofit association was not recognized as a separate legal entity apart from its members. Under the common law, members of a nonprofit association were not automatically liable for the association's actions, but a member was vicariously liable for an association's actions if the member authorized or ratified the actions. Under TUUNAA, a nonprofit association is a legal entity separate from its members for purposes of determining and enforcing rights, duties, and liabilities in contract and tort, and a person is not liable for breach of a nonprofit corporation's contract merely because the person is a member or is authorized to participate in the management of the affairs of the association. The court noted that both TUUNAA and the common law provide that a member is not liable "merely" by virtue of being a member, but "merely" means something substantially different under TUUNAA. Based on the scant case law in Texas and

elsewhere applying the uniform statute, the official comments to the uniform statute, and secondary sources analyzing the statute, the court concluded that TUUNAA abrogated the common law so that a member of the WCCBA could not be liable for the actions of the association merely because the member assented to or ratified the lease agreement.

A petition for review has been filed with the Texas Supreme Court, and the court has requested briefing on the merits.

IX. REDUCTION OF MINORITY SHAREHOLDER'S COMPENSATION, NONPAYMENT OF DIVIDENDS, AND OTHER CONDUCT NOT CONSTITUTING SHAREHOLDER OPPRESSION; FAILURE OF FRAUD AND BREACH OF FIDUCIARY DUTY CLAIMS IN ABSENCE OF HARM

ARGO Data Resource Corporation v. Shagrithaya, 380 S.W.3d 249 (Tex. App.—Dallas 2012, pet. filed).

Shagrithaya, the 47% shareholder of ARGO Data Resource Corporation (“ARGO”), brought this action against Martin, the 53% shareholder, and ARGO. The trial court entered a judgment ordering payment of a dividend in the amount of \$85 million plus payment of damages based on shareholder oppression, suppression of dividends, fraud, and derivative claims for breach of fiduciary duty. The court of appeals reversed and rendered, concluding that the majority shareholder’s conduct did not constitute oppression and that the fraud and breach of fiduciary duty claims failed because there was no showing of harm.

Martin and Shagrithaya formed ARGO in 1980 with \$1,000 in capital. ARGO’s business was providing software and related services to the retail financial services industry. Shagrithaya developed the technology, and Martin ran the business side. The two men elected themselves as directors and officers and decided on a year-to-year basis how much their compensation would be. There were no written or oral employment agreements, but Shagrithaya testified that he understood they would receive an equal salary as co-founders. For 25 years, they did receive equal compensation. At first, neither received any salary as they built up the business, and for more than 20 years the corporation did not pay a dividend because their plan was to build up the company and sell it. In 2004, ARGO issued its first dividend of \$160,000, and in 2008 ARGO’s capital had grown to \$152 million.

Martin’s and Shagrithaya’s compensation increased over time to nearly \$1 million a year.

In the late 1990s and early 2000s, Martin and Shagrithaya began discussing their future roles in the company. Martin moved to the role of CEO and promoted an employee, Engebos, as COO and eventually as president. Another employee was named as Shagrithaya’s successor, and Shagrithaya became chief technology officer. Martin became dissatisfied with Shagrithaya’s apparent unwillingness to give up his responsibility for creating products and take on more management responsibility. Shagrithaya believed, however, that it would not be easy to pass on his creative vision to someone else. In 2006, Martin told Shagrithaya that he could not justify paying him \$1 million per year and cut Shagrithaya’s compensation to \$300,000 for that year. When Shagrithaya learned that his compensation had been cut, he met with Martin and discussed “stepping down,” which Martin understood to mean Shagrithaya would sell his shares. Martin and Shagrithaya began discussions about a buyout of Shagrithaya’s shares by ARGO, and an appraiser suggested by Shagrithaya was chosen to value his shares. During this time period, ARGO moved corporate offices, and Shagrithaya was given a smaller office on a different floor from the large offices in the executive suite. Also during this time period, an IRS audit of ARGO for excess accumulated earnings took place, and ARGO took the position that its business needs for retaining earnings included a plan (which had not been disclosed to Shagrithaya) begun in 2003 to phase out Shagrithaya that would likely include a redemption of his shares. The IRS ultimately agreed that ARGO was not retaining excess accumulated earnings even without regard to a buyout of Shagrithaya’s shares, and the IRS withdrew its assessment of an accumulated earnings tax.

After the appraisal of Shagrithaya’s shares, Martin agreed to have ARGO purchase Shagrithaya’s shares for \$66 million, which included a 35% minority discount. Because the sale was not to a third party, Shagrithaya did not believe a discount should be applied, and he refused to approve the offer. Shagrithaya’s lawyer informed Martin that Shagrithaya would be obtaining his own appraisal of his shares and demanded that ARGO increase Shagrithaya’s compensation to equal Martin’s. Shagrithaya also wanted ARGO to retain an investment banker to advise them on the sale of the company and to declare an \$85 million dividend. These proposals were not acted on. Martin received proposals from Wachovia Securities to represent ARGO in a proposed transaction with a third-

party buyer, but Martin was not interested and never informed Shagrithaya of the proposal. Martin proposed several alternatives to resolve the issue of Shagrithaya's position and ownership interest in ARGO, but Shagrithaya believed they all benefited Martin more than they benefited him. Eventually, Shagrithaya stated that he no longer wanted to discuss a buyout and that he wanted his compensation restored to its previous level, access to ARGO's books and records, issuance of an \$85 million dividend, and retention of an investment banker to advise on the possible sale of ARGO. Shagrithaya was given access to the books and records, and Shagrithaya's accountant performed an audit that revealed several instances in which corporate funds were used for personal purposes of Martin. After an audit by ARGO and review of the charges, Martin reimbursed ARGO for more than the amount Shagrithaya's audit stated was owed.

Shagrithaya filed this action in which he alleged direct claims for breach of fiduciary duty, fraud, malicious suppression of dividends, minority shareholder oppression, breach of contract, and defamation. He also asserted derivative claims for breach of fiduciary duty, fraud, and malicious suppression of dividends. A year after the suit was filed, a board meeting was held at which Martin appointed Engebos as a third director because a previous board meeting had resulted in a stalemate. At this board meeting, action was taken to elect a slate of officers, set compensation, and authorize a \$25 million dividend. In each case, Martin and Engebos outvoted Shagrithaya and took action opposed by Shagrithaya. Shagrithaya resigned from the company after this meeting. The trial of the case took place several months later.

Shareholder Oppression. The jury found the following acts on which the trial court based its finding of shareholder oppression: (1) Martin reduced Shagrithaya's annual compensation by 70% without approval, if required, by the board of directors or shareholders; (2) Martin's compensation was maintained at \$1 million for a two-year period without approval, if required, of the board of directors or shareholders; (3) Martin engaged in a plan to retain the corporation's earnings to buy out Shagrithaya's shares without disclosing the plan to Shagrithaya; (4) Martin caused ARGO to retain earnings rather than paying a greater amount of dividends to its shareholders than it actually paid; (5) Martin dominated and controlled the board of directors with the actual result of suppressing the issuance of dividends for the purpose of preventing Shagrithaya from sharing in the profits of ARGO and depreciating the value of Shagrithaya's shares; (6)

Martin failed to disclose to the board of directors that the IRS had assessed a retained earnings tax against ARGO of approximately \$1.2 million; (7) Martin made an offer to purchase Shagrithaya's shares for \$66 million; (8) Martin required Shagrithaya to report to Engebos as president without obtaining the approval of the board of directors; (9) Martin misused corporate assets by (i) acquiring a Colorado condominium from ARGO without disclosing the sale to, or obtaining approval of, the board of directors, (ii) using ARGO's funds to pay personal travel expenses or other personal or family expenses, and (iii) maintaining his wife on the corporate payroll while she was performing no services; (10) Martin failed to disclose to the board of directors that he had retained a law firm to challenge the IRS tax assessment against ARGO.

Before addressing each of the jury's findings in relation to the oppression claim, the court of appeals generally addressed the shareholder oppression doctrine as it has developed in Texas. Under Texas case law, it is within the province of the jury as factfinders to determine whether certain acts occurred, but the determination of whether such acts constitute oppression is a question of law for the court. Courts must exercise caution in determining what constitutes oppressive conduct, and officers and directors are afforded broad latitude in conducting corporate affairs. The minority's expectations must be balanced against the corporation's need to exercise its business judgment and run its business effectively. Courts take a broader view of oppression in closely held corporations. The cause of action for oppression was codified in the Texas Business Corporation Act in Article 7.05 and is now found in Section 11.404 of the Business Organizations Code. The statute authorizes a court to fashion an equitable remedy if the actions of those in control of the corporation are illegal, oppressive, or fraudulent. "Oppression" is not defined in the statute, but the courts have recognized two non-exclusive definitions based on reasonable expectations and fair dealing. The court discussed the distinction between general reasonable expectations and specific reasonable expectations. The court noted that Shagrithaya asserted a separate "malicious suppression of dividends" claim in addition to shareholder oppression, but the court of appeals stated that the claim for malicious suppression of dividends was merely a form of shareholder oppression and must be analyzed as such. Applying the two non-exclusive definitions of oppression (i.e., the reasonable expectations test and the fair dealing test), the court of appeals concluded that none of the 11 acts the jury found in support of Shagrithaya's oppression claim,

nor any of the acts found in support of his malicious suppression of dividends claim, showed minority shareholder oppression.

The jury's finding that Martin reduced Shagrithaya's compensation without approval of the board or shareholders was largely undisputed but did not support a finding of shareholder oppression. The court stated that an expectation of annual employment compensation is not a general expectation of all shareholders; therefore, Shagrithaya had to establish facts showing his specific expectation that a certain level of compensation was central to his decision to join the corporation. Shagrithaya testified he and Martin had no discussions about compensation before they founded ARGO, and there was no written or oral agreement. To the extent Shagrithaya expected to be compensated in an amount equal to Martin, such was the case for 25 years. The court stated that it was not reasonable for Shagrithaya to expect that, without an agreement, he would indefinitely be entitled to maintain a level of compensation without regard to the circumstances. Although the court noted that it was not holding that a reduction in compensation can never constitute oppression, the court stated that an expectation of continued employment at a certain level cannot be considered objectively reasonable absent an employment agreement. The court also concluded that the reduction in compensation was not so burdensome, harsh, or wrongful that it constituted shareholder oppression. Although it may have been wrongful for Martin to unilaterally reduce Shagrithaya's compensation without board approval, the action related to Shagrithaya's status as an employee and not a shareholder. Additionally, the absence of board approval was later corrected in a vote setting compensation levels retroactive to the date of reduction of Shagrithaya's compensation. Shagrithaya was outvoted at the board meeting, but his inability to control board decisions was inherent in his position as a minority shareholder. The board set compensation levels based on an independent report, and Shagrithaya's dispute over his level of compensation was purely an employment matter that did not prejudice his rights as a shareholder and thus was not a visible departure from the standards of fair dealing that would support a finding of shareholder oppression. Likewise, the undisputed finding of the jury that Martin maintained his own level of compensation without board approval for a period of time did not cause Shagrithaya any harm because it was later retroactively approved by the board, and any specific expectation by Shagrithaya that he would maintain an equal level of compensation absent an employment

contract was objectively unreasonable. Although a shareholder has no general reasonable expectation about the compensation level of the corporation's executives, a shareholder does have a right to proportionate participation in earnings. Martin's compensation level was supported by an independent report, and there was no evidence that his compensation was a de facto dividend or affected Shagrithaya's interest as a shareholder.

The fact findings relating to the retention of earnings by ARGO for the undisclosed purpose of buying out Shagrithaya's interest and suppressing dividends to reduce the value of his shares were in part supported by the evidence, but the court of appeals concluded that the evidence did not support a finding that Shagrithaya was individually targeted for the purpose of preventing him from sharing in the profits or that the value of his shares was depreciated. To the extent the jury findings were supported by the evidence, the court concluded that they did not support a finding of oppression. Martin's decision to retain earnings in ARGO did not substantially defeat Shagrithaya's specific reasonable expectations because the plan when the shareholders started the company was to build the company by retaining earnings. As for general expectations, a shareholder has no general expectation of receiving a dividend. Payment of dividends is in the discretion of the board, and a shareholder's general reasonable expectation is limited to sharing in the company's earnings through the appreciation in value of the shares and sharing proportionately in any dividend the board chooses to declare. Additionally, there were some dividends paid during the period at issue, and Shagrithaya shared proportionately in them. Finally, Martin's failure to disclose to Shagrithaya the plan to retain earnings to buy out Shagrithaya's interest was not burdensome, harsh, or wrongful conduct because buying out a shareholder's interest is not an improper purpose for retaining earnings. The failure to pay dividends did not prevent Shagrithaya from sharing in the profits of the company or depreciate the value of his shares and thus did not prejudice his rights as a shareholder.

Martin's failure to disclose to the board (the other board member at the time being Shagrithaya) that the IRS had assessed a retained earnings tax against ARGO did not harm Shagrithaya's interests because the assessment was challenged and ultimately reversed. If a shareholder's interest is not affected by conduct, the court concluded that the conduct cannot support a finding of oppression. The court also concluded that Martin's failure to disclose the retention of a law firm to challenge the assessment was not oppression

because ARGO benefited from the successful challenge, and there was no showing that Martin reaped any personal benefit that was denied to Shagrithaya.

The fact that ARGO made an offer to purchase Shagrithaya's shares for \$66 million did not support a finding of oppression according to the court of appeals because fair market value (i.e., a value that includes a minority discount) is an appropriate measure of the value of shares if the minority is not being forced to relinquish his shares. Shagrithaya was not forced to relinquish his shares, and he had in fact expressed interest in being bought out. The valuation was made by an independent appraiser that was not shown to be biased or inaccurate. Furthermore, the court stated that the mere offer to purchase the shares for fair market value cannot amount to oppression.

The jury's finding that Shagrithaya was required to report to Engebos without board approval related to Shagrithaya's status as an employee and not to his rights as a shareholder. Additionally, the appointment was later approved by the board. Absent any evidence of harm to Shagrithaya's interests as a shareholder, the court concluded that this act did not rise to the level of shareholder oppression.

Finally, the three acts relating to misuse of corporate assets did not support a finding of oppression because Martin repaid to the corporation more than the amount Shagrithaya claimed was owed. There was no evidence that the minority shareholder's expectations or rights as a shareholder were harmed because any harm was remedied.

Fraud. The court also concluded that equitable relief based on the jury's finding of fraud was not warranted because a finding of fraud requires a showing of actual injury. The fraud claim was based on Martin's failure to disclose to Shagrithaya his plan to buy out Shagrithaya's shares with retained earnings. The court concluded that there was no evidence that Shagrithaya was harmed by the withholding of this information. The value of his shares continued to increase, and there was no evidence that but for Martin's conduct the company would have been sold or that Shagrithaya would have been better off if his assets had not been locked up in this one undiversified asset.

Implied Contract. The court next concluded that the evidence was insufficient to support the jury's verdict that Shagrithaya and Martin entered into an implied contract that their compensation would be equal while they both remained active in ARGO. The alleged agreement failed for indefiniteness as a matter of law.

Breach of Fiduciary Duty. Finally, the court concluded that the jury's findings on the derivative claims for breach of fiduciary duty did not support an award of damages because there was no evidence that ARGO was harmed or that Martin benefited by the acts on which damages were based. The findings of breach of fiduciary duty on which damages were based related to Martin's decision to retain earnings and ARGO's payment of legal fees in connection with negotiations between Martin and Shagrithaya in the months before Shagrithaya filed suit. The court said that the decision to retain earnings rather than pay larger dividends benefited the corporation and could not be seen to benefit Martin as a shareholder. Also, the legal fees paid for ARGO to challenge the IRS assessment of a retained earnings tax resulted in a successful challenge to the IRS assessment and thus did not harm ARGO or benefit Martin. Legal fees paid by ARGO in connection with discussions about buying out Shagrithaya and payment of a dividend impacted ARGO's interests, and there was no showing that the attorneys considered Martin's interests to the detriment of ARGO. The jury also found that Martin breached his fiduciary duty by purchasing a condominium from ARGO. Although the jury did not award damages with respect to this act, the trial court ordered Martin to return the property to ARGO and ARGO to reimburse Martin. The court of appeals concluded that this equitable relief, which was not requested by Shagrithaya, was not warranted because the evidence showed that ARGO benefited from the sale and was paid a fair price.

A petition for review has been filed with the Texas Supreme Court, and the court has requested briefing on the merits.

X. EQUITABLE FAIR-VALUE BUYOUT OF OPPRESSED SHAREHOLDER TRUMPS BUY-SELL AGREEMENT; ABSENCE OF FIDUCIARY DUTY BY MAJORITY SHAREHOLDER TO MINORITY SHAREHOLDER

Cardiac Perfusion Services, Inc. v. Hughes, 380 S.W.3d 198 (Tex. App.—Dallas 2012, pet. filed).

The court in this case concluded that a court-ordered buyout of a minority shareholder's shares for the fair value of the shares was appropriate notwithstanding that the shareholders had entered into a buy-sell agreement providing for a buyout of the shareholder's shares at book value. The minority shareholder claimed that the book value of the shares was reduced by the majority shareholder's oppressive conduct, and the minority shareholder sued for

shareholder oppression rather than breach of contract. Consistent with numerous other decisions of intermediate Texas courts, the court of appeals rejected the argument that the majority shareholder owed the minority shareholder a formal fiduciary duty as a matter of law, and the trial court thus did not err in declining to render judgment in favor of the minority shareholder on his breach of fiduciary duty claim.

Joubran, the founder and initial sole shareholder of Cardiac Perfusion Services, Inc. (“CPS”), sold 10% of CPS’s shares to Hughes, and the two men entered into a buy-sell agreement requiring a buyout of a shareholder’s stock upon termination of the shareholder’s employment with CPS at a purchase price equal to the book value of the shares as of the fiscal year preceding the termination. A dispute arose between the parties, and Hughes’s employment with CPS was terminated.

After termination of Hughes’s employment, CPS and Joubran sued Hughes for damages for breach of fiduciary duty and tortious interference with a contract of CPS and for a declaratory judgment that Joubran’s obligation to purchase Hughes’s stock was governed by the buy-sell agreement and that the purchase price was reduced by damages to CPS caused by Hughes’s conduct. Hughes asserted a counterclaim against Joubran for shareholder oppression. The jury found that Joubran: (1) suppressed payment of profit distributions to Hughes; (2) paid himself excessive compensation from CPS’s funds, (3) improperly paid family members using corporate funds; (4) used corporate funds to pay personal expenses; (5) used his control of CPS to lower the value of Hughes’s shares; and (6) refused to let Hughes examine CPS’s books and records. The trial court concluded that Joubran engaged in shareholder oppression based on the jury’s findings. The jury found that the fair value of Hughes’s shares was \$300,000, and the trial court concluded that the most equitable remedy was to require Joubran and CPS to buy back Hughes’s shares for the fair value of \$300,000 found by the jury. On appeal, CPS and Joubran argued that the trial court erred in concluding that the equitable doctrine of oppression nullified the buy-sell agreement, i.e., in ordering that the shares be purchased for their fair value rather than their book value as specified by the buy-sell agreement. The trial court’s conclusion that the conduct found by the jury constituted shareholder oppression apparently was not challenged on appeal.

The court of appeals concluded that the Texas cases relied upon by CPS and Joubran were distinguishable because they did not involve a trial court’s equitable discretion in the context of a claim for

shareholder oppression. Hughes claimed that Joubran’s conduct reduced the book value of Hughes’s shares, and Hughes sued for oppression, not breach of contract. The court of appeals relied upon the discussion of the “enterprise value” method of determining fair value in *Ritchie v. Rupe* and the holding in *Davis v. Sheerin* that a court-ordered buyout of stock for its fair value is an appropriate remedy for shareholder oppression in a closely held corporation. The trial court in this case instructed the jury to value the shares using the valuation method sanctioned in *Ritchie*, and the court of appeals concluded that the trial court did not abuse its discretion by ordering the redemption of the minority shareholder’s shares for fair value.

CPS and Joubran raised three complaints regarding the testimony of Hughes’s valuation expert. First, they argued that the expert’s testimony on the “fair value” of Hughes’s stock was not supported by a coherent measure of value. The court characterized this complaint as a complaint about reliability that depended on arguments that were not raised below. Thus, the court declined to address this argument. Second, CPS and Joubran argued that the expert’s testimony was conclusory and thus legally insufficient. The court discussed the testimony of the expert about his valuation opinions and the facts supporting those opinions and concluded that the expert’s testimony was not conclusory and was legally sufficient to support the jury’s finding of a fair value of \$300,000. Third, CPS and Joubran argued that the expert’s valuation was erroneous because it was based on an incorrect assumption that CPS was an S corporation. The court concluded that the expert did not erroneously assume that CPS was an S corporation because the testimony showed there was conflicting evidence concerning whether CPS was an S or C corporation, and the expert calculated the value for both.

Hughes asserted on cross-appeal that the trial court erred in refusing to render judgment in his favor on his claim against Joubran for damages for breach of fiduciary duty. Although the jury found that there was not a relationship of trust and confidence between Joubran and Hughes, the jury also found that Joubran did not comply with his fiduciary duty to Hughes, and the jury found actual and exemplary damages based on such conduct. Hughes argued that the jury’s finding that there was no relationship of trust and confidence between Joubran and Hughes was immaterial because Joubran owed him a fiduciary duty as a matter of law based on Joubran’s status as a majority shareholder dominating control over CPS. The court of appeals noted that the Texas Supreme Court has expressly

declined to decide the legal question of whether a majority shareholder in a closely held corporation owes a minority shareholder a general fiduciary duty under Texas law. The court cited intermediate appellate cases rejecting the argument that a shareholder in a closely held corporation owes a co-shareholder a fiduciary duty as a matter of law and stated that cases relied on by Hughes at most stood for the proposition that a majority shareholder who controls a closely held corporation may owe a fiduciary duty to a minority shareholder under certain circumstances, not that every controlling majority shareholder owes a minority shareholder a fiduciary duty as a matter of law. Thus, the trial court did not err in declining to render judgment for Hughes on his claim for breach of fiduciary duty.

A petition for review has been filed with the Texas Supreme Court, and the court has requested briefing on the merits.

XI. 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, 371 S.W.3d 267 (Tex. App.—Houston [1st Dist.] 2012, pet. filed).

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 sought to recover profit distributions allegedly withheld by the individual who was both the controlling member of the LLC and a fellow limited partner. 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 LLC 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 manager 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 serves 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.

A petition for review has been filed with the Texas Supreme Court, and the court has requested briefing on the merits.

XII. 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., 367 S.W.3d 355 (Tex. App.—Houston [1st Dist.] 2012, pet. granted, judgment vacated w.r.m.).

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.

Affirmative Defense of Release. 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.

Fraud: Actionable and Non-actionable Statements. 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.

Fraud: Effect of Contractual Releases and Disclaimers on Reliance Element. 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.

Fraud: Justifiable Reliance. 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.

Fiduciary Duty. 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. As 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.

Shareholder Oppression. 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.

Texas Securities Act. 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.

Common-Law and TSA Damages. 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.

This case was appealed to the Texas Supreme Court, which requested briefing on the merits. While the petition for review was pending, the parties settled the case and asked the Texas Supreme Court to grant the petition for review, vacate the judgments in the lower courts, and remand the case for rendition of judgment in accordance with the settlement. The Texas Supreme Court took this action without considering the merits of the case. The parties asked the court of appeals to withdraw its opinion, but the court of appeals declined to withdraw its opinion. *See Allen v. Devon Energy Holdings, L.L.C.*, 2013 WL 273026 (Tex. App.—Houston [1st Dist.] Jan. 24, 2013) (mem. op.).

XIII. LLC VEIL PIERCING

Shook v. Walden, 368 S.W.3d 604 (Tex. App.—Austin 2012, pet. denied).

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 version of the single business enterprise theory submitted to the jury was materially identical to that rejected by the Texas Supreme Court in *SSP Partners v. Gladstrong Investments (USA) Corp.*, 275 S.W.3d 444 (Tex. 2008). 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*, 721 S.W.2d 270 (Tex. 1986), 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 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. The court of appeals noted 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 that Wisconsin decision. The

court of appeals 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 and conformed pre-existing 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.

A dissenting justice argued that the equitable standard set forth in *Castleberry* was the correct approach in this case given the absence of a statutory standard. Because an actual fraud finding is not required under *Castleberry*, the dissenting justice would have affirmed the judgment imposing personal

liability on Shook based on the jury's findings (which the dissenting justice considered to be supported by the record) that the LLC was operated as Shook's alter ego and as a sham.

XIV. USE OF SINGLE BUSINESS ENTERPRISE THEORY IN ALTER EGO ANALYSIS

Tryco Enterprises, Inc. v. Robinson, 390 S.W.3d 497 (Tex. App.–Houston [1st Dist.] 2012, pet. dism'd).

In this decision of the Houston First Court of Appeals, the court appeared to somewhat equate the concept of a single business enterprise to an alter ego relationship. (Another opinion of the Houston First Court of Appeals, *Fazio v. Cypress/GR Houston I, L.P.*, 2012 WL 3524842 (Tex. App.–Houston [1st Dist.] Aug. 16, 2012), followed a similar approach, but the court of appeals agreed to reconsider that case *en banc*, issued a substitute opinion, and withdrew the panel's opinion. The majority in the *en banc* opinion did not reach the veil-piercing issue.) The court in *Tryco* imposed the obligation of a corporation on affiliated individuals or entities based on the existence of a single business enterprise and alter ego relationship coupled with use of the corporate fiction for an illegitimate purpose. The court acknowledged that the Texas Supreme Court, in *SSP Partners v. Gladstrong Investments (USA) Corp.*, 275 S.W.3d 444 (Tex. 2008), held that parties are not jointly liable for a corporation's obligation merely because they are part of a single business enterprise. Relying on *SSP Partners*, the court of appeals stated that piercing the corporate veil to impose liability under the alter ego theory requires a two-prong showing: (i) that the persons or entities upon whom a claimant seeks to impose liability are alter egos of the debtor, and (ii) that the corporate fiction was used for illegitimate purposes, i.e., to perpetrate fraud. The court stated that whether the persons or entities sought to be charged are alter egos of the primary debtor can be assessed using the single business enterprise factors (i.e., whether the entities shared a common business name, common offices, common employees, or centralized accounting; whether one entity paid the wages of the other entity's employees; whether one entity's employees rendered services on behalf of the other entity; whether one entity made undocumented transfers of funds to the other entity; and whether the allocation of profits and losses between the entities is unclear). The court concluded that the evidence showed that the corporate obligors and certain related individuals or entities were part of a single business enterprise and were alter egos

of each other. The court characterized the separate bases for piercing the corporate veil identified in *Castleberry* as “criteria” for meeting the second prong and concluded that the second prong was met based on evidence of five of the six criteria.

In a dissenting opinion, Justice Massengale took issue with the majority’s veil-piercing analysis and holdings. First, the dissent argued that the majority improperly treated the separate theories set forth in *Castleberry* as “criteria” rather than independent grounds for recovery that must be specifically pled. At trial, the plaintiff’s only two veil-piercing theories were single business enterprise and alter ego. Because the supreme court held that the single business enterprise theory is not a viable theory to impose one corporation’s liability on another, the dissent stated that alter ego was the only basis on which the court could affirm the trial court’s judgment. The trial court’s judgment imposed one corporation’s liability on a second corporation to which all of the assets of the first corporation were transferred after forfeiture of the first corporation’s charter and on individuals who were officers of both corporations. The dissent discussed the evidence relating to the relationship between the two corporations and between the first corporation and the individual officers and concluded that the evidence did not support a finding of alter ego. With respect to the relationship between the two corporations, the dissent argued that they could not be alter egos because they did not exist and operate at the same time. With respect to the relationship between the first corporation and the individuals, the dissent objected to the majority’s reliance on failure to follow corporate formalities because courts of appeals have held that observance of formalities is no longer a relevant factor in analyzing alter ego based on Section 21.223 of the Business Organizations Code and its predecessor provision. The dissent also argued that the forfeiture of the corporate obligor’s charter and transfer of all its assets to another corporation so that the first corporation could not satisfy its obligation was more closely akin to a typical “sham to perpetrate a fraud,” which the plaintiff did not plead. Finally, the dissent argued that the evidence did not satisfy the actual fraud standard that must be met to constitute an illegitimate use of the corporate structure, and that there was no evidence that any actual fraud was for the direct personal benefit of the individuals or the second corporation.

XV. 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. granted).

A minority shareholder in a closely held corporation sued the corporation and its directors alleging shareholder oppression. The minority shareholder prevailed on her claim that the directors’ refusal to meet with potential buyers of her shares was oppressive under both the reasonable expectations and fair dealing tests, and the trial court ordered the corporation to buy back the minority shareholder’s shares. The court of appeals agreed with the trial court that management’s refusal to meet with prospective purchasers of the minority shareholder’s stock constituted shareholder oppression. The Texas Supreme Court granted a petition for review. Oral arguments in the case were heard on February 26, 2013.

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

Webre v. Sneed, 358 S.W.3d 322 (Tex. App.—Houston [1st Dist.] 2011, pet. filed).

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 demand requirement ordinarily applicable in a derivative action did not apply because of the statutory provisions on closely held corporations. The court also rejected challenges to the shareholder’s standing revolving around the business judgment rule. The case has been appealed to the Texas Supreme Court, and the court has requested briefing on the merits.

XVII. DUTIES OF LLC MANAGING MEMBER TO LLC AND OTHER MEMBERS

ETRG Investments, LLC v. Hardee (In re Hardee), Bankr. No. 11-60242, Adv. No. 11-6011, 2013 WL 1084494 (Bankr. E.D. Tex. Mar. 14, 2013).

In this adversary proceeding, an LLC and two of its members sought a determination that debts to them arising from activities of the debtor, Hardee, while he was managing member of the LLC, were nondischargeable in Hardee's bankruptcy. One exception to discharge on which the plaintiffs relied was the exception for a debt arising from a defalcation by a fiduciary. The court's opinion consists of findings of fact and conclusions of law after the trial in the adversary proceeding. The court concluded that a managing member of a Texas LLC owes fiduciary duties to the LLC, but not to the other members, under agency law and by analogy to corporate law. The court found that Hardee breached his fiduciary duties to the LLC and that the debt to the LLC was nondischargeable as a defalcation in a fiduciary capacity.

In its findings of fact, the court found that Hardee, as the sole person authorized to transact business and direct the financial activities of the LLC, including the payment of tax obligations of the LLC, acted as an agent of the LLC and as such had a formal fiduciary relationship. The failure to tender tax payments was a willful breach of duty and thus a defalcation while acting in a fiduciary capacity. As for Hardee's relationship to the other two plaintiffs, the court found that these members failed to establish that Hardee had a formal fiduciary relationship with them. The company agreement governing the LLC did not impose or even address any fiduciary duties owed by and among the LLC members. Furthermore, the court found that the members failed to establish that Hardee had an informal fiduciary relationship with them or a trust relationship that existed prior to the creation of the tax obligations at issue that would create fiduciary duties to the members.

In its conclusions of law, the court set forth numerous conclusions of law regarding fiduciary duties as they related to this proceeding. The Texas Business Organizations Code, which governs LLCs, does not directly address or define the duties owed by managers and members but implies that certain duties may be owed and allows the contracting parties to specify the breadth of those duties in the LLC agreement. One type of fiduciary relationship recognized under Texas law is a formal fiduciary relationship that arises as a matter of law and includes relationships between principal and agent. An agent has authority to transact business or manage some affair for another person or entity and owes a duty of care. Texas law also recognizes that a fiduciary relationship exists between corporate officers or directors and the corporation they serve, and one of the

duties imposed on corporate management is a duty of care that requires diligence and prudence in the management of the corporation's affairs. Although LLCs are not corporations in the strictest sense, Texas law implies that the fiduciary status of corporate officers and directors and their corresponding duties of care, loyalty, and obedience apply to managers and/or members governing the activities of an LLC. Thus, the court concluded that imposition of fiduciary duties on the management of an LLC under Texas law is appropriate and warranted, and Hardee acted in a fiduciary capacity as to the LLC. Breach of Hardee's fiduciary duties required a willful neglect of duties owed, which is measured objectively by reference to what a reasonable person in the debtor's position knew or reasonably should have known and charges the debtor with knowledge of the law without regard to actual intent or motive. Hardee was charged with insuring that all required payments of employment taxes were made by the LLC to the appropriate taxing authorities, and Hardee's failure in each instance to make the tax payments on behalf of the LLC constituted a breach of the fiduciary duties he owed the LLC. Therefore, the debt owed by the LLC to the IRS to satisfy its tax obligations for the period in which Hardee was the managing member of the LLC constituted a defalcation by a fiduciary and was excepted from discharge in Hardee's bankruptcy proceeding.

As for the individual members' request that any amount they were required to pay to satisfy the accrued IRS tax liabilities should also be a nondischargeable debt, the court noted a significant difference between a manager's fiduciary relationship to the LLC and the manager's relationship to fellow members. Case law has recognized that there is no formal fiduciary relationship created as a matter of law between members of an LLC. The designation of Hardee in the LLC agreement as the "Tax Matters Member" had no legal significance in the absence of a demonstration that the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) applied to this LLC—the small partnership exception might well have exempted the members of the LLC from the application of TEFRA. Thus, Hardee had no formal fiduciary relationship with the two plaintiffs who were members of the LLC. An informal fiduciary relationship is a confidential relationship arising from moral, social, domestic, or personal relationships in which one person trusts in and relies on another. The effect of imposing a fiduciary duty is to require the fiduciary party to place another's interest above its own, and a fiduciary relationship is thus not one that is

created lightly. Hardee had no informal fiduciary relationship with the members, and any liability of Hardee to either of the members created by Hardee's failure to render tax payments on behalf of the LLC was not excepted from discharge as a result of a breach of fiduciary duties because Hardee owed no fiduciary duties to the members.