FIDUCIARY DUTIES, EXCULPATION, AND INDEMNIFICATION IN TEXAS BUSINESS ORGANIZATIONS

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CHAPTER 13

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FIDUCIARY DUTIES, EXCULPATION, AND INDEMNIFICATION IN TEXAS BUSINESS ORGANIZATIONS

I. INTRODUCTION

Statutory developments beginning in the 1990's have impacted the analysis of fiduciary duties in the business organizations context. The duties of general partners are now defined by statutory provisions that delineate the duties without referring to them as "fiduciary" duties and specifically provide that partners shall not be held to the standard of a trustee. Whether limited partners in a limited partnership have fiduciary duties is not well-settled, but the new Business Organizations Code ("BOC") clarifies that a limited partner does not owe the duties of a general partner solely by reason of being a limited partner. While the fiduciary duties of directors are still principally defined by common law, various provisions of the corporate statutes are relevant to the application of fiduciary duty concepts in the corporate context. Because limited liability companies (LLCs) are a relatively recent phenomenon and the Texas LLC statutes do not specify duties of managers and members, there is some uncertainty with regard to the duties in this area, but the LLC statutes allude to or imply the existence of duties, and managers in a manager-managed LLC and members in a member-managed LLC should expect to be held to fiduciary duties similar to the duties of corporate directors or general partners. In each type of entity, the governing documents may vary (at least to some extent) the duties and liabilities of managerial or governing persons. The power to define duties, eliminate liability, and provide for indemnification is addressed somewhat differently in the statutes governing the various forms of business entities. For example, some types of provisions typically found in corporate certificates of formation or bylaws may operate quite differently and be much less clear if included in LLC governing documents. The **Appendix** to this paper contains some examples of problematic exculpation and indemnification provisions in the LLC context.

II. CORPORATIONS

A. Fiduciary Duties of Corporate Directors, Officers, and Shareholders

The provisions of the BOC governing for-profit corporations (like the predecessor Texas Business Corporation Act), do not explicitly set forth or define the fiduciary duties of corporate directors; however, case law generally recognizes that directors owe a duty of obedience, a duty of care, and a duty of loyalty. *See Gearhart Indus, Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 718 (5th Cir. 1984); *FDIC v. Harrington*, 844 F.Supp. 300, 306 (N.D. Tex. 1994); *Resolution Trust Corp. v. Norris*, 830 F.Supp. 351 (S.D. Tex. 1993).

Duty of Obedience. The directors' duty of obedience forbids *ultra vires* acts but is rarely implicated given that modern corporation laws define corporate powers expansively and permit broad purpose clauses in the certificate of formation. *See* Tex. Bus. Org. Code §§ 2.001, 2.003, 2.007, 2.008, 2.101, 3.005(a)(3); *see also* Tex. Bus. Org. Code § 20.002 (defining scope of *ultra vires* doctrine). In general, courts appear reluctant to hold directors liable for *ultra vires* acts. As one court has summed up the Texas law in this area, "Texas courts have refused to impose personal liability on corporate directors for illegal or *ultra vires* acts of corporate agents unless the directors either participated in the act or had actual knowledge of the act." *Resolution Trust Corp. v. Norris*, 830 F.Supp. 351, 357 (S.D. Tex. 1993).

Duty of Care. Until the 1990's, Texas cases dealing with director liability for breach of the duty of care, as distinct from the duty of loyalty, had been few and far between. The Fifth Circuit analyzed a director's duty of care under Texas law in *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707 (5th Cir. 1984) as follows:

> Under the law of most jurisdictions, the duty of care requires a director to be diligent and prudent in managing the corporation's affairs. Ubelaker at 784. The leading case in Texas defining a director's standard of care is *McCollum v. Dollar*, 213 S.W. 259 (Tex.Comm'n App.1919, holding approved). That case held that a director must handle his corporate duties with such care as "an ordinarily prudent man would use under similar circumstances." *Id.* at 261. The question of director negligence is a question of fact and must be decided on a case-by-case basis. *Id.* Texas courts hold directors liable for negligent mismanagement of their corporations, but the decisions do not specifically refer to such acts as violations of the duty of care, preferring to speak in general terms of directors as fiduciaries. *International Bankers Life Ins. Co. v. Holloway, supra*; *Tenison v. Patton, supra*; *Dowdle v. Texas Am. Oil Corp.*, 503 S.W.2d 647, 651 (Tex.Civ.App.—El Paso 1973, no writ); *Fagan v. La Gloria Oil & Gas Co.*, 494 S.W.2d 624, 628 (Tex.Civ.App.—Houston [14th Dist.] 1973, no writ); *Sutton v. Reagan & Gee*, 405 S.W.2d 828, 834 (Tex.Civ.App.—San Antonio 1966, writ ref'd n.r.e.). Unquestionably, under Texas law, a director as a fiduciary must exercise his

unbiased or honest business judgment in pursuit of corporate interests. *In re Westec Corp.*, 434 F.2d 195, 202 (5th Cir.1970); *International Bankers Life Ins. Co. v. Holloway*, *supra* at 577. "The modern view definitely stresses the duty of loyalty and avoids specific discussion of the parameters of due care." Ubelaker at 789.[footnote omitted]

In other jurisdictions, a corporate director who acts in good faith and without corrupt motive will not be held liable for mistakes of business judgment that damage corporate interests. Ubelaker at 775; *see, e.g., Lasker v. Burks*, 404 F. Supp. 1172 (S.D.N.Y.1975). This principle is known as the business judgment rule and it is a defense to accusations of breach of the duty of care. Ubelaker at 775, 790. Few Texas cases discuss the issues of a director's standard of care, negligent mismanagement, and business judgment. An early case, *Cates v. Sparkman*, 73 Tex. 619, 11 S.W. 846 (1889), set the standard for judicial intervention in cases involving these issues:

> [I]f the acts or things are or may be that which the majority of the company have a right to do, or if they have been done irregularly, negligently, or imprudently, or are within the exercise of their discretion and judgment in the development or prosecution of the enterprise in which their interests are involved, these would not constitute such a breach of duty, however unwise or inexpedient such acts might be, as would authorize interference by the courts at the suit of a shareholder.

Id. at 622, 11 S.W. at 849. Even though *Cates* was decided in 1889, and despite the ordinary care standard announced in *McCollum v. Dollar*, *supra*, Texas courts to this day will not impose liability upon a noninterested corporate director unless the challenged action is ultra vires or is tainted by fraud. See *Robinson v. Bradley*, 141 S.W.2d 425 (Tex.Civ.App.—Dallas 1940, no writ); *Bounds v. Stephenson*, 187 S.W. 1031 (Tex.Civ.App.—Dallas 1916, writ ref.); *Caffall v. Bandera Tel. Co.*, 136 S.W. 105 (Tex.Civ.App. 1911); *Farwell v. Babcock*, 27 Tex.Civ.App. 162, 65 S.W. 509 (Tex.Civ.App. 1901); see also *Zauber v. Murray Sav. Ass'n*, 591 S.W.2d 932 (Tex.Civ.App.—Dallas 1979, writ ref'd n.r.e.). Such is the business judgment rule in Texas.

741 F.2d at 720-21.

Thus, despite the "ordinary care" standard announced in early Texas cases, the Fifth Circuit characterized the business judgment rule in Texas as protecting all but fraudulent or *ultra vires* conduct, which would literally protect even grossly negligent conduct and thus provide more protection than the Delaware business judgment rule. The tension between the standard of care and standard of liability in Texas received little attention in the reported cases until federal banking regulatory agencies began seeking recovery from the directors of failed financial institutions (and their liability insurers) for their alleged mismanagement of the failed institutions. Federal district courts were then faced squarely with the issue of what degree of negligence, if any, would subject the directors to liability under Texas corporate law. These federal district courts generally rejected the argument of the FDIC and RTC that directors are liable under Texas common law for acts of mismanagement that amount to simple negligence, but concluded that the business judgment rule does not protect a breach of the duty of care that amounts to gross negligence or an abdication of responsibilities resulting in a failure to exercise any judgment. *See FDIC v. Schreiner*, 892 F.Supp. 869 (S.D. Tex. 1995); *FDIC v. Daniel*, 158 F.R.D. 101 (E.D. Texas. 1994); *RTC v. Acton*, 822 F.Supp. 307 (N.D. Tex. 1994); *FDIC v. Benson*, 867 F.Supp. 512 (S.D. Tex. 1994); *FDIC v. Harrington*, 844 F.Supp. 300 (N.D. Tex. 1994); *Resolution Trust Corp. v. Norris*, 830 F.Supp. 351 (S.D. Tex.. 1993); *FDIC v. Brown*, 812 F.Supp. 722 (S.D. Tex. 1992); *Resolution Trust Corp. v. Bonner*, 1993 WL 414679 (S.D. Tex. 1993). At least one court in Texas has relied upon this line of cases outside the banking context. *See Weaver v. Kellog*, 216 B.R. 563, 584 (S.D. Tex. 1997). In *Floyd v. Hefner*, 2006 WL 2844245 (S.D. Tex. 2006), however, Judge Harmon followed the *Gearhart* opinion and rejected the proposition that corporate directors can be held liable for gross negligence under current Texas law. The court concluded that the district court opinions that followed a gross negligence standard appear to be the product of the special treatment that banks receive under Texas law[1] whereas *Floyd v. Hefner* involved actions taken by directors of an oil and gas exploration company, which the court characterized as "a far more speculative business." In *TTT Hope, Inc. v. Hill*, Civil Action No. H-07-3373, 2008 WL 4155465 (S.D. Tex. 2008), the court discussed the division in case law as to whether the business judgment rule permits a gross

[1]In 2003, H.B. 1076 amended the Texas Banking Code to provide that bank officers and directors may be held liable only for acts of gross negligence. H.B. 1076 states that the statute was intended merely to clarify existing law regarding the proper standard of care for bank officers and directors.

negligence claim against a director under Texas law, but the court concluded that it need not resolve the issue because the record did not raise a fact issue as to the defendant's gross negligence.

The Texas Supreme Court alluded to the Texas business judgment rule in a recent opinion addressing the sufficiency of a shareholder's demand prior to filing a derivative suit. *In re Schmitz*, 285 S.W.3d 451 (Tex. 2009). In *Schmitz*, the Texas Supreme Court cited *Cates v. Sparkman*, 73 Tex. 619, 11 S.W. 846, 849 (1889) and *Pace v. Jordan*, 999 S.W.2d 615, 623 (Tex.App.–Houston [1st Dist.] 1999, pet. denied) when referring to the business judgment rule. Interestingly, the court did not cite the *Gearhart* case. *Cates v. Sparkman* and *Pace v. Jordan* state that acts of the board of directors that are merely unwise, inexpedient, negligent, or imprudent do not authorize the courts to interfere at the behest of a shareholder. According to these cases, judicial interference with a board decision is warranted only if the board's conduct or breach of duty is characterized by "*ultra vires*, fraudulent, and injurious practices, abuse of power and oppression...clearly subversive of the rights of...a shareholder." *Cates*, 11 S.W. at 849; *see also Pace*, 999 S.W.2d at 623. *Pace v. Jordan*, goes on, however, to state that a board may only invoke the protection of the business judgment rule if the directors are informed of all material information reasonably available to them before making a decision. *Pace*, 999 S.W.2d at 624.

Though the BOC does not specify the standard of care applicable to directors of a for-profit corporation, it contains a number of provisions that are relevant to a director's potential liability for breach of the duty of care. In recognition that informed decision-making by directors cannot feasibly involve personal research or expertise on the part of each director with respect to the myriad business decisions faced, the BOC provides that a director may, in good faith and with ordinary care, rely on information, opinions, reports, or statements prepared or presented by officers or employees of the corporation, by a committee of the board of which the director is not a member, or by legal counsel, accountants, investment bankers, or others with professional or other expertise. Tex. Bus. Org. Code § 3.102; *see also* Tex. Bus. Corp. Act art. 2.41D (expired eff. Jan. 1, 2010). Additionally, as further discussed below, the corporate statutes contain broad indemnification provisions and even permit a corporation's certificate of formation to eliminate the liability of a director for breach of the duty of care.

Duty of Loyalty. The director's duty of loyalty "demands that there shall be no conflict between duty and self-interest. The [methods] for the determination of honesty, good faith and loyal conduct are many and varied, and no hard and fast rule can be formulated. The standard of loyalty is measured by no fixed scale." *Imperial Group (Texas), Inc. v. Scholnick*, 709 S.W.2d 358, 365 (Tex.App.–Tyler 1986, writ ref'd n.r.e.) quoting *Guth v. Loft*, 23 Del. 255, 5 A.2d 503, 510 (1939). Common examples of transactions or conduct implicating the duty of loyalty are self-dealing and usurpation of a corporate opportunity. *See Int'l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1963); *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707 (5th Cir. 1984).

The BOC contains provisions outlining procedures under which interested director transactions will be deemed valid notwithstanding the director's interest in the transaction or participation in the meeting at which the transaction is approved. *See* Tex. Bus. Org. Code § 21.418; *see also* Tex. Bus. Corp. Act art. 2.35-1 (expired eff. Jan. 1, 2010). Generally, these procedures require full disclosure by the interested director and approval by disinterested directors or the shareholders. If one of these procedures is not followed, the transaction will nevertheless withstand challenge if it passes scrutiny for "fairness" to the corporation. Likewise, before a director can safely embark on what would be considered a corporate opportunity, the opportunity must be fully disclosed to and declined by the corporation. *See Imperial Group (Texas), Inc. v. Scholnick*, 709 S.W.2d 358, 365 (Tex.App.–Tyler 1986, writ ref'd n.r.e.).

Officers. As agents of the corporation, officers have duties of obedience, care, and loyalty. *See generally* RESTATEMENT (THIRD) OF AGENCY §§ 8.01-8.12 (2006) (dealing with an agent's duties of loyalty and performance); RESTATEMENT (SECOND) OF AGENCY §§ 377-398 (1958) (dealing with an agent's duties of service, obedience, and loyalty). *See also Johnson v. Brewer & Pritchard, P.C.*, 73 S.W.3d 193, 200 (Tex. 2002) (stating that agency is a special relationship giving rise to a fiduciary duty on the part of the agent to act solely for the benefit of the principal); PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 cmt. a (1994) (stating that it is relatively well-settled that officers will be held to the same duty of care standards as directors and that sound public policy supports holding officers to the same duty of care and business judgment standards as directors); PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS Part V, introductory note b (1994) (stating that courts have usually treated officers in the same category as directors when imposing and enforcing the duty of fair dealing). The application of these duties may vary somewhat from the application to directors, but often the courts speak of officers and directors in one breath when addressing duties. In terms similar to provisions permitting directors to rely on information and expertise supplied by others, the BOC permits officers, in the discharge of a duty, to rely on information, opinions, reports, or statements of other officers or employees, attorneys, accountants, investment bankers, or other professionals or experts. Tex. Bus. Org. Code § 3.105;

see also Tex. Bus. Corp. Act art. 2.42 (expired eff. Jan. 1, 2010). BOC Section 21.418, detailing procedures for valid interested director transactions, also applies to interested officer transactions. *See also* TBCA Article 2.35-1 (expired eff. Jan. 1, 2010).

Shareholders. Courts of appeals have generally held that shareholders, even in a closely held corporation, do not owe one another fiduciary duties. *See Hoggett v. Brown*, 971 S.W.2d 472, 488 (Tex.App.–Houston [14th Dist.] 1997, pet. denied); *see also Schoellkopf v. Pledger*, 739 S.W.2d 914, 920 (Tex.App.–Dallas 1984), rev'd on other grounds, 762 S.W.2d 145 (Tex. 1988); *Kaspar v. Thorne*, 755 S.W.2d 71(Tex.App.–Dallas 1988, no writ); *Pabich v. Kellar*, 71 S.W.3d 500 (Tex.App.–Ft. Worth 2002, pet. denied). In *Willis v. Donnelly*, 199 S.W.3d 262 (Tex.2006), the Texas Supreme Court expressly refrained from addressing the question of whether a majority shareholder in a closely held corporation owes a minority shareholder a general fiduciary duty under Texas law. An employee asserted a breach of fiduciary duty claim against the controlling shareholders of two corporations based on the corporations' failure to issue him stock that was promised to him. Assuming without deciding that the relationship of majority and minority shareholder can give rise to a fiduciary duty, the supreme court held that the record did not support the existence of such a duty because the employee never became a shareholder. Because the employee's claim was that he was denied shareholder status, his only potential relief was for breach of contract.

Although shareholders do not generally owe one another fiduciary duties, the relationship between particular shareholders may constitute a confidential relationship giving rise to fiduciary duties when influence has been acquired and confidence has been justifiably reposed. *Flanary v. Mills*, 150 S.W.3d 785 (Tex.App.–Austin 2004, pet. denied) (stating that "[a] person is justified in placing confidence in the belief that another party will act in his or her best interest only where he or she is accustomed to being guided by the judgment or advice of the other party, and there exists a long association in a business relationship, as well as personal friendship").

A majority shareholder owes the corporation limited fiduciary duties, and, under certain circumstances, a controlling shareholder may breach a duty owed directly to a minority shareholder. *See Hoggett v. Brown*, 971 S.W.2d at 488 n. 13; *Schautteet v. Chester State Bank*, 707 F.Supp. 885 (E.D. Tex. 1988); *see also Patton v. Nicholas*, 154 Tex. 385, 279 S.W.2d 848 (Tex. 1955); *Thwyssen v. Cron*, 781 S.W.2d 682 (Tex.App.–Houston [1st Dist.] 1989, writ denied); *Duncan v. Lichtenberger*, 671 S.W.2d 948 (Tex.App.–Ft. Worth 1984, writ ref'd n.r.e.).

Texas courts of appeals have recognized a cause of action for majority shareholder "oppression" of a minority shareholder. "Oppressive" conduct has been defined as:

> (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 invest; 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 each shareholder is entitled to rely.

Davis v. Sheerin, 754 S.W.2d 375, 381-82 (Tex.App.—Houston [1st Dist.] 1988, writ denied) (awarding minority shareholder equitable buy-out at fair value as determined by jury based upon the majority's refusal to recognize the minority's ownership in the corporation); *see also Redmon v. Griffith*, 202 S.W.3d 225, 234 (Tex.App.–Tyler 2006, pet. denied); *Cotten v. Weatherford Bancshares, Inc.*, 187 S.W.3d 687, 699-700 (Tex.App.–Fort Worth 2006, pet. denied); *Willis v. Bydalek*, 997 S.W.2d 798, 801 (Tex. App.—Houston [1st Dist.] 1999, pet. denied); *Gibney v. Culver*, No. 13-06-112-CV, 2008 WL 1822767, *16-17 (Tex.App.–Corpus Christi 2008, pet. denied). Courts in some cases have commented that a minority shareholder's reasonable expectations must be balanced with the corporation's need to exercise its business judgment and that a corporation's officers and directors are afforded rather broad latitude in conducting corporate affairs despite the majority's duty to the minority. *Willis v. Bydalek*, 997 S.W.2d 798, 801 (Tex.App.—Houston [1st Dist.] 1999, pet. denied) (holding that firing of shareholder who was at-will employee did not amount to oppression under the circumstances present in that case); *Gibney v. Culver*, No. 13-06-112-CV, 2008 WL 1822767, *17 (Tex.App.–Corpus Christi 2008, pet. denied) (holding that plaintiff failed to establish oppression with respect to payment of dividends or access to corporation's books and records).

In a corporation that has modified its management structure to provide for operation and management directly by the shareholders under a shareholders' agreement, such shareholders have the duties and liabilities that would otherwise be imposed on directors. *See* Tex. Bus. Org. Code §§ 21.106, 21.727; *see also* Tex. Bus. Corp. Act art. 2.30-1F, art. 12.37C (expired eff. Jan. 1, 2010).

B. Statutory Authorization to Modify Duties and Liabilities of Corporate Directors and Officers in Governing Documents

Exculpation. The BOC permits limitation or elimination of the liability of a corporate director in the certificate of formation within certain parameters. Tex. Bus. Org. Code § 7.001; *see also* Tex. Rev. Civ. Stat. art. 1302-7.06 (expired eff. Jan. 1, 2010). Specifically, the statute provides that the certificate of formation of a corporation may limit or eliminate the liability of a director for monetary damages to the corporation or shareholders for an act or omission in the person's capacity as a director subject to certain exceptions. The statute does not permit elimination or limitation of liability for:

1) breach of the director's duty of loyalty;
2) an act or omission not in good faith that constitutes a breach of duty to the corporation or involves intentional misconduct or a knowing violation of the law;
3) a transaction from which the director received an improper benefit, whether or not the benefit resulted from an act within the scope of the director's duties; or
4) an act or omission for which liability is expressly provided by a statute.

This provision is sometimes summarized as generally permitting elimination of liability for duty of care violations by directors. If the standard of liability for a breach of the duty of care is simple negligence, this provision obviously provides meaningful protection from liability for such negligence. If the standard of liability for a breach of the duty of care is gross negligence or fraud, it is not clear whether a breach of the duty of care could be in "good faith" so as to fall outside the second exception above. The Texas Supreme Court has generally defined gross negligence to involve actual subjective awareness of an extreme degree of risk and conscious indifference to the rights, welfare, and safety of others. *See Transp. Ins. Co. v. Moriel*, 879 S.W.2d 10 (1994). *Moriel* was cited in *Weaver v. Kellogg*, 216 B.R. 563 (S.D. Tex. 1997) for the definition of gross negligence in the context of a director's duty.

Renunciation of Corporate Opportunity. Note that Section 7.001 of the Business Organizations Code (which is the successor to Article 7.06 of the Texas Miscellaneous Corporation Laws Act) does not permit elimination of director liability for the breach of a duty of loyalty. Corporate opportunity issues ordinarily must be addressed at the time they arise. If a director makes full disclosure to the corporation regarding the business opportunity when it arises and the corporation declines the opportunity, the director is permitted to proceed; however, until 2003, the corporate statutes in Texas contained no specific statutory provisions indicating that a preemptive waiver of liability in the governing documents would be effective so as to relieve a director from the obligation to first offer a business opportunity to the corporation before personally taking advantage of the opportunity. The Delaware General Corporation Law was amended in 2000 to expressly permit a corporation to renounce, in its certificate of incorporation or by action of the board of directors, any interest or expectancy in specified business opportunities or specified classes or categories of business opportunities presented to the corporation or its officers, directors, or shareholders. Del. Code Ann. tit. 8, § 122(17). The Texas Business Corporation Act ("TBCA") was similarly amended in 2003, and Article 2.20(20) of the TBCA was carried forward in the BOC. Thus, the BOC provides that a corporation has the power to renounce, in its certificate of formation or by action of its board of directors, an interest or expectancy of the corporation in, or an interest or expectancy in being offered an opportunity to participate in, specified business opportunities or specified classes or categories of business opportunities that are presented to the corporation or one or more of its officers, directors, or shareholders. Tex. Bus. Org. Code § 2.101(21). This provision is included in the general powers provision of the BOC and applies to domestic entities of all types governed by the BOC.

Shareholders' Agreements. Another approach to limiting fiduciary duties in the corporate context is to utilize a shareholders' agreement under Sections 21.101-21.109 of the BOC. (These provisions are the successor to Article 2.30-1 of the TBCA.) Under these provisions, a corporation that is not publicly traded may be governed by a shareholders' agreement entered into by all persons who are shareholders at the time of the agreement. BOC Section 21.101(a) lists matters that may be included in a shareholders' agreement even though they are inconsistent with one or more provisions of the corporate statutes. Included in the list is a catch-all provision that states that such an agreement is effective even though it "otherwise governs the exercise of corporate powers, the management of the business and affairs of the corporation, or the relationship among the shareholders, the directors, and the corporation as if the corporation were a partnership or in a manner that would otherwise be appropriate only among partners and not contrary to public policy." Tex. Bus. Org. Code § 21.101(a)(11); *see also* Tex. Bus. Corp. Act art. 2.30-1A(9) (expired eff. Jan. 1, 2010). Thus, it appears that fiduciary duties of those in a management role of a corporation governed by such an agreement may be modified or waived in ways not generally permitted by corporate law so long as such provisions would be permissible in the context of a partnership. (There may be a similar argument under

Section 21.714 of the BOC (*see also* Tex. Bus. Corp. Act art. 12.32 (expired eff. Jan. 1, 2010)) for "close corporations" that comply with Subchapter O of BOC Chapter 21. The predecessor to Subchapter O of the BOC was the Texas Close Corporation Law found in Part 12 of the TBCA.)

Indemnification. BOC Chapter 8 outlines circumstances under which indemnification of directors, officers, and others is required, permitted, and prohibited. These indemnification provisions are somewhat lengthy and detailed. The predecessor provision in the TBCA was Article 2.02-1. A corporation is required to indemnify a director or officer who is "wholly successful on the merits or otherwise" unless indemnification is limited or prohibited by the certificate of formation. Tex. Bus. Org. Code § 8.051, 8.003; *see also* Tex. Bus. Corp. Act art. 2.02-1H, U (expired eff. Jan. 1, 2010). A corporation is prohibited from indemnifying a director who is found liable for willful or intentional misconduct in the performance of the director's duty to the corporation, breach of the director's duty of loyalty to the corporation, or an act or omission not in good faith constituting a breach of duty to the corporation. Tex. Bus. Org. Code § 8.102(b)(3). *Cf.* Tex. Bus. Corp. Act art. 2.02-1C, E (corporation prohibited from indemnifying director who is found liable to corporation, or for improper receipt of personal benefit, if liability arose out of willful or intentional misconduct in performance of director's duty to corporation). A corporation is permitted, without the necessity of any enabling provision in the certificate of formation or bylaws, to indemnify a director who is determined to meet certain standards. Tex. Bus. Org. Code § 8.101, 8.102; *see also* Tex. Bus. Corp. Act art. 2.02-1B, E (expired eff. Jan. 1, 2010). These standards require that the director (1) acted in good faith; (2) reasonably believed the conduct was in the best interest of the corporation (if the conduct was in an official capacity) or that the conduct was not opposed to the corporation's best interest (in cases of conduct outside the director's official capacity); and (3) in the case of a criminal proceeding, had no reasonable cause to believe the conduct was unlawful. Tex. Bus. Org. Code § 8.101(a); *see also* Tex. Bus. Corp. Act art. 2.02-1B (expired eff. Jan. 1, 2010). If a director is found liable to the corporation or on the basis of improperly receiving a personal benefit, indemnification, if permissible at all, is limited to reasonable expenses. Tex. Bus. Org. Code § 8.102(b); Tex. Bus. Corp. Act art. 2.02-1E (expired eff. Jan. 1, 2010). Indemnification may be limited by the certificate of formation, or it may be mandated by the certificate of formation, bylaws, a resolution of the directors or shareholders, or a contract. Tex. Bus. Org. Code §§ 8.003, 8.103(c); *see also* Tex. Bus. Corp. Act art. 2.02-1G, U (expired eff. Jan. 1, 2010). Directors may only be indemnified to the extent consistent with the statute. Tex. Bus. Org. Code § 8.004; *see also* Tex. Bus. Corp. Act art. 2.02-1M (expired eff. Jan. 1, 2010). Officers, employees, agents, and others who are not also directors may be indemnified "to the extent consistent with other law...as provided by (1) [the corporation's] governing documents; (2) general or specific action of the [board of directors]; (3) resolution of the [corporation's shareholders]; (4) contract; or (5) common law." Tex. Bus. Org. Code § 8.105; *see also* Tex. Bus. Corp. Act art. 2.02-1O, Q (expired eff. Jan. 1, 2010). Insurance providing coverage for unindemnifiable areas is expressly permitted. Tex. Bus. Org. Code § 8.151; *see also* Tex. Bus. Corp. Act art. 2.02-1R (expired eff. Jan. 1, 2010).

Chapter 8 of the BOC governs any proposed indemnification by a domestic entity after January 1, 2010, even if the events on which the indemnification is based occurred before the BOC became applicable to the entity. Tex. Bus. Org. Code § 402.007. A special transition provision in the BOC regarding indemnification states that "[i]n a case in which indemnification is permitted but not required under Chapter 8, a provision relating to indemnification contained in the governing documents of a domestic entity on the mandatory application date that would otherwise have the effect of limiting the nature or type of indemnification permitted by Chapter 8 may not be construed after the mandatory application date as limiting the indemnification authorized by Chapter 8 unless the provision is intended to limit or restrict permissive indemnification under applicable law." Tex. Bus. Org. Code § 402.007. This provision will be helpful in interpreting some pre-BOC indemnification provisions, but its application will not always be clear; therefore, a careful review of indemnification provisions in pre-BOC governing documents is advisable.

Although the indemnification statutes set specific limits on the extent to which directors may be protected by the governing documents, more protective provisions could possibly be achieved through a shareholders' agreement under Sections 21.101-21.109 of the BOC. *See also* Tex. Bus. Corp. Act art. 2.30-1 (expired eff. Jan. 1, 2010). As noted above in the discussion of director exculpation, Sections 21.101-21.109 permit a corporation that is not publicly traded to be governed by a shareholders' agreement entered into by all persons who are shareholders at the time of the agreement. BOC Section 21.101 lists matters that may be included in a shareholders' agreement even though they are inconsistent with one or more provisions of the corporate statutes. Included in the list is a catch-all provision that states that such an agreement is effective even though it "governs the exercise of corporate powers, the management of the business and affairs of the corporation, or the relationship among the shareholders,

the directors, and the corporation as if the corporation were a partnership or in a manner that would otherwise be appropriate only among partners and not contrary to public policy." Tex. Bus. Org. Code § 21.101(a)(11); *see also* Tex. Bus. Corp. Act art. 2.30-1A(9) (expired eff. Jan. 1, 2010). Thus, it appears that indemnification beyond the parameters set by BOC Chapter 8 may be achieved under such an agreement if it would be permissible in a partnership and would not offend public policy. (There may be a similar argument under Section 21.714 of the BOC (*see also* Tex. Bus. Corp. Act art. 12.32 (expired eff. Jan. 1, 2010)) for "close corporations" that comply with Subchapter O of BOC Chapter 21. The predecessor to Subchapter O of the BOC was the Texas Close Corporation Law found in Part 12 of the TBCA.)

III. Limited Liability Companies

A. Fiduciary Duties of Managers and Managing Members

The provisions of the BOC governing LLCs (like the provisions of the predecessor Texas Limited Liability Company Act ("TLLCA")) do not define or expressly impose fiduciary duties on managers or members of an LLC, but various provisions of the statute implicitly recognize that such duties may exist. Commentators and practitioners have generally assumed that managers in a manager-managed LLC and members in a member-managed LLC have fiduciary duties along the lines of corporate directors or general partners in a partnership. These duties would generally embrace a duty of obedience, duty of loyalty, and duty of care to the LLC. Duty of loyalty concerns underlie statutory provisions addressing interested manager transactions and renunciation of business opportunities. *See* Tex. Bus. Org. Code §§ 2.101(21), 101.255; *see also* Tex. Rev. Civ. Stat. art. 1528n, art. 2.17 (expired eff. Jan. 1, 2010); Tex. Bus. Corp. Act art. 2.02(20) (expired eff. Jan. 1, 2010) (applicable by virtue of Tex. Rev. Civ. Stat. art. 1528n, art. 2.02A (expired eff. Jan. 1, 2010)). Provisions of the BOC permitting governing persons (including managers and managing members of an LLC) to rely on various types of information in discharging a duty implicitly recognize that such persons are charged with a duty of care in their decision making. Tex. Bus. Org. Code § 3.102; *see also* Tex. Bus. Org. Code § 3.105 (reliance by officers on information in discharging a duty). Finally, as further discussed below, the BOC provides that, to the extent managers or members are subject to duties and liabilities, including fiduciary duties, the company agreement may expand or restrict the duties and liabilities and provide for indemnification. Tex. Bus. Org. Code §§ 101.401, 101.402, 101.052; *see also* Tex. Rev. Civ. Stat. art.1528n, art. 2.20 (expired eff. Jan. 1, 2010).

In an unpublished opinion, the Dallas Court of Appeals concluded that members of an LLC do not necessarily owe other members fiduciary duties. *Suntech Processing Systems, L.L.C. v. Sun Communications, Inc.*, 2000 WL 1780236 (Tex. App.—Dallas Dec. 5, 2000, pet. denied). The court relied on Texas case law rejecting the notion that co-shareholders of a closely held corporation are necessarily in a fiduciary relationship. That the articles of organization imposed upon members a duty of loyalty to the LLC did not mandate any such duty between the members according to the court.

In *Pinnacle Data Services, Inc. v. Gillen*, 104 S.W.3d 188 (Tex.App.–Texarkana 2003, no pet.), a member of an LLC sued the other two members alleging various causes of action based on the action of the other two members in amending the LLC articles of organization to change the LLC from a member-managed LLC to a manager-managed LLC and excluding the plaintiff member from management. The plaintiff member owned a 50% interest in the LLC. The regulations required the approval of 66 2/3% in interest to amend the articles of organization, while the articles of organization required the approval of 2/3 of the members. The defendant members relied on the provision in the articles of organization, and the court held that the provision in the articles controlled because the TLLCA permits the regulations to contain any provision not inconsistent with the articles of organization. The court of appeals reversed the trial court's summary judgment in favor of the defendant members on the breach of fiduciary duty claim, however, stating that the determination that the articles of organization controlled disposed of the breach of contract claim, but not the breach of fiduciary duty-based claims. The court appeared to analogize the duties of the LLC members to those of corporate officers and directors, but the opinion is not entirely clear in this regard. The court apparently accepted that an LLC member may bring a claim for "oppression" as defined in the corporate context, but the court upheld summary judgment in favor of the defendants on this claim, stating that the plaintiff had failed to set forth any evidence in support of its oppression claim.

In *Doonan v. Wood*, 224 S.W.3d 271 (Tex.App.–El Paso 2005, no pet.), the court rejected the breach of fiduciary duty claim of an LLC's minority member and his spouse against an investment company limited partnership that made a loan to the LLC and acquired a membership interest. The court stated that the minority member's spouse did not establish that she was owed a fiduciary duty, and, assuming a fiduciary duty was owed to the minority member, the various acts alleged, including foreclosure on LLC assets and enforcement of the minority member's personal guaranty, did not raise any genuine issue of material fact as to breach of

fiduciary duty because the actions were taken for legitimate business reasons rather than for the fiduciary to profit by taking advantage of its position.

In *Lundy v. Masson*, 260 S.W.3d 482 (Tex.App.–Houston [14th Dist.] 2008, pet. denied), a corporation asserted breach of fiduciary duty claims against its former president. In the course of the opinion, the court revealed that the corporation was originally formed as an LLC and later converted to a corporation. The jury was instructed that the president owed the company a fiduciary duty, and the jury found that he breached his duty. The trial court entered a judgment for the corporation. On appeal by the former president, the court of appeals found that the evidence was sufficient to establish a breach of fiduciary duty and affirmed.

In *Gadin v. Societe Captrade*, 2009 WL 1704049 (S.D. Tex. 2009), the plaintiff, a 35% member of an LLC, sued the 65% member for breach of fiduciary duty, minority member oppression, and an accounting. The plaintiff alleged that there was an attempt to purchase his membership interest at an under-valued price, that he was forced to resign from the LLC, and that the defendant and its principals took clients, records, and financial information from the LLC. The defendant sought dismissal of the breach of fiduciary duty claim on the basis that the plaintiff failed to state facts showing that a member of an LLC owes another member a fiduciary duty or that there was more than a subjective trust by the plaintiff in the defendant so as to support an informal fiduciary relationship. The plaintiff responded that he used his personal credit, business contacts, and name in order to fund the start-up and business operations of the LLC and that he relied upon the representations by the defendant and its principals that his investment of time and resources would make his stake in the LLC profitable. The court discussed formal and informal fiduciary relationships under Texas law and noted that the TLLCA does not directly address the duties owed by managers and members. The court stated that Texas courts have not yet held that a fiduciary duty exists as a matter of law among members in an LLC and noted that, where fiduciary duties among members have been recognized in other jurisdictions, the duties have been based on state-specific statutes. The court denied the defendant's motion to dismiss "[b]ecause the existence of a fiduciary duty is a fact-specific inquiry that takes into account the contract governing the relationship as well as the particularities of the relationships between the parties." The court noted that the defendant's motion to dismiss did not address the plaintiff's claim for minority member oppression.

For cases in other states that have addressed fiduciary duties of managers or members, see Elizabeth S. Miller, *More Than a Decade of LLP and LLC Case Law: A Cumulative Survey of Cases Dealing With Limited Liability Partnerships and Limited Liability Companies*, June 2007, and subsequent case law updates available at http://law.baylor.edu.

B. Statutory Authorization to Modify Duties and Liabilities of Members and Managers in Governing Documents

Exculpation. Prior to 1997, Article 8.12 of the TLLCA followed the corporate approach to exculpation of directors by incorporating by reference Article 7.06 of the Texas Miscellaneous Corporation Laws Act (Tex. Rev. Civ. Stat. art. 1302-7.06 (expired eff. Jan. 1, 2010)). The original version of Article 8.12 of the TLLCA indicated that a manager's liability could be eliminated in the articles of organization to the extent permitted for a director under Article 1302-7.06. In 1997, amendments to the statute effected a significant departure from this approach. The reference to Article 1302-7.06 was eliminated from the TLLCA, and a new provision, Article 2.20B, was added as follows:

> To the extent that at law or in equity, a member, manager, officer, or other person has duties (including fiduciary duties) and liabilities relating thereto to a limited liability company or to another member or manager, such duties and liabilities may be expanded or restricted by provisions of the regulations.

This provision (which is included in the BOC at Section 101.401) was modeled after similar provisions in the Delaware LLC and limited partnership acts[2] and leaves the extent to which duties and liabilities may be limited or eliminated to be determined by the courts as a matter of public policy.

As noted above, the BOC permits expansion or restriction of fiduciary duties of members and managers in the company agreement. Tex. Bus. Org. Code § 101.401; *see also* Tex. Rev. Civ. Stat. art. 1528n, art. 2.20 (expired Jan. 1, 2010). An LLC also has the specific

[2]The Delaware statutes were amended in 2004 to expressly permit the elimination of fiduciary duties (but not the implied covenant of good faith and fair dealing) in a limited partnership agreement or LLC agreement. *See* Delaware Limited Liability Company Act § 18-1101. These amendments were a response by the Delaware legislature to a Delaware Supreme Court opinion signaling that the prior Delaware provision did not authorize elimination of fiduciary duties. *See Gotham Partners, L.P. v. Hollywood Realty Partners, L.P.*, 817 A.2d 160 (Del. 2002) (noting, in response to Chancery Court opinions indicating that the Delaware limited partnership act permitted a limited partnership agreement to *eliminate* fiduciary duties, that the statute actually stated that fiduciary duties and liabilities could be *expanded* or *restricted*, but did not state that they could be *eliminated*).

power to renounce company opportunities. Tex. Bus. Org. Code § 2.101(21); *see also* Tex. Rev. Civ. Stat. art. 1528n, art. 2.02A (expired eff. Jan. 1, 2010) (pursuant to which Tex. Bus. Corp. Act art. 2.02(20) (expired eff. Jan. 1, 2010) applied to an LLC).

Thus far, courts in other jurisdictions have been inclined to give effect to contractual provisions limiting fiduciary duties and specifying permissible conduct of LLC managers and members. In the first LLC case addressing issues of this sort to a significant degree, the Ohio Court of Appeals interpreted and enforced a provision of an operating agreement limiting the scope of a member's duty not to compete with the LLC. *McConnell v. Hunt Sports Enters.*, 725 N.E.2d 1193 (Ohio App. 1999). In this case, the court stated that LLC members (of what was apparently a member-managed LLC) are in a fiduciary relationship that would generally prohibit competition with the business of the LLC. The court concluded, however, that members may contractually limit or define the scope of the fiduciary duties. Specifically, the court recognized the validity of a provision in the operating agreement of an Ohio LLC that provided as follows:

> Members May Compete. Members shall not in any way be prohibited from or restricted in engaging or owning an interest in any other business venture of any nature, including any venture which might be competitive with the business of the Company.

Under this provision, the court found that a member was clearly and unambiguously permitted to compete against the LLC to obtain a hockey franchise sought by the LLC. The court rejected an argument that the provision only allowed members to engage in other types of businesses. The court commented that action related to obtaining the franchise or "the method of competing" could constitute a breach of duty if it amounted to "dirty pool," but noted the trial court's finding that the competing members had not engaged in willful misconduct, misrepresentation, or concealment.

For cases in other states that have addressed contractual provisions addressing fiduciary duties of managers or members, see Elizabeth S. Miller, *More Than a Decade of LLP and LLC Case Law: A Cumulative Survey of Cases Dealing With Limited Liability Partnerships and Limited Liability Companies*, June 2007, and subsequent case law updates available at http://law.baylor.edu.

Indemnification. Prior to 1997, the TLLCA provided that an LLC was permitted to indemnify members, managers, and others to the same extent a corporation could indemnify directors and others under the TBCA and that an LLC must, to the extent indemnification was required under the TBCA, indemnify members, managers, and others to the same extent. Thus, applying these provisions in the LLC context, indemnification was mandated in some circumstances even if the articles of organization and regulations were silent regarding indemnification. On the other hand, there were certain standards and procedures that could not be varied in the articles of organization or regulations. Article 2.20A of the TLLCA was amended in 1997 to read as follows:

> Subject to such standards and restrictions, if any, as are set forth in its articles of organization or in its regulations, a limited liability company shall have the power to indemnify members and managers, officers, and other persons and purchase and maintain liability insurance for such persons.

Tex. Rev. Civ. Stat. art. 1528n, art. 2.20A (expired eff. Jan. 1, 2010). Sections 8.002, 101.052, and 101.402 of the BOC generally carry forward this approach. Thus, the current LLC indemnification provisions neither specify any circumstances under which indemnity would be required nor place any limits on the types of liabilities that may be indemnified. It will be left to the courts to determine the bounds equity or public policy will place on the obligation or power to indemnify. Thus, for example, if a company agreement states that a manager or member "shall be indemnified to the maximum extent permitted by law," it is not clear how far the indemnification obligation extends. Would the LLC be required to indemnify for bad faith acts or intentional wrongdoing?

IV. General Partnerships (including Limited Liability Partnerships "(LLPs")) and Limited Partnerships (including Limited Liability Limited Partnerships ("LLLPs"))

A. Fiduciary Duties of Partners in General Partnership (including LLP)

The principle that general partners owe their partners and the partnership fiduciary duties is oft-recited in the case law. Perhaps the most famous case in this area is Justice Cardozo's opinion in *Meinhard v. Salmon*, 249 NY 458, 164 N.E. 545 (1928). Texas cases have reiterated the unyielding duty of loyalty standard set forth in that case. *See Huffington v. Upchurch*, 532 S.W.2d 576 (Tex. 1976); *Johnson v. Peckham*, 132 Tex. 148, 120 S.W.2d 786 (1938); *Kunz v. Huddleston*, 546 S.W.2d 685 (Tex.App.–El Paso 1977, writ ref'd n.r.e.). On the other hand, the duty of care has received little attention in the case law. In the Texas Revised Partnership Act ("TRPA"), which became effective January 1, 1994, the legislature defined a partner's duties of care and loyalty

and adopted provisions intended to clarify the extent to which contractual modification of the duties is permissible.

The Texas Uniform Partnership Act (which became effective in Texas in 1962 and expired in 1999) addressed only certain aspects of the fiduciary duties of partners. In fleshing out the fiduciary duties of partners, courts have often spoken in broad, sweeping terms. At times, courts have even referred to partners as trustees. The current statutory provisions include a more comprehensive description of partner duties than the Texas Uniform Partnership Act but eschew some of the broader language found in some cases. BOC Sections 152.204-152.207, which carry forward the provisions of Section 4.04 of the TRPA, certainly describe the core of what has traditionally been referred to by the courts as partner fiduciary duties, but the Bar Committee comments to Section 4.04 of the TRPA reflect the Committee's hope that the statutorily described duties will not be expanded by loose use of "fiduciary" concepts from other contexts or by the broad rhetoric from some prior cases. *See* Tex. Rev. Civ. Stat. art. 6132b-4.04, Comment of Bar Committee – 1993. In fact, the drafters of the TRPA quite deliberately refrained from using the term "fiduciary," and the statutes explicitly provide that a partner is not a trustee and is not to be held to such a standard. Tex. Rev. Civ. Stat. art. 6132b-4.04(f) (expired eff. Jan. 1, 2010); Tex. Bus. Org. Code § 152.204(d). On the other hand, the statutes leave courts some flexibility because the duties are not listed or described in exclusive terms.

Few cases thus far have addressed the duties as they are described under the TRPA and BOC. The Texas Supreme Court addressed Section 4.04 of the TRPA in one case and indicated that the law as it applied in that case was not changed by the TRPA; however, the case was actually governed by the Texas Uniform Partnership Act. *See M.R. Champion, Inc. v. Mizell*, 904 S.W.2d 617 (Tex. 1995). In *Johnson v. Brewer & Pritchard, P.C.*, 73 S.W.3d 193, 199-200 (Tex. 2002), a case involving the fiduciary duty owed by an agent to a principal, the Texas Supreme Court noted that it had historically held that partners owe one another certain fiduciary duties but that it "need not consider here the impact of the provisions of the Texas Revised Partnership Act on duties partners owe to one another." In *Deere v. Ingram*, 288 S.W.3d 866, 892 (Tex. 2009), the court characterized Section 4.04 of the TRPA as "recognizing the unwaivable duties of care and loyalty and the obligation of good faith required of partners under the Texas Revised Partnership Act" and cited case law "recognizing 'as a matter of common law that '[t]he relationship between ... partners ... is fiduciary in character.'" The court did not analyze the duties of partners, however, because the court held that there was no legally sufficient evidence that the parties in that case were partners.

Federal courts applying Texas law and Texas courts of appeals have generally assumed that partners' duties under the current statutes are consistent with their duties under common law. A Fifth Circuit Court of Appeals case pointed out that the TRPA "significantly amended" partnership law in 1994 to "refine the nature and scope of partners' duties to each other" and stated that some aspects of the statutory duties may not be "fiduciary" in nature for purposes of certain provisions of the Bankruptcy Code, but the court did not reach any conclusions as to how or if the statutory duties of partners are materially different from the duties imposed on partners at common law. *See In re Gupta*, 394 F.3d 347 (5th Cir. 2004).[3] A bankruptcy court

[3]After Gupta was found liable to Eastern Idaho Tumor Institute, Inc. ("Eastern Idaho") for breach of their joint venture agreement and breach of fiduciary duty, Gupta filed for Chapter 7 bankruptcy. Eastern Idaho argued that Gupta's liability for breach of fiduciary duty was non-dischargeable under Section 523(a)(4) of the Bankruptcy Code, which renders debts that arise from "fraud or defalcation while acting in a fiduciary capacity" non-dischargeable. The bankruptcy court granted Eastern Idaho summary judgment, and the district court affirmed. The Fifth Circuit noted that it has held a trust relationship must exist prior to the wrong and with reference to it in order to constitute a "technical trust" within the non-dischargeability provision. The court acknowledged, however, that it has not hesitated to characterize debts as non-dischargeable where they arose from misappropriation by persons serving in a traditional, pre-existing fiduciary capacity as understood by state law principles. Thus, debts of corporate officers to the corporation or a minority shareholder, as well as debts of a managing partner of a limited partnership to the limited partners (*In re Bennett*, 989 F.2d 779 (5th Cir. 1993)), have been held non-dischargeable. At the time it decided *In re Bennett*, the court noted a split among lower court decisions as to whether co-equal partners owe each other "fiduciary" duties for purposes of Section 523(a)(4). The court acknowledged that two circuit courts since *Bennett* have concluded debts of a partner toward fellow partners or the partnership are non-dischargeable on this ground and no circuit court has held to the contrary. Eastern Idaho attempted to simplify the issue by characterizing Gupta as a managing partner, but the court declined to view Gupta in such a manner because there was no such finding in the state court proceedings and the evidence suggested that the venture was managed jointly. The court stated that Gupta's precise role, whether as manager or co-equal venturer would be irrelevant if all partners are fiduciaries to each other for purposes of Section 523(a)(4); however, the court stated that Texas law, as articulated under the TRPA, failed to support that broad proposition. The court noted that Texas law was significantly amended by the TRPA in 1994 to "refine the nature and scope of partners' duties to each other." The court quoted the provision of the TRPA that states a

cited both case law and Section 4.04 of the TRPA for the proposition that partners owe one another and the partnership "fiduciary" duties including the duties of loyalty and care. *See In re Leal*, 360 B.R. 231 (Bankr. S.D. Tex. 2007). In *McBeth v. Carpenter*, 565 F.3d 171 (5th Cir. 2009), the Fifth Circuit Court of Appeals stated that "[u]nder Texas law, managing partners owe trust obligations to the partnership, having a duty of loyalty and due care as well as being under an obligation to discharge their duties in good faith and in the reasonable belief that they are acting in the best interest of the partnership," citing Section 4.04 of the TRPA. Notwithstanding the court's observation in *Gupta* (discussed in note 3) that the TRPA significantly amended Texas law "to refine the nature and scope of partners' duties" and to provide that a partner is not held to a trustee standard, the court quoted from Texas case law analogizing a general partner in a limited partnership to a trustee. The court also concluded that there is no distinction between the duties of general and limited partners in a limited partnership. This questionable conclusion is further discussed below. A bankruptcy court cited Section 152.205 of the BOC along with Texas case law for the proposition that partners owe one another "fiduciary" duties and stated that Texas courts have analogized the duty owed by a general partner to a limited partner to that owed by a trustee to a beneficiary. See *In re Houston Drywall*, 2008 WL 2754526 (Bankr. S.D. Tex. 2008) (mem. op.).

Duty of Care. A partner owes a duty of care to the partnership and the other partners. Tex. Bus. Org. Code § 152.204(a); *see also* Tex. Rev. Civ. Stat. art. 6132b-4.04(a) (expired eff. Jan. 1, 2010). The duty is defined in BOC Section 152.206 (*see also* Tex. Rev. Civ. Stat. art. 6132b-4.04(c) (expired eff. Jan. 1, 2010)) as a duty to act in the conduct and winding up of the partnership business with the care of an ordinarily prudent person under similar circumstances. An error in judgment does not by itself constitute a breach of the duty of care. Further, a partner is presumed to satisfy this duty if the partner acts on an informed basis, in good faith, and in a manner the partner reasonably believes to be in the best interest of the partnership. Tex. Bus. Org. Code §§ 152.206, 152.204(b); Tex. Rev. Civ. Stat. art. 6132b-4.04(c), (d) (expired eff. Jan. 1, 2010). These provisions obviously draw on the corporate business judgment rule in articulating the duty of care. Nevertheless, it is unclear in the final analysis if the standard is simple or gross negligence. The sparse case law in this area (pre-dating the TRPA) indicates that a partner will not be held liable for mere negligent mismanagement. *See Ferguson v. Williams*, 670 S.W.2d 327 (Tex.App.–Austin 1984, writ ref'd n.r.e.). It is unlikely the drafters intended to up the ante in this regard. On the other hand, the TRPA stopped short of expressly setting forth a gross negligence standard (which is the standard specified in the Revised Uniform Partnership Act). In a case governed by the TRPA, a bankruptcy court rejected a partner's claim for damages based on mismanagement of the other partner, stating that business ventures and partnerships involve risks, and that there is no legal remedy available to a businessman who is disappointed by the partnership's actual revenues or profits absent a contractual guarantee or tortious conduct. According to the court, poor management performance, absent a showing of wrongful conduct, is not actionable. *In re Leal*, 360 B.R. 231, 239 (Bankr. S.D. Tex. 2007). Although the court noted earlier in the opinion that the TRPA governed the case and cited provisions in Section 4.04, the court did not discuss the relationship between the duty of care as described in Section 4.04 and its conclusions regarding the mismanagement claim. The court also rejected a claim for damages based on the other partner's poor recordkeeping, although the court later appeared to allude

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partner, in that capacity, is not a trustee and is not held to the same standards as a trustee (Tex. Rev. Civ. Stat. art. 6132b-4.04(f)) as well as the State Bar Committee Comment explaining that Section 4.04 "defines partnership duties and implies that they are not to be expanded by loose use of 'fiduciary' concepts from other contexts or by the rhetoric of some prior cases." The court went on to state, however, that it was not saying Texas partners no longer owe special duties to each other. The court noted that Section 4.04 defines duties of loyalty and care, together with obligations to discharge those duties in good faith and in the best interests of the partnership. The court observed that the duty of loyalty expressly includes a duty of accounting to the partnership and holding and using property or money for the partnership's benefit during its existence and winding up. Under these provisions, the court concluded that certain duties may rise to the level of "fiduciary" for purposes of Section 523(a)(4). The court discussed the Texas Supreme Court's comments in *M.R. Champion, Inc. v. Mizell* and concluded that it appeared the duty to account for money owed to the partnership may constitute a pre-existing, express or technical trust for purposes of Section 523(a)(4). Because the jury findings underlying the judgment against Gupta in state court did not tie the damages for breach of fiduciary duty to specific instances of misconduct that might correlate to areas of responsibility that may still be deemed "fiduciary" under Texas partnership law, the court reversed the lower court's summary judgment in favor of Eastern Idaho. The jury's finding of Gupta's fiduciary duty was predicated on "a relationship of trust and confidence," a standard the Fifth Circuit previously determined was too broad to satisfy the federal standard under Section 523(a)(4). A separate finding of Gupta's breach of fiduciary duty based on general phrases concerning the duty (e.g., to conduct transactions that were "fair and equitable" to Eastern Idaho), rather than on specific events or actions that might fall within the parameters of the TRPA, was likewise insufficient.

to the partner's poor recordkeeping as a breach of fiduciary duty.

Under the BOC, provisions based on Article 2.41D of the TBCA are applicable not only to directors of a corporation, but to governing persons of other types of entities as well. Under these provisions, a partner may, in good faith and with ordinary care, rely on information, opinions, reports, or statements of specified persons when the partner is discharging a duty such as the duty of care. Tex. Bus. Org. Code § 3.102.

Duty of Loyalty. Unlike the duty of care, a partner's duty of loyalty was the subject of a good deal of case law prior to the passage of the TRPA. In the BOC, like the predecessor TRPA, a partner's duty of loyalty is described as including:

1) accounting to the partnership and holding for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business or from use of partnership property;
2) refraining from dealing with the partnership on behalf of a party having an interest adverse to the partnership; and
3) refraining from competing with the partnership or dealing with the partnership in a manner adverse to the partnership.

Tex. Bus. Org. Code § 152.205; *see also* Tex. Rev. Civ. Stat. art. 6132b-4.04(b) (expired Jan. 1. 2010). These provisions embrace the typical areas traditionally encompassed by the duty of loyalty, e.g., self-dealing and conflicts of interest, usurpation of partnership opportunity, and competition. To temper some of the broader expressions of partner duties in the case law, however, the statute specifically states that a partner does not breach a duty merely because his conduct furthers his own interest and that a partner is not a trustee and should not be held to a trustee standard. *See* Tex. Bus. Org. Code §§ 152.204(c), (d); *see also* Tex. Rev. Civ. Stat. art. 6132b-4.04(e), (f) (expired Jan. 1, 2010). A court has some room to find that conduct not specifically embraced in the three categories listed nevertheless implicates the duty of loyalty in a given case since the statute states that the duty of loyalty "includes" the matters set forth above.

A bankruptcy court cited both case law and Section 4.04 of the TRPA for the proposition that partners owe one another and the partnership "fiduciary" duties. *See In re Leal*, 360 B.R. 231 (Bankr. S.D. Tex. 2007). The court stated that the duties include the aspects of a partner's duty of loyalty specified in Section 4.04 of the TRPA, as well as an obligation not to usurp opportunities for personal gain, a strict duty of good faith and candor, and an obligation of the utmost good faith, fairness, and honesty in their dealings with each other in matters pertaining to the partnership. 360 B.R. at 235-36. The court noted at one point in its opinion that a partner who withdraws ceases to owe the fiduciary duties of a partner (e.g., the duty not to compete under Section 4.04 of the TRPA only applies to a partner); however, a withdrawn partner owes the duties owed by a former agent following termination of the agency relationship. 360 B.R. at 241.

In *McBeth v. Carpenter*, 565 F.3d 171 (5th Cir. 2009), the Fifth Circuit Court of Appeals stated that "[u]nder Texas law, managing partners owe trust obligations to the partnership, having a duty of loyalty and due care as well as being under an obligation to discharge their duties in good faith and in the reasonable belief that they are acting in the best interest of the partnership," citing Section 4.04 of the TRPA. A bankruptcy court cited Section 152.205 of the BOC along with Texas case law for the proposition that partners owe one another "fiduciary" duties and stated that Texas courts have analogized the duty owed by a general partner to a limited partner to that owed by a trustee to a beneficiary. *See In re Houston Drywall*, 2008 WL 2754526 (Bankr. S.D. Tex. 2008) (mem. op.).

Duties Owed to Transferees of Deceased Partners. Effective September 1, 2003, Section 4.04(a) of the TRPA was amended to provide that partners owe the duties of loyalty and care to "transferees of deceased partners under Section 5.04(b)" in addition to the other partners and the partnership. *See also* Tex. Bus. Org. Code § 152.204(a). This amendment was requested by Representative Will Hartnett. Prior to this amendment, some courts had held that partners owe no fiduciary duties to assignees or transferees. *See Griffin v. Box*, 910 F.2d 255, 261 (5th Cir.1990) (applying Texas law and stating that general partners did not owe a fiduciary duty to transferees of partnership interests who had not been admitted as substituted partners); *Adams v. United States*, 2001 WL 1029522 (N.D. Tex.2001) (stating that remaining partners did not owe a fiduciary duty to assignees of the deceased partner under Texas law); *but see Bader v. Cox*, 701 S.W.2d 677, 685 (Tex.App.–Dallas 1985, writ ref'd n.r.e.) (stating that surviving partners owed fiduciary duties to the representative of a deceased partner under the Texas Uniform Partnership Act).

As a default rule, the BOC (like the predecessor TRPA) provides that the partnership interest of a deceased partner is automatically redeemed by the partnership for its fair value as of the date of death of the partner; thus, the statutory default provisions do not ordinarily give rise to transferees of a deceased partner. *See* Tex. Bus. Org. Code § 152.601; *see also* Tex. Rev. Civ. Stat. art. 6132b- 7.01(a) (expired eff. Jan. 1, 2010). Rather, it appears that the deceased partner's personal representative, surviving spouse, heirs, and devisees should be regarded as creditors until paid. If, however,

a partnership agreement negates the automatic redemption provision under the statutes, the personal representative, surviving spouse, heirs, and devisees of a deceased partner will be regarded as transferees of the deceased partner's partnership interest to the extent they succeed to the deceased partner's partnership interest, and BOC Section 152.204(a) would apply.

Obligation of Good Faith. The BOC imposes on a partner the obligation to discharge any duty and exercise any rights or powers in conducting or winding up partnership business in good faith and in a manner the partner reasonably believes to be in the best interest of the partnership. Tex. Bus. Org. Code § 152.204(b); *see also* Tex. Rev. Civ. Stat. art. 6132b- 4.04(d) (expired eff. Jan. 1, 2010). Though courts may be tempted to elevate this language into an independent duty, this obligation is not stated as a separate duty, but merely as a standard for discharging a partner's statutory or contractual duties. *See* Tex. Rev. Civ. Stat. art. 6132b-4.04, Bar Committee Comment–1993.

Duty to Disclose, Render Information. The BOC requires that partners be furnished complete and accurate information on request. Tex. Bus. Org. Code § 152.213(a); *see also* Tex. Rev. Civ. Stat. art. 6132b-4.03(c) (expired eff. Jan. 1, 2010). Furthermore, the partnership must provide access to its books and records to partners and their agents and attorneys for inspection and copying. Tex. Bus. Org. Code § 152.212(a)(c); *see also* Tex. Rev. Civ. Stat. art. 6132b-4.03(b) (eff. Jan. 1, 2010). The Texas Uniform Partnership Act did not address whether or when a partner has a duty to disclose information absent a request, and the current statutes are silent on this point as well. Case law has traditionally imposed upon partners a duty of disclosure in certain circumstances, such as when a partner is purchasing the partnership interest of a fellow partner. *See, e.g., Schlumberger Tech. Corp. v. Swanson*, 959 S.W.2d 171, 175 (Tex.1997); *Johnson v. Peckam*, 132 Tex. 148, 120 S.W.2d 786, 788 (1938); *Harris v. Archer*, 134 S.W.3d 411, 431 (Tex.App.–Amarillo 2004, pet. denied); *Johnson v. Buck*, 540 S.W.2d 393, 399 (Tex.App.—Corpus Christi 1976, writ ref'd n.r.e.).

B. Fiduciary Duties of Partners in Limited Partnership (including LLLP)

General Partners. Case law has held general partners in a limited partnership to fiduciary standards. *See Hughes v. St. David's Support Corp.*, 944 S.W.2d 423 (Tex.App.–Austin 1997, writ denied)("[I]n a limited partnership, the general partner stands in the same fiduciary capacity to the limited partners as a trustee stands to a trust."); *McLendon v. McLendon*, 862 S.W.2d 662 (Tex.App.–Dallas 1993, writ denied)("In a limited partnership, the general partner acting in complete control stands in the fiduciary capacity to the limited partners as a trustee stands to the beneficiaries of a trust."); *Crenshaw v. Swenson*, 611 S.W.2d 886 (Tex. Civ.App.–Austin 1980, writ ref'd n.r.e.)(same); *Watson v. Ltd. Partners of WCKT*, 570 S.W.2d 179 (Tex.Civ.App.–Austin 1978, writ ref'd n.r.e.)(same).

Not only the general partner, but those in control of the general partner have been held to such standards. *See, e.g., In re Bennett*, 989 F.2d 779 (5th Cir. 1993). A bankruptcy court recently addressed the duties of an individual who was the CEO of a corporate general partner of a limited partnership in the case of *In re Harwood (FNFS, Ltd. v. Harwood)*, 404 B.R. 366, 394-97 (Bankr. E.D. Tex. 2009) (mem. op.). Although the individual did not dispute that he owed the corporate general partner a fiduciary duty as its CEO, he argued that he did not owe a fiduciary duty to the limited partnership that the corporate general partner managed. In response to this contention, the court stated as follows: "While the use of multi-tiered organizational structures may have formerly provided an absolute shield to individuals seeking protection from liability to subsidiary entities, strict adherence to that standard has eroded as the expanding use of entities, rather than individuals, as general partners has forced the courts to engage in a closer examination of the responsibilities imposed upon, and the protections granted to, those individuals whose actions and/or omissions directly determine the conduct of any entity serving as a general partner of a limited partnership. Indeed, Texas courts have engaged in such examinations and have assessed liability for breach of fiduciary duty to a limited partnership against an individual serving as the managing partner of a general partnership that, in turn, acted as a general partner for that limited partnership, as well as against an individual serving as the sole officer of a corporate general partner of a limited partnership." The individual then argued that a person who is only one of multiple officers and directors of a corporate general partner should not be deemed to be in a fiduciary relationship with the limited partnership, but the court stated that the relevant analysis was whether the degree of control actually exercised by a corporate officer over the actions of a corporate general partner warranted a recognition of the fiduciary responsibilities realistically assumed by the individual in relation to the affected limited partnership. The court held that the individual's control in this case justified imposing a fiduciary duty upon him in relation to both the limited partnership and the corporate general partner.

Though courts have been inclined to refer to a general partner of a limited partnership as a "trustee," it is no longer appropriate to speak in terms of "trustee" standards for a general partner. The general partnership statutes negate the trustee standard, and a general partner in a limited partnership has the liabilities of a partner in a general partnership to the other partners and the

partnership unless the limited partnership statutes or the partnership agreement provide otherwise. Tex. Bus. Org. Code § 153.152(a)(2); *see also* Tex. Bus. Org. Code § 153.003(a) (providing that the provisions of Chapter 152 of the BOC govern limited partnerships in a case not provided for by Chapter 153). These provisions "linking" the law governing general partnerships to limited partnership law are consistent with provisions contained in the predecessor Texas Revised Limited Partnership Act ("TRLPA"). *See* Tex. Rev. Civ. Stat. art. 6132a-1, § 4.03(b) (expired eff. Jan. 1, 2010); Tex. Rev. Civ. Stat. art. 6132a-1, § 13.03 (expired eff. Jan. 1, 2010). Thus, a general partner in a limited partnership has the duties of care and loyalty set forth in Chapter 152 of the BOC (discussed above) but no longer should be described as a "trustee." Notwithstanding the explicit statutory rejection of the trustee standard, some courts continue to analogize partners to trustees. For example, in *McBeth v. Carpenter*, 565 F.3d 171, 177 (5th Cir. 2009), the Fifth Circuit Court of Appeals stated that "[u]nder Texas law, managing partners owe trust obligations to the partnership, having a duty of loyalty and due care as well as being under an obligation to discharge their duties in good faith and in the reasonable belief that they are acting in the best interest of the partnership," citing Section 4.04 of the TRPA. The court quoted from Texas case law analogizing a general partner in a limited partnership to a trustee. *See also In re Houston Drywall*, 2008 WL 2754526 (Bankr. S.D. Tex. 2008) (mem. op.) (citing Section 152.205 of the BOC and case law for the proposition that partners owe one another fiduciary duties and stating that Texas courts have analogized a general partner's duty to a limited partner to that owed by a trustee to a beneficiary).

The impact of the 2003 amendment to TRPA Section 4.04(a), carried forward in BOC Section 152.204(a), which provides that the duties of loyalty and care are owed to transferees of deceased partners, should be considered in the context of limited partnerships. One can expect that the personal representative, surviving spouse, heirs, and devisees of a deceased limited partner whose interest is not bought out will assert that the general partner owes them fiduciary duties under BOC Section 152.204(a) by virtue of the linkage of the general partnership statutes to the limited partnership statutes.

Title 1 of the BOC contains some provisions based on corporate law that are not found in the predecessor TRLPA. Under the BOC, provisions based on Article 2.41D of the TBCA are applicable not only to directors of a corporation, but to governing persons of other types of entities as well. Under these provisions, a general partner in a limited partnership may, in good faith and with ordinary care, rely on information, opinions, reports, or statements of specified persons when the partner is discharging a duty such as the duty of care. Tex. Bus. Org. Code § 3.102. Furthermore, the BOC provides that a limited partnership may renounce, in its certificate of formation or by action of its general partners, an interest or expectancy in specified business opportunities or a specified class of business opportunities. Tex. Bus. Org. Code § 2.101(21).

Limited Partners. There has been some uncertainty with regard to whether limited partners owe fiduciary duties to the partnership or other partners. While the duties enumerated in Section 4.04 of the TRPA might literally have been read to apply to limited partners (by virtue of the linkage of the TRPA to the TRLPA under TRLPA Section 13.03), such an approach was not a logical application of the statutes. Some provisions of the TRPA clearly only applied to general partners even though the TRLPA was silent in such regard and the TRPA acted as a gap-filler. Ordinarily, limited partners should not owe fiduciary duties as limited partners because they are merely passive investors. There is case law in other jurisdictions holding that limited partners do not, based solely on their status as limited partners, have fiduciary duties, and two appellate courts in Texas have so held. *See Villa West Assocs. v. Kay*, 146 F.3d 798 (10th Cir. 1998); *In re Kids Creek Partners*, 212 B.R. 898 (N.D. Ill. 1997); *AON Props. v. Riveraine Corp.*, 1999 WL 12739 (Tex.App.–Houston [14th Dist.] January 14, 1999, no pet.)(not designated for publication); *Crawford v. Ancira*, 1997 WL 214835 (Tex.App.–San Antonio April 30, 1997, no pet.)(not designated for publication). These unpublished opinions by Texas Courts of Appeals lack precedential weight, however, because the decisions were issued prior to 2003.

In *Zinda v. McCann Street, Ltd.*, 178 S.W.3d 883 (Tex.App.–Texarkana 2005, pet. denied), the court of appeals concluded that three limited partners owed fiduciary duties to the other limited partner based on the general proposition that a partnership is a fiduciary relationship and that partners owe one another certain fiduciary duties. The court relied upon statements from case law dealing with general partners and cited Section 4.04 of the TRPA without providing any explanation for applying these principles to limited partners. Ultimately, the court found the evidence sufficient to support the jury's finding that the defendants satisfied their fiduciary duty to the plaintiff, concluding that the defendant limited partners had treated the plaintiff fairly.

In *McBeth v. Carpenter*, 565 F.3d 171, 177-78 (5th Cir. 2009), the Fifth Circuit Court of Appeals analyzed whether a general partner and certain limited partners owed a fiduciary duty to other limited partners. The court stated that "[u]nder Texas law, managing partners owe trust obligations to the partnership, having a duty of loyalty and due care as well as being under an obligation to discharge their duties in good faith and in the reasonable belief that they are acting in the best interest

of the partnership," citing Section 4.04 of the TRPA. The court also quoted Texas case law analogizing a general partner in a limited partnership to a trustee. With respect to limited partners, the court stated that Texas law recognizes fiduciary obligations between limited partners and applies the same partnership principles that govern the relationship between a general partner and limited partners. In addition to relying on decisions by courts of appeals in Texas that have failed to distinguish between general and limited partners' duties (*Zinda v. McCann St., Ltd.*, 178 S.W.3d 883, 890 (Tex.App.–Texarkana 2005, pet. denied) and *Dunnagan v. Watson*, 204 S.W.3d 30, 46-47 (Tex.App.–Fort Worth 2006, pet. denied)), the court stated that the Texas Supreme Court has made no distinction between the fiduciary duties of general and limited partners. The court quoted from *Insurance Co. of North America v. Morris*, 981 S.W.2d 678, 674 (Tex. 1998), a case in which the supreme court referred to the fiduciary duties that arise in certain formal relationships, "including attorney-client, partnership, and trustee relationships." The Fifth Circuit in *McBeth* noted parenthetically that *Insurance Co. of North America v. Morris* was a case evaluating claims involving limited partnerships, implying that the supreme court's statement regarding partner fiduciary duties was intended to encompass limited partners; however, the supreme court did not discuss or analyze the duties of limited partners in that case. That case involved claims by investors in a limited partnership against an insurance company that was seeking reimbursement from the investors with regard to payment made on surety bonds. The relationship in issue was that of surety and principal, and the supreme court concluded that the surety-principal relationship is not generally of a fiduciary nature and that the insurance company did not have any affirmative duty of disclosure to the investors.

In *McBeth v. Carpenter*, the evidence showed that Carpenter was in a position of control over the partnership by virtue of his control of the LLC general partner, and the court thus concluded that Carpenter owed the plaintiffs a fiduciary duty. Likewise, the court concluded that the limited partner defendants owed the plaintiffs a fiduciary duty as co-limited partners in the partnership and as entities controlled by Carpenter. The court noted in a footnote that it was not bound by unpublished cases cited by the defendant limited partners for the proposition that limited partners do not owe one another fiduciary duties. Further, the court stated that, even accepting the argument that limited partners do not ordinarily owe one another fiduciary duties, Carpenter's position of control over the limited partner defendants, and the fact that it was often unclear on whose behalf he was acting, was a basis to impose fiduciary duties on the limited partners in this case. The court did not address whether or to what extent Section 153.003(c) of the BOC (discussed in the following paragraph) would have made any difference in the court's analysis if it had been applicable.

The BOC contains provisions clarifying that a limited partner is not subject to the duties of a general partner based solely on the limited partner's status as a limited partner. BOC Section 153.003(b) provides that "[t]he powers and duties of a limited partner shall not be governed by a provision of Chapter 152 that would be inconsistent with the nature and role of a limited partner as contemplated by this chapter," and BOC Section 153.003(c) provides that "a limited partner shall not have any obligation or duty of a general partner solely by reason of being a limited partner." These new provisions were necessitated by the structure of the BOC. Chapter 1 defines "partner" as including both general and limited partners. A literal application of this definition, along with the general linkage provision of Section 153.003(a) (providing that the provisions of Chapter 152 of the BOC govern limited partnerships in a case not provided for by Chapter 153), would cause all of the provisions in Chapter 152 governing general partnerships to apply to limited partners as well as general partners where Chapter 153 was silent on an issue. The language in Section 153.003(b) was added to make clear that provisions of Chapter 152 that would be inconsistent with the nature of a limited partner (e.g., provisions conferring agent status and apparent authority on each partner) do not apply to limited partners. The language in Section 153.003(c) specifically makes it clear that limited partners do not have the duties of a general partner (e.g., duties of loyalty and care) solely by reason of being a limited partner.

There is case law in some jurisdictions suggesting that limited partners should be subject to fiduciary duties to the extent they actually have control in management matters, e.g., because of control of the general partner. *See RJ Assocs., Inc. v. Health Payors' Org. Ltd. P'ship*, 1999 WL 550350 (Del. Ch. 1999) (containing dictum suggesting that, unless a partnership agreement provides to the contrary, any limited partner owes fiduciary duties to the partnership); *KE Prop. Mgmt. v. 275 Madison Mgmt.*, 1993 WL 285900 (Del. Ch. 1993); *Red River Wings, Inc. v. Hoot, Inc.*, 751 N.W.2d 206 (N.D. 2008) (holding that majority limited partners who controlled or acted in concert with the general partner could be held personally liable to the minority limited partners for breach of fiduciary duties) and cases cited therein.

C. Statutory Authorization to Modify Duties and Liabilities of Partners

Exculpation Under General Partnership Statutes. The partnership agreement cannot eliminate the duties of care and loyalty or the obligation of good faith in a general partnership; however, the statutes do permit the partnership agreement to modify the duties of care and

loyalty and the obligation of good faith, subject to a "not manifestly unreasonable" standard. Tex. Bus. Org. Code § 152.002(b)(2), (3), (4); *see also* Tex. Rev. Civ. Stat. art. 6132b-1.03(b)(2), (3), (4) (expired eff. Jan. 1, 2010).

With respect to the partners' duty of care, the BOC provides that the partnership agreement may not eliminate the duty of care but may determine the standards by which the performance of the obligation is to be measured if the standards are "not manifestly unreasonable." Tex. Bus. Org. Code § 152.002(b)(3); *see also* Tex. Rev. Civ. Stat. art. 6132b-1.03(a)(3) (expired eff. Jan. 1, 2010). How far, then, can the partnership agreement go? If the statutory standard is simple negligence (*see* discussion of the duty of care under II.A above), will a gross negligence standard in the partnership agreement pass muster as "not manifestly unreasonable?" One would think that it generally should. In one case decided prior to the passage of the TRPA, a court dealt with a mismanagement claim against a general partner in a limited partnership where the partnership agreement stated that the general partner would not be liable absent willful malfeasance or fraud. *Grider v. Boston Co., Inc.*, 773 S.W.2d 338 (Tex.App.–Dallas 1989, writ denied). The court assumed the clause was enforceable to protect the general partner against the mismanagement claim. The court stated that, when the parties bargain on equal terms, a fiduciary may contract for the limitation of liability. Public policy would preclude, according to the court, limitation of liability for (1) self-dealing, (2) bad faith, (3) intentional adverse acts, and (4) reckless indifference with respect to the interest of the beneficiary. *Id*. at 343.

With respect to the partners' duty of loyalty, the BOC provides that the partnership agreement may not eliminate the duty of loyalty but may identify specific types or categories of activities that do not violate the duty of loyalty if "not manifestly unreasonable." Tex. Bus. Org. Code § 152.002(b)(2); *see also* Tex. Rev. Civ. Stat. art. 6132b-1.03(a)(2) (expired eff. Jan. 1, 2010). One obvious issue here, in addition to the meaning of "manifestly unreasonable," is how "specific" these provisions must be in identifying types or categories of activities. The answer may depend upon the circumstances, such as the sophistication of the parties, scope of activities of the partnership, etc. Provisions in partnership agreements permitting partners to engage in competition and to take advantage of business opportunities are fairly commonplace. Under the BOC, a domestic entity may "renounce, in is certificate of formation or by action of its governing authority, an interest or expectancy of the entity in, or an interest or expectancy of the entity in being offered an opportunity to participate in, specified business opportunities or a specified class or category of business opportunities presented to the entity or one or more of its managerial officials or owners." Tex. Bus. Org. Code § 2.101(21). This provision applies to a general partnership governed by the BOC, but it is not clear whether it adds anything significant to the provisions of Section 152.002(b)(2) since a general partnership does not file a certificate of formation.

Finally, the BOC provides that the obligation of good faith may not be eliminated by the partnership agreement, but the agreement may determine the standards by which the performance is to be measured if the standards are "not manifestly unreasonable." Tex. Bus. Org. Code § 152.002(b)(4); *see also* Tex. Rev. Civ. Stat. art. 6132b-1.03(a)(4) (expired eff. Jan. 1, 2010). Again the parameters of this provision are not readily apparent and probably will depend, at least in part, on the circumstances of any particular case.

Exculpation Under Limited Partnership Statutes. Chapter 153 of the BOC does not address the extent to which the duties and liabilities of general partners in a limited partnership may be altered by agreement of the partners except to state as follows:

> Except as provided by this chapter, the other limited partnership provisions, *or a partnership agreement*, a general partner of a limited partnership:...(2) has the liabilities of a partner in a partnership without limited partners to the partnership and to the other partners.

Tex. Bus. Org. Code § 153.152(a)(2) (emphasis added); *see also* Tex. Rev. Civ. Stat. art. 6132a-1, § 4.03(a) (expired eff. Jan. 1, 2010). This language indicates that the partnership agreement may modify the liabilities of a general partner. It is not clear whether it is an authorization without express limits or is linked to the provisions in BOC Section 152.003 that prohibit elimination of duties and set a "manifestly unreasonable" floor for contractual variation.

Indemnification Under General Partnership Statutes. The BOC provides that a domestic entity, which would include a general partnership, has the power to "indemnify and maintain liability insurance for managerial officials, owners, members, employees, and agents of the entity or the entity's affiliates." Tex. Bus. Org. Code § 2.101(16); *see also* Tex. Rev. Civ. Stat. art. 6132b-3.01(15) (expired eff. Jan. 1, 2010) (providing that a partnership has the power to "indemnify a person who was, is, or is threatened to be made a defendant or respondent in a proceeding and purchase and maintain liability insurance for such person"). There are no specified limits on this power, and the partnership agreement governs the relations of the partners except to the extent the statute specifically restricts the partners' ability to define their relationship under BOC Section 152.002(b). Tex. Bus. Org. Code § 152.002(a); *see also* Tex. Rev. Civ. Stat. art. 6132b-1.03(a) (expired eff. Jan.

1, 2010). The power to indemnify is not referred to in BOC Section 152.002(b) (nor was it referred to in the predecessor TRPA Section 1.03(b)), but it would seem that indemnification, or contractual provisions for indemnification, for liabilities arising from breaches of duty that could not have been waived under those provisions may be of questionable validity. The BOC provides, as a default rule, for repayment of a partner who reasonably incurs a liability in the proper conduct of the business or for the preservation of its business or property. Tex. Bus. Org. Code § 152.203(d); *see also* Tex. Rev. Civ. Stat. art. 6132b-4.01(c) (expired Jan. 1, 2010).

Indemnification Under Limited Partnership Statutes. In the BOC, one set of indemnification provisions governs both corporations and limited partnerships. *See* Tex. Bus. Org. Code §§ 8.001-8.152. The TRLPA contained indemnification provisions patterned largely after the TBCA provisions. *See* Tex. Rev. Civ. Stat. art. 6132a-1, §§ 11.01-11.21 (expired eff. Jan. 1, 2010). A limited partnership is required to indemnify a general partner who is "wholly successful on the merits or otherwise" unless indemnification is limited or prohibited by a written partnership agreement. Tex. Bus. Org. Code §§ 8.051-8.003; *see also* Tex. Rev. Civ. Stat. art. 6132a-1, §§ 11.08, 11.21 (expired eff. Jan. 1, 2010). A limited partnership is prohibited from indemnifying a general partner who is found liable for willful or intentional misconduct in the performance of a duty to the limited partnership, breach of the partner's duty of loyalty to the limited partnership, or an act or omission not in good faith constituting a breach of duty to the limited partnership. Tex. Bus. Org. Code § 8.102(b)(3); *cf.* Tex. Rev. Civ. Stat. art. 6132a-1, §§ 11.03, 11.05 (prohibiting indemnification of general partner found liable to limited partners or partnership, or for improperly receiving personal benefit, if liability arose out of willful or intentional misconduct in performance of duty to limited partnership). Under the TRLPA, a limited partnership was permitted, *if provided in a written partnership agreement*, to indemnify a general partner who was determined to meet certain standards. Tex. Rev. Civ. Stat. art. 6132a-1, §§ 11.02, 11.05 (expired eff. Jan. 1, 2010). The BOC provides for such permissive indemnification without the necessity of any provisions in the partnership agreement. Tex. Bus. Org. Code §§ 8.102, 8.103. The standards for permissive indemnification require that the general partner acted in good faith, reasonably believed the conduct was in the best interest of the partnership (if the conduct was in an official capacity) or that the conduct was not opposed to the partnership's best interest (in cases of conduct outside the general partner's official capacity), and, in the case of a criminal proceeding, had no reasonable cause to believe the conduct was unlawful. Tex. Bus. Org. Code § 8.101; *see also* Tex. Rev. Civ. Stat. art. 6132a-1, § 11.02 (expired eff. Jan. 1, 2010). If a general partner is found liable to the limited partners or the partnership or on the basis of improperly receiving a personal benefit, permissible indemnification is limited to reasonable expenses. Tex. Bus. Org. Code § 8.102(b); *see also* Tex. Rev. Civ. Stat. art. 6132a-1, § 11.05 (expired eff. Jan. 1, 2010). A general partner may only be indemnified to the extent consistent with the statutes. Tex. Bus. Org. Code § 8.004; *see also* Tex. Rev. Civ. Stat. art. 6132a-1, § 11.13 (expired eff. Jan. 1, 2010). Limited partners, employees, and agents who are not also general partners may be indemnified to the extent consistent with other law as provided by the partnership agreement, general or specific action of the general partner, contract, or common law. Tex. Bus. Org. Code § 8.105; *see also* Tex. Rev. Civ. Stat. art. 6132a-1, §§ 11.15, 11.17 (expired eff. Jan. 1, 2010). Insurance providing coverage for unindemnifiable areas is expressly permitted. Tex. Bus. Org. Code § 8.151; Tex. Rev. Civ. Stat. art. 6132a-1, § 11.18 (expired eff. Jan. 1, 2010).

Chapter 8 of the BOC governs any proposed indemnification by a domestic entity after January 1, 2010, even if the events on which the indemnification is based occurred before the BOC became applicable to the entity. Tex. Bus. Org. Code § 402.007. A special transition provision in the BOC regarding indemnification states that "[i]n a case in which indemnification is permitted but not required under Chapter 8, a provision relating to indemnification contained in the governing documents of a domestic entity on the mandatory application date that would otherwise have the effect of limiting the nature or type of indemnification permitted by Chapter 8 may not be construed after the mandatory application date as limiting the indemnification authorized by Chapter 8 unless the provision is intended to limit or restrict permissive indemnification under applicable law." Tex. Bus. Org. Code § 402.007. This provision will be helpful in interpreting some pre-BOC indemnification provisions, but its application will not always be clear; therefore, a careful review of indemnification provisions in pre-BOC governing documents is advisable.

V. Advancement

The issue of advancement of expenses in connection with a proceeding should also be considered in connection with indemnification and exculpation. BOC Chapter 8 contains provisions authorizing advancement of expenses in the corporate and limited partnership contexts pursuant to specific procedures. The BOC permits advancement of expenses to a governing person upon a written affirmation by the governing person that the person has met the standard necessary for indemnification and a written undertaking to repay the

amount paid or reimbursed if it is finally determined that the person has not met the standard or that indemnification is prohibited. Tex. Bus. Org. Code § 8.104(a); *see also* Tex. Bus. Corp. Act art. 2.02-1K (expired eff. Jan. 1, 2010); Tex. Rev. Civ. Stat. art. 6132a-1, § 11.11 (expired eff. Jan. 1, 2010). The written undertaking need not be secured and may be accepted by the entity without regard to the person's ability to make repayment. Tex. Bus. Org. Code § 8.104(c); *see also* Tex. Bus. Corp. Act art. 2.02-1L (expired eff. Jan. 1, 2010); Tex. Rev. Civ. Stat. art. 6132a-1, § 11.12 (expired eff. Jan. 1, 2010). Advancement of expenses of governing persons can be made mandatory by provisions in the governing documents or a contract or by action of the owners or governing authority. Tex. Bus. Org. Code § 8.104(b); *see also* Tex. Bus. Corp. Act art. 2.02-1K (expired eff. Jan. 1, 2010); Tex. Rev. Civ. Stat. art. 6132a-1, § 11.11 (expired eff. Jan. 1, 2010). Advancement for officers, agents, and employees who are not governing persons is permitted to the extent consistent with other law as provided by the governing documents, action of the governing authority or owners, contract, or common law. Tex. Bus. Org. Code § 8.105; *see also* Tex. Bus. Corp. Act art. 2.02-1P, Q (expired eff. Jan. 1, 2010); Tex. Rev. Civ. Stat. art. 6132a-1, §§ 11.15, 11.17 (expired eff. Jan. 1, 2010).

In the LLC context, the BOC authorizes advancement of expenses without specifying procedures. *See* Tex. Bus. Org. Code §§ 101.402(a)(2) (stating that LLC may "pay in advance or reimburse expenses incurred by a person"); *cf.* Tex. Rev. Civ. Stat. art.1528n, art. 2.20(A) (expired eff. Jan. 1, 2010) (referring to LLC's power to indemnify and provide insurance, but not explicitly mentioning advancement).

VI. Conclusion

Fiduciary duty issues in the business organizations context are not controlled by case law alone. The statutes governing the various types of business organizations contain provisions relating to fiduciary duties and liabilities arising from such duties, and the governing documents of a particular entity may contain provisions affecting the fiduciary duties and liabilities of those involved in the business. Whether the different approaches to fiduciary duties, liabilities, and indemnification under the various Texas business entity statutes amount to a significant difference between the entities might be debated; however, subtle differences may prove significant in particular cases.

APPENDIX

Problematic Indemnification and Exculpation Provisions in the LLC Context

Example #1:

> The Company shall have the power to indemnify a Manager, Member, officer, or other person to the fullest extent permissible under Article 2.20 of the Texas Limited Liability Company Act (TLLCA) and Article 2.02-1 of the Texas Business Corporation Act (TBCA).

Issues: References to the TLLCA and TBCA are somewhat commonly found in articles of organization or regulations of LLCs formed before January 1, 2006, i.e., the date the BOC became effective. Unfortunately, these sorts of references may also find their way into the governing documents of an LLC formed after the effective date of the BOC if the form has not been carefully reviewed and updated. Entities formed prior to January 1, 2006 continued to be governed by the pre-BOC statutes until January 1, 2010 unless an election to be governed by the BOC was made before 2010. On January 1, 2010, however, the pre-BOC statutes were repealed; therefore, it is advisable for pre-BOC entities to review and amend their governing documents to avoid the question of how to interpret operative provisions that depend upon repealed statutes. Obviously, newly formed LLCs should avoid references to pre-BOC statutes that have been repealed. Simply replacing the references to the pre-BOC statutes with the analogous provisions of the BOC, however, still leaves a more subtle problem unaddressed.

The combined references to the LLC and corporate statutes in the above provision create an ambiguity. Is the intent of the provision to limit the LLC's ability to indemnify to the standards and procedures set forth in the corporate statutes? Or, by stating that the LLC has the power to indemnify to the extent permissible under the both the LLC indemnification statute and the corporate indemnification statute, does the provision encompass any further latitude provided under the broadly worded LLC statute? Unlike the provisions of TBCA Art. 2.02-1 and Chapter 8 of the BOC applicable in the corporate context, TLLCA Art. 2.20 and BOC §101.402 do not set forth any prohibitions or limitations on indemnification, nor do the LLC provisions specify procedures to be followed to authorize indemnification when a request or claim for indemnification is made. The provision should make clear whether the intent is to permit indemnification to the fullest extent, but only to the extent, provided in the corporate statutes, or to permit indemnification to the fullest extent permitted by the corporate statute and to such further extent permitted by the LLC statute (in which case the reference to the corporate statute may be superfluous). Note that Chapter 8 of the BOC does not automatically apply to LLCs, but an LLC is permitted to adopt the indemnification provisions of Chapter 8 if so desired or to adopt "other provisions, which will be enforceable," relating to indemnification, advancement of expenses, or insurance. Whereas the terminology in the TBCA would have to be "translated" to LLC terms, the terminology in Chapter 8 is more conducive to application in the LLC context.

One additional observation that may be made about the above provision is that it does not mandate any indemnification. Under the corporate statute, indemnification of a director or officer is required if the individual is "wholly successful, on the merits or otherwise" in the defense of a proceeding. Thus, it is not necessary to provide for mandatory indemnification to this extent in the corporate documents. (Often-times, of course, the desire is to expand the scope of mandated indemnification, and the corporate documents can make indemnification mandatory where it would otherwise be permitted by the statute but not required.) In the LLC context, the statute does not purport to mandate indemnification at all as a default rule, and the provision in the example above does not make it clear that the mandatory indemnification in the corporate context is being adopted for the LLC. Perhaps a manager or officer could rely on common law agency principles in some circumstances in the absence of a provision in the company agreement, but questions in this regard can be avoided by addressing the issue in the company agreement.

Example #2:

> Notwithstanding the foregoing provisions of this Article [detailed provisions modeled after corporate indemnification provisions], the Company shall approve indemnification of any Indemnitee to the fullest extent then permitted by law.

Issues: As previously noted, the LLC statutes do not place any express limitations on indemnification. The statutes simply permit an LLC to indemnify a person and indicate that provisions other than those in Chapter 8 of the BOC are enforceable. If the company agreement sets forth detailed provisions (for example, based on the corporate indemnification statute), but then includes a broad catch all provision such as that above, it is unclear what, if any, limitations exist with respect to indemnification. Would indemnification be mandated even where the manager is found liable to the LLC for an egregious violation of the duty of loyalty? The answer is left to the courts.

Example #3:

> A Manager shall not be personally liable to the Company or its Members for monetary damages for any act or omission in his or her capacity as a Manager except to the extent a statute of the State of Texas expressly precludes elimination or limitation of such personal liability. Any repeal or modification of this Article shall be prospective only, and shall not adversely affect limitation of the personal liability of a Manager existing at the time of the repeal or modification.

Issues: BOC § 101.401 provides that the company agreement (or, by virtue of BOC § 101.051(a), the certificate of formation) "may expand or restrict any duties, including fiduciary duties, and related liabilities that a member, manager, officer, or other person has to the company or to a member or manager of the company." Unlike BOC § 7.001, which forms the backdrop for the above type of provision exculpating directors in the corporate context and expressly precludes elimination of certain types of liability, BOC § 101.401 has no explicit limitations on the exculpation of liability of an LLC manager. If you represent an investor in an LLC, what do you tell the investor about the scope of such a provision? Has a manager been released from liability no matter how egregious the manager's breach of duty? In contrast to the Delaware LLC Act, which expressly permits elimination of duties and liabilities (but does not permit elimination of the implied contractual covenant of good faith and fair dealing or liability for a bad faith breach of such covenant), BOC § 101.401 does not go so far as to say the duties and liabilities of a manager can be "eliminated." Thus, there may be some public policy limitations on the scope of an exculpation provision worded like the one set forth above, but the Texas courts have not yet addressed the extent of the latitude provided under BOC § 101.401. It might also be argued that the elimination of a manager's liability for "an act or omission in his or her capacity as a Manager" does not literally address certain duty of loyalty situations such as competition or usurpation of opportunity that might be characterized as involving activity that is undertaken by the manager on his or her own behalf rather than in the manager's capacity as a manager.

Example #4:

> No Manager shall be liable to the Company or its Members for monetary damages for an act or omission by the Manager in the Manager's capacity as a Manager except as otherwise expressly provided by Section 7.001 of the Texas Business Organizations Code.

Issues: Like its predecessor Texas Miscellaneous Corporation Laws Act Art. 1302-7.06B, Subsections (b) and (c) of BOC § 7.001 permit the certificate of formation of a corporate entity to eliminate or limit director liability except for certain enumerated types of liabilities, such as a breach of the director's duty of loyalty. The intent of the provision in the example is presumably to provide the same scope of exculpation for a manager as may be provided for a corporate director, but a literal reading of the provision goes further. In order to provide partnerships and LLCs more flexibility and freedom to contract in this respect, subsections (b) and (c) of BOC § 7.001 do not apply to LLCs and partnerships. BOC § 7.001(d) states that the liability of a governing person in a partnership or LLC may be limited or restricted as provided in the statutes applicable to those entities. BOC § 101.401 states that an LLC may expand and restrict the duties and liabilities of a manager, and the statute does not impose any express limits or prohibitions on the extent to which such duties and liabilities can be restricted. Thus, because BOC § 7.001(b) and (c) do not by their terms apply to LLCs, and BOC § 7.001(d) authorizes limitation of liability as provided in the LLC statute, the reference to Section 7.001 in the above provision does not literally provide any exceptions to the exculpation of liability. Just adding "(b)" to the reference to Section 7.001 in the provision above may make it sufficiently clear that the intent is to adopt the limitations on exculpation set forth in subsection (b), but there is still a literal gap because the express limitations set forth in subsection (b) do not by their terms apply to LLC managers. It is certainly possible to provide the same scope of exculpation in the case of an LLC manager by explicitly setting forth the exculpation and the limits on exculpation – i.e., spelling out in the same terms as the statute the elimination of liability and exceptions to elimination of liability – without reference to

Section 7.001. Alternatively, if a short-hand provision referring to BOC § 7.001 is desired, the provision should make clear that the provision provides for a manager's exculpation to the fullest extent, but only to the extent, that exculpation is permitted for a director of a corporation under Section 7.001(b) and (c).

Example #5:

> A Member, whether or not serving as a Manager, may engage in or possess an interest in other businesses or ventures of any nature and description. Such other businesses or ventures may be the same as or similar to the Company's and in direct competition with the Company, and may be engaged in independently or with others. Neither the Company nor the other Members shall have any right, by virtue of this Company Agreement or the relationship created thereby, in or to such other ventures or businesses, or to the income or proceeds therefrom, and the pursuit of such businesses or ventures, even if competitive with the Company, shall not be deemed wrongful or improper.

Issues: A similar provision appeared in the limited partnership agreement of a District of Columbia limited partnership addressed in *Alloy v. Wills Family Trust*, 944 A.2d 1234 (Md. App. 2008). The court in *Alloy v. Wills Family Trust* recognized the contractual freedom of the partners of a limited partnership to modify the fiduciary duties of the general partners, but concluded that the breach of fiduciary duty claim of a limited partner against the general partners was viable notwithstanding the above provision permitting the partners to engage in and possess other business ventures of any nature. The provision did not protect the general partners from liability for secretly competing with the partnership because the clause did not relieve the general partners from the obligation to *disclose* such opportunities to the partnership.

The limited partnership in issue was governed by District of Columbia partnership law, and the court applied the provisions of the D.C. Revised Uniform Partnership Act defining and authorizing modification of fiduciary duties. The court noted that these provisions were applicable to general partners in a limited partnership by virtue of the D.C. Revised Uniform Limited Partnership Act provision that a general partner of a limited partnership has the rights and powers and is subject to the liabilities and restrictions of a general partner in a general partnership.

The limited partnership agreement identified the limited partnership as a business venture relating to certain real property upon which were located warehouse buildings and stated that the business and purpose of the partnership was to own, develop, improve, operate and maintain the property. The partnership agreement contained the following provision:

> The Partnership shall be a limited partnership only for the purposes specified in Article II hereof, and this Agreement shall not be deemed to create a partnership among the Partners with respect to any activities whatsoever other than the activities within the business purposes of the Partnership specified in Article II hereof. Any of the Partners may engage in and possess any interest in other business or real estate ventures of any nature and description, independently or with others, including but not limited to, the ownership, financing, leasing, operating, managing and developing of real property; and neither the Partnership nor the other Partners shall have any rights in and to such independent ventures or the income or profits derived therefrom.

For purposes of the appeal, the court of appeals assumed without deciding that (1) language explicitly authorizing partners to compete with the partnership business is not required to waive the duty not to compete, (2) the waiver is specific enough to unambiguously identify the purchase and offer of competing warehouses in the same neighborhood as "specific types or categories of activities that do not violate the duty of loyalty," and (3) such a waiver of the duty of loyalty is not "manifestly unreasonable." Even with these assumptions, the court upheld the trial court's decision to send the breach of fiduciary duty claim to the jury because the waiver did not dispense with the duty to disclose opportunities and conflicts, and there was testimony regarding a prior course of dealing of disclosure by the partners such that a reasonable juror could conclude that the partners agreed that prompt disclosure of opportunities and conflicts would be the measure of each partner's good faith and loyalty in transactions that competed with the partnership. The court also concluded that the breach of fiduciary duty claim was a viable claim upon which the plaintiff could recover nominal damages notwithstanding an absence of proof of monetary loss stemming from the breach.

As an alternative ground for its breach of fiduciary duty claim, the plaintiff limited partner alleged that the general partners attempted to "squeeze out" the plaintiff. The trial court did not permit the plaintiff to submit this claim to the jury. The court of appeals concluded that the limited partner plaintiff was entitled to pursue a squeeze out/oppression

claim based on evidence of the general partners' secret competition, discontinuance of what had been regular cash distributions, and sudden allocation to the limited partner of over one-half million dollars in taxable income.

Example #6:

> The Manager shall conduct the affairs of the Company in good faith in a manner the Manager believes to be in the best interests of the Company. **THE MANAGER IS LIABLE FOR ERRORS AND OMISSIONS IN PERFORMING ITS DUTIES WITH RESPECT TO THE COMPANY ONLY IN THE CASE OF BAD FAITH, GROSS NEGLIGENCE, OR BREACH OF THE PROVISIONS OF THIS AGREEMENT, BUT NOT OTHERWISE.** The Manager shall devote such time and effort to the Company business and operations as is necessary to promote fully the interests of the Company; however, the Manager is not required to devote full time to Company business.
>
> To the fullest extent permitted by law, the Company shall indemnify each Manager, Member, and Affiliate, and their respective officers, directors, partners, managers, employees, and agents, and hold them harmless from and against all losses, costs, liabilities, damages, and expenses (including, without limitation, costs of suit and attorney's fees) any of them may incur as a Member or Manager in the Company or in performing the obligations of that Member or Manager with respect to the Company, **SPECIFICALLY INCLUDING THE SOLE, PARTIAL, OR CONCURRENT NEGLIGENCE OF THE INDEMNIFIED PERSON**; provided, however, that this indemnity does not apply to actions constituting bad faith, gross negligence, or breach of the provisions of this Agreement.

Issues: The first paragraph above addresses liability or exculpation, and the second paragraph addresses indemnification. The use of all caps, bold-face type, and certain language above reflects a concern regarding the "fair notice" requirements applicable to exculpatory and indemnification agreements that operate to release or indemnify a party in advance from the party's own negligence. *See, e.g., Dresser Industries, Inc. v. Page Petroleum, Inc.*, 853 S.W.2d 505 (Tex. 1993) (holding fair notice requirements, which include the express negligence doctrine and the conspicuousness requirement, apply to both indemnity agreements and releases which protect a party from the party's own negligence in advance). It is not clear whether or to what extent the fair notice requirements addressed in the *Dresser* line of cases apply to provisions addressing liability and indemnification of governing persons with respect to fiduciary-type duties in partnerships and LLCs. Certainly, it would be unusual to see charter and bylaw provisions in the corporate context drafted in such a way as to evidence concern with the conspicuousness and express negligence requirements applied in the *Dresser* line of cases, and it may be persuasively argued that the duties and standards applicable to governing persons in business organizations, along with the statutory authorization for contractual variation and indemnification, do not call for application of the "fair notice" requirements in the same manner that they have been applied in other contexts. Nevertheless, practitioners may want to avoid the issue by drafting exculpatory and indemnification provisions in a manner that satisfies the conspicuousness and fair notice requirements. If this is the goal, the practitioner should carefully study the decisions addressing the conspicuousness requirement and express negligence doctrine.

Another observation that may be made regarding the above provisions relates to the list of persons referenced in the indemnification provision versus the liability/exculpation provision. The liability/exculpation provision is phrased only in terms of the manager. If the manager is an entity and its owners, governing persons, officers, or other agents make decisions for the manager or engage in transactions on behalf of the manager in its capacity as manager of the LLC, do such persons have any duties to the LLC, and are they subject to the same standard of liability as the manager? *See In re Kilroy (Guerriero v. Kilroy)*, 2008 WL 780692 (Bankr. S.D. Tex. March 24, 2008) (applying Delaware law and concluding that, where a provision in the limited partnership agreement limited the general partner's duty, a higher standard could not be imposed on the controlling member of the LLC general partner). Alternatively, if the manager delegates responsibilities to officers of the LLC or others who act directly on the LLC's behalf, are these persons protected by the provision addressing liability of the manager. A recent Texas bankruptcy decision applying Delaware LLC law posed some of these questions. The court indicated that individuals who were acting as agents of the manager would be protected by the terms of the clause exculpating the manager. As for the standard applicable to officers of the LLC itself, the court reasoned that, under the management and delegation structure specified in the LLC agreement, the president of the LLC had no duties because a broad exculpation provision eliminated all duties of the manager, and the LLC agreement stated that the president's authority "was subject to the same duties and powers" granted to the manager under the agreement. Any duties of the other officers of the LLC were derived under the LLC agreement by a delegation

or prescription by the manager or president, and absent any evidence of such a delegation or prescription, the court concluded the officers owed no duties. *See In re Heritage Organization, L.L.C. (Faulkner v. Korman)*, 2008 WL 5215688 (Bankr. N.D. Tex. Dec. 12, 2008). These issues obviously merit careful thought and explicit drafting to reflect the intent in the context of any particular LLC.

Example #7:

> The Company must, before final disposition of a Proceeding, advance funds to pay for or reimburse the reasonable Expenses incurred by a Person who is a Party to a Proceeding because he or she is a Member, Manager or Officer if such Person delivers to the Company a written affirmation of his or her good faith belief that his or her conduct does not constitute behavior that would result in Liability for (i) intentional misconduct or a knowing violation of law, or (ii) any transaction for which such Member, Manager or Officer received a personal benefit in violation or breach of any provision of this Agreement; and such Member, Manager or Officer furnishes the Company a written undertaking, executed personally or on his or her behalf, to repay any advances if it is ultimately determined that he or she is not entitled to indemnification under this Section.

Issues: The above provision was discussed in a recent New York decision addressing advancement and indemnification of litigation expenses in the LLC context. *See Ficus Investments, Inc. v. Private Capital Management, LLC*, 872 N.Y.S.2d 93 (N.Y. App. 1st Dept. 2009). The court relied upon Delaware case law in interpreting this provision, entitled "Advance for Expenses," in a Florida LLC's operating agreement. Another provision in the operating agreement, entitled "Obligation to Indemnify; Limits," relieved the LLC of the obligation to indemnify a member, manager, or officer who "is adjudged liable to the Company or is subjected to injunctive relief in favor of the Company" for intentional misconduct or a knowing violation of law or for any transaction for which the individual received an unauthorized personal benefit. The action arose out of allegations that the LLC's CEO and other named defendants misappropriated millions of dollars in funds and assets of the LLC. During the course of the proceeding, the CEO sought reimbursement and advancement of his litigation fees and expenses. The trial court had already issued multiple temporary restraining orders and preliminary injunctions against the CEO, and the plaintiffs argued that the issue of advancement was academic if he would not be entitled to indemnification. The appellate court concluded, however, that the provision referring to injunctive relief pertained solely to indemnification and was separate and distinct from the advancement provision. Advancement was contingent only upon the person's submission of a written affirmation that he or she had not engaged in the prohibited conduct and an undertaking to repay any funds disbursed. Two other individuals whose status as "officers" the plaintiffs contested, but who had been held out as officers of the LLC, were also entitled to advancement according to the court.