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OVERVIEW OF FIDUCIARY DUTIES, EXCULPATION, AND INDEMNIFICATION IN TEXAS BUSINESS ORGANIZATIONS
Elizabeth S. Miller

BUMPING INTO YOUR OWN PRIOR ART
Peter L. Brewer

RECENT BUSINESS DEVELOPMENTS

- OFFICIAL PUBLICATION OF THE BUSINESS LAW SECTION OF THE STATE BAR OF TEXAS -
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OVERVIEW OF FIDUCIARY DUTIES, EXCULPATION, AND INDEMNIFICATION IN TEXAS BUSINESS ORGANIZATIONS

By: Elizabeth S. Miller*

I. INTRODUCTION

Statutory developments beginning in the 1990s have impacted the analysis of fiduciary duties in the Texas 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 Texas 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.

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 the corporation (but not individual shareholders) a duty of obedience, a duty of care, and a duty of loyalty.[1]

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[1] *See* Ritchie v. Rupe, 443 S.W.3d 856, 868 (Tex. 2014); Gearhart Indus., Inc. v. Smith Int'l, Inc., 741 F.2d 707, 719-721 (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).

1. Director's Duty of Obedience

The director's 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.[2] In general, courts appear reluctant to hold directors liable for *ultra vires* acts. As one court has summed up 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."[3]

2. Director's Duty of Care

Until the 1990s, 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 Industries, Inc. v. Smith International, Inc.*[4] 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

[2] *See* TEX. BUS. ORGS. CODE §§ 2.001, 2.003, 2.007, 2.008, 2.101, 3.005(a)(3); *see also id.* at § 20.002 (defining scope of *ultra vires* doctrine).

[3] Resolution Trust Corp. v. Norris, 830 F. Supp. 351, 357 (S.D. Tex. 1993).

[4] Gearhart Indus., Inc. v. Smith Int'l, Inc., 741 F.2d 707 (5th Cir. 1984).

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.[5]

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 the 1990s when 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.[6]

[5] *Gearhart,*741 F.2d at 720-21.

[6] *See* FDIC v. Schreiner, 892 F. Supp. 869 (S.D. Tex. 1995); FDIC v. Daniel, 158 F.R.D. 101 (E.D. Texas. 1994); Resolution Trust Corp. v. Acton, 844 F. Supp. 307, 314 (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 two courts in Texas have relied upon this line of cases outside the banking context. See *In re* Life Partners Holdings, Inc. S'holder Derivative Litig., 2015 WL 8523103 (W.D. Tex. 2015); Weaver v. Kellog, 216 B.R. 563, 584 (S.D. Tex. 1997).

In *Floyd v. Hefner,*[7] 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,[8] 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,*[9] the court discussed the division in case law as to whether the business judgment rule permits a gross 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.

In *In re Life Partners Holdings, Inc. Shareholder Derivative Litigation*,[10] Judge Moses acknowledged Judge Harmon's rejection of the proposition that directors can be held liable for gross negligence under Texas law but joined the majority of federal district courts in finding that Texas courts would hold a director liable for breach of the duty of care if the director causes the corporation harm through gross negligence. In *Life Partners*, Judge Moses also addressed the standard of liability applicable to a claim for failure of oversight under Texas law. The court noted that courts in Texas have indicated that the business judgment rule does not protect a failure to exercise oversight or supervision, but Judge Moses looked to Delaware law for a framework for determining director liability in the absence of an exact standard of liability for failure of oversight under Texas law. The court concluded that director oversight liability in Texas, as in Delaware, is premised on conscious disregard of oversight responsibility, which entails bad faith and is thus a breach of the duty of loyalty.

The Texas Supreme Court alluded to the Texas business judgment rule in a 2009 opinion addressing the sufficiency of a shareholder's demand prior to filing a derivative suit.[11] In *Schmitz*, the Texas Supreme Court cited *Cates v. Sparkman*,[12] and *Pace v. Jordan*,[13] 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

[7] Floyd v. Hefner, 2006 WL 2844245 (S.D. Tex. 2006).

[8] 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.

[9] TTT Hope, Inc. v. Hill, 2008 WL 4155465 (S.D. Tex. 2008); *see also* Hui Ye v. Xiang Zhang, 2020 WL 2521292 (S.D. Tex. 2020) (stating that it is clear that a corporate director's simple negligence is not actionable as a breach of fiduciary duty, but that it is unclear whether directors are liable for gross negligence, and assuming without deciding that directors may be liable for gross negligence, the conduct at issue did not constitute gross negligence).

[10] *In re* Life Partners Holdings, Inc. S'holder Derivative Litig., 2015 WL 8523103 (W.D. Tex. 2015).

[11] *In re* Schmitz, 285 S.W.3d 451 (Tex. 2009).

[12] Cates v. Sparkman, 73 Tex. 619, 11 S.W. 846, 849 (1889).

[13] Pace v. Jordan, 999 S.W.2d 615, 623 (Tex. App.—Houston [1st Dist.] 1999, pet. denied).

practices, abuse of power and oppression...clearly subversive of the rights of...a shareholder."[14] *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.[15]

In 2014, in *Ritchie v. Rupe*, the Texas Supreme Court cited *Gearhart* when describing the common law fiduciary duties of corporate directors as follows:

> Directors, or those acting as directors, owe a fiduciary duty to the corporation in their directorial actions, and this duty "includes the dedication of [their] uncorrupted business judgment for the sole benefit of the corporation." *Int'l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 577 (Tex. 1963); *see also Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 723-24 (5th Cir. 1984)(describing corporate director's fiduciary duties of obedience, loyalty, and due care).[16]

In 2015, the Texas Supreme Court addressed the business judgment rule in the context of a double derivative suit brought by a shareholder of a closely held corporation against officers of the corporation's wholly owned subsidiary.[17] The court described the business judgment rule as "generally protect[ing] corporate officers and directors, who owe fiduciary duties to the corporation, from liability for acts that are within the honest exercise of their business judgment and discretion."[18] The court explained that the special BOC provisions applicable to derivative suits on behalf of closely held corporations alter the role of the business judgment rule in the analysis of a shareholder's standing to assert a claim on behalf of the corporation such that the board's decision not to assert the claim cannot deprive a shareholder of standing to pursue the claim derivatively. However, the court confirmed that the business judgment rule still applies to the merits of a claim against the officers and directors of a closely held corporation such that the officers and directors do not have liability for acts within the honest exercise of their business judgment.

The court in *Sneed* reiterated its explanation in *Cates* that "courts will not interfere with the officers or directors in control of the corporation's affairs based on allegations of mere mismanagement, neglect, or abuse of discretion."[19] In order to merit relief, a claim for breach of duty against an officer or director must be "characterized by ultra vires, fraudulent, and injurious practices, abuse of power, and oppression on the part of the company or its controlling agency clearly subversive of the rights of the minority, or of a shareholder, and which, without such interference, would leave the latter remediless."[20]

[14] *Cates*, 11 S.W. at 849; *see also Pace*, 999 S.W.2d at 623.
[15] *Pace*, 999 S.W.2d at 624.
[16] Ritchie v. Rupe, 443 S.W.3d 856, 868 (Tex. 2014).
[17] Sneed v. Webre, 465 S.W.3d 169 (Tex. 2015).
[18] *Id.* at 173, citing *Cates v. Sparkman*, 11 S.W. at 848-49.
[19] *Sneed,* 465 S.W.3d at 186.
[20] *Id.*

In *Chapman v. Arfeen*,[21] the court of appeals stated that "[n]egligent or grossly negligent conduct falls within the [protection provided by the] business judgment rule" and held that the lower court properly dismissed claims against an officer whose conduct was alleged to constitute gross negligence but was not alleged to involve fraud, dishonesty, or self-dealing.

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.[22] 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.

3. <u>Director's Duty of Loyalty</u>

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."[23] Common examples of transactions or conduct implicating the duty of loyalty are self-dealing and usurpation of a corporate opportunity.[24]

In *In re Life Partners Holdings, Inc. Shareholder Derivative Litigation*,[25] Judge Moses addressed the standard of liability under Texas law applicable to a claim against directors for a failure of oversight and concluded that liability for failure to exercise oversight responsibility would entail a breach of the duty of loyalty. The court noted that courts in Texas have indicated that the business judgment rule does not protect directors from liability for failure to exercise oversight or supervision, but the court looked to Delaware law for a framework for determining director liability in the absence of an exact standard of liability for failure of oversight under Texas law. The court concluded that director oversight liability in Texas, as in Delaware, is premised on conscious disregard of oversight responsibility, which entails bad faith and is thus a breach of the duty of loyalty.

[21] Chapman v. Arfeen, 2018 WL 4139001, at *15 (Tex. App.—Beaumont 2018, pet. denied).

[22] TEX. BUS. ORGS. CODE § 3.102; *see also* TEX. BUS. CORP. ACT art. 2.41D (expired Jan. 1, 2010). The provisions that govern derivative suits on behalf of corporations other than closely held corporations also reflect a deference to the good faith, informed determination of disinterested, independent directors as to whether the derivative proceeding is in the best interest of the corporation. *See* TEX. BUS. ORGS. CODE § 21.558(a).

[23] Imperial Grp. (Tex.), 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).

[24] *See*, *e.g.,* 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); Landon v. S & H Mktg. Grp., Inc., 82 S.W.3d 666 (Tex. App.—Amarillo 2002, no pet.).

[25] *In re* Life Partners Holdings, Inc. S'holder Derivative Litig., 2015 WL 8523103, at *12 (W.D. Tex. 2015).

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.[26] 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.[27] In 2011, the interested-director provisions of the BOC were amended to make clear that if at least one of the three conditions provided by the statute is met, neither the corporation nor its shareholders have any cause of action against the conflicted director for breach of duty in respect of the contract or transaction because of the director's relationship or interest or as a result of the director's taking any of the actions described in BOC Section 21.418(d), i.e., the execution of a consent or participation in a meeting of directors.

4. Officers

As agents of the corporation, officers have duties of obedience, care, and loyalty.[28] 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.[29] 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.[30] BOC Section 21.418, detailing procedures for valid interested-director transactions, also applies to interested-officer transactions.[31]

5. Shareholders

Courts of appeals have generally held that shareholders, even in a closely held corporation,

[26] *See* TEX. BUS. ORGS. CODE § 21.418; *see also* TEX. BUS. CORP. ACT art. 2.35-1 (expired Jan. 1, 2010).

[27] *See* Imperial Group (Tex.), Inc. v. Scholnick, 709 S.W.2d 358, 365 (Tex. App.—Tyler 1986, writ ref'd n.r.e.).

[28] *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).

[29] *See, e.g.,* Sneed v. Webre, 465 S.W.3d 169, 172 (Tex. 2015) (describing the business judgment rule as "generally protect[ing] corporate officers and directors, who owe fiduciary duties to the corporation, from liability for acts that are within the honest exercise of their business judgment and discretion)."

[30] TEX. BUS. ORGS. CODE § 3.105; *see also* TEX. BUS. CORP. ACT art. 2.42 (expired Jan. 1, 2010).

[31] *See also* TBCA Article 2.35-1 (expired Jan. 1, 2010).

do not owe one another fiduciary duties.[32] In *Willis v. Donnelly*,[33] 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.

In *Ritchie v. Rupe*,[34] the Texas Supreme Court stated that it had "never recognized a formal fiduciary duty between majority and minority shareholders in a closely-held corporation," citing *Willis v. Donnelly*,[35] and the court noted that no party had asked the court to do so. The court went on to say that "[t]he dissent's contention that this Court should recognize a common-law duty between majority and minority shareholders, rather than between corporate controllers and the corporation, for [misapplication of corporate funds and diversion of corporate opportunities] is contrary to well-established law."

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.[36] The supreme court in *Ritchie v. Rupe*[37] acknowledged that an informal fiduciary duty may be owed by a shareholder to another shareholder based on a moral, social, domestic, or purely personal relationship of trust and confidence prior to and independent from the parties' business relationship. On remand of that case, the Dallas Court of Appeals held that the evidence did not support the jury's finding of a confidential relationship between the plaintiff minority shareholder and other shareholders of the family-owned corporation at issue in the case.[38]

In *Allen v. Devon Energy Holdings, L.L.C.*,[39] the court of appeals noted that the vast majority of intermediate appellate courts in Texas have declined to recognize a broad formal fiduciary duty by a majority shareholder to a minority shareholder in a closely held corporation,

[32] *See* Hoggett v. Brown, 971 S.W.2d 472, 488 (Tex. App.—Houston [14th Dist.] 1997, pet. denied); *see also* Allen v. Devon Energy Holdings, L.L.C., 367 S.W.3d 355 (Tex. App.—Houston [1st Dist.] 2012, pet. granted, judgm't vacated w.r.m.); 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 151 (Tex. App.—Dallas 1988, no writ); Pabich v. Kellar, 71 S.W.3d 500 (Tex. App.—Fort Worth 2002, pet. denied).

[33] Willis v. Donnelly, 199 S.W.3d 262, 276-77 (Tex. 2006).

[34] Ritchie v. Rupe, 443 S.W.3d 856, 874-75 n.27 (Tex. 2014).

[35] *Willis,* 199 S.W.3d 262, 276-77.

[36] Flanary v. Mills, 150 S.W.3d 785, 794 (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)."

[37] *Ritchie,* 443 S.W.3d 856, 874-75 n.27.

[38] Ritchie v. Rupe, 2016 WL 145581, *5-7 (Tex. App.—Dallas 2016, pet. denied).

[39] Allen v. Devon Energy Holdings, L.L.C., 367 S.W.3d 355, 391 (Tex. App.—Houston [1st Dist.] 2012, pet. granted, judgm't vacated w.r.m.).

but the court concluded that case law supports the proposition that a controlling shareholder owes a formal fiduciary duty to a minority shareholder in the context of the communication of an offer to purchase the minority shareholder's shares, including an offer to redeem the shares where the redemption will result in an increase in the controlling shareholder's ownership of the corporation.

Until 2014, courts of appeals in Texas had recognized the availability of various equitable remedies, including a court-ordered buyout, where a minority shareholder established that the majority shareholder engaged in "oppressive" conduct. "Oppressive" conduct was defined by the courts 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.[40]

The seminal case in this area was *Davis v. Sheerin*.[41] In the years after the *Davis* case, oppression cases in Texas appeared with increasing frequency.[42]

In 2014, the Texas Supreme Court disapproved of the manner in which courts of appeals had been applying the oppression doctrine and significantly limited the reach of the oppression doctrine. In *Ritchie v. Rupe*,[43] the court: (1) rejected the "reasonable expectations" and "fair dealing" tests for oppression that courts of appeals had been applying in Texas since 1988 and adopted a definition requiring abuse of authority by management with intent to harm an owner in disregard of management's honest business judgment; (2) held that a rehabilitative receivership is the only remedy for oppression under Section 11.404 of the BOC; and (3) declined to recognize a common-law cause of action for oppression. In the future, minority shareholders will thus seek to assert their grievances as breaches of fiduciary duty to the corporation (in a derivative suit in which the minority shareholder will be relieved of certain requirements in the context of a closely held corporation and may have the prospect of direct recovery under Tex. Bus. Orgs. Code § 21.563) or as violations or grounds for relief pursuant to common-law causes of action or statutory

[40] Davis v. Sheerin, 754 S.W.2d 375, 381-82 (Tex. App.—Houston [1st Dist.] 1988, writ denied) (awarding minority shareholder an equitable buyout at fair value as determined by the jury based upon the majority's refusal to recognize the minority's ownership in the corporation).

[41] *Id.*

[42] *See, e.g.,* Kohannim v. Katoli, 440 S.W.3d 798 (Tex. App.—El Paso 2013, pet. denied); Boehringer v. Konkel, 404 S.W.3d 18 (Tex. App.—Houston [1st Dist.] 2013, no pet.); ARGO Data Res. Serv., Inc. v. Shagrithaya, 380 S.W.3d 249 (Tex. App.—Dallas 2012, pet. denied); Allen v. Devon Energy Holdings, L.L.C., 367 S.W.3d 355 (Tex. App.—Houston [1st Dist.] 2012, pet. granted, judgm't vacated w.r.m.); 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); Pinnacle Data Servs., Inc. v. Gillen, 104 S.W.3d 188 (Tex. App.—Texarkana 2003, no pet.); Willis v. Bydalek, 997 S.W.2d 798, 801 (Tex. App.—Houston [1st Dist.] 1999, pet. denied); Four Seasons Equip., Inc. v. White (In re White), 429 B.R. 201 (Bankr. S.D. Tex. 2010).

[43] *Ritchie*, 443 S.W.3d 856, 866-877.

provisions (e.g., shareholder right to examine corporate books and records under Tex. Bus. Orgs. Code § 21.218, appointment of a receiver under Tex. Bus. Orgs. Code § 11.404), fraud, breaches of contractual obligations, etc., to the extent applicable.

In *DeNucci v. Matthews*,[44] the minority shareholder asserted claims against the majority shareholder for fraud, breach of fiduciary duty, and shareholder oppression. On appeal, the minority shareholder conceded his shareholder oppression claim in light of the Texas Supreme Court's opinion in *Ritchie v. Rupe*, but the court of appeals affirmed an award of damages in favor of the corporation based on the minority shareholder's derivative claim for breach of fiduciary duty. Interestingly, the opinion reveals that the trial court also awarded the minority shareholder equitable relief that included reinstatement of the minority shareholder to the board of directors and an order to require the corporation to retain a bookkeeper and provide the minority shareholder access to the financial records. This equitable relief (which apparently was not challenged on appeal) is an example of one trial court's willingness to employ equitable relief in favor of a shareholder in response to a breach of fiduciary duty to the corporation.

A few Texas cases have alluded to a fiduciary duty on the part of a majority shareholder running to the corporation.[45] 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.[46]

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

1. <u>Exculpation</u>

The BOC permits limitation or elimination of the liability of a corporate director in the certificate of formation within certain parameters.[47] 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;

[44] DeNucci v. Matthews, 463 S.W.3d 200, 207, 209 (Tex. App.—Austin 2015, no pet.).

[45] *See* Hoggett v. Brown, 971 S.W.2d 472, 488 n. 13 (Tex. App.—Houston [14th Dist.] 1997, pet. denied); Schautteet v. Chester State Bank, 707 F. Supp. 885, 889 (E.D. Tex. 1988).

[46] *See* TEX. BUS. ORGS. CODE §§ 21.106, 21.727; *see also* TEX. BUS. CORP. ACT art. 2.30-1F, art. 12.37C (expired Jan. 1, 2010).

[47] TEX. BUS. ORGS. CODE § 7.001; *see also* TEX. REV. CIV. STAT. art. 1302-7.06 (expired Jan. 1, 2010).

(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.[48] In *In re Life Partners Holdings, Inc. Shareholder Derivative Litigation*,[49] the court stated that the question of whether claims for breach of care can be exculpated under Section 7.001 of the Business Organizations Code was a matter of first impression under Texas law. The court held that Section 7.001(b) authorizes the same scope of exculpation as the comparable statutory provision in Delaware, which Delaware courts have held authorizes exculpation for claims for breach of care based on gross negligence. The court observed that Section 7.001 either authorizes exculpation for breaches of care or it exculpates nothing at all.

[48] *See* Transp. Ins. Co. v. Moriel, 879 S.W.2d 10 (Tex. 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.

[49] *In re* Life Partners Holdings, Inc. S'holder Derivative Litig.,49 2015 WL 8523103 *8-9 (W.D. Tex. 2015).

2. Renunciation of Corporate Opportunity

Because 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 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.[50] 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.[51] This provision is included in the general powers provision of the BOC and applies to domestic entities of all types governed by the BOC.

3. 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.[52] 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."[53] 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 Sections 21.714 and 21.719 of the BOC for

[50] DEL. CODE ANN. tit. 8, § 122(17).
[51] TEX. BUS. ORGS. CODE § 2.101(21).
[52] These provisions are the successor to Article 2.30-1 of the TBCA.
[53] TEX. BUS. ORGS. CODE § 21.101(a)(11); *see also* TEX. BUS. CORP. ACT art. 2.30-1A(9) (expired Jan. 1, 2010).

"close corporations" that comply with Subchapter O of BOC Chapter 21.)[54]

4. 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.

The BOC specifies circumstances under which a corporation is required to indemnify a director, permitted to indemnify a director, and prohibited from indemnifying a director. 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.[55] A corporation is prohibited from indemnifying a director who is found liable to the corporation or for improperly receiving a personal benefit if the liability was based on 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.[56] 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.[57] 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.[58] 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.[59] 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.[60] Directors may only be indemnified to the extent consistent with the statute.[61]

Officers are required and permitted to be indemnified to the same extent as directors.[62] 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

[54] *See also* TEX. BUS. CORP. ACT arts. 12.32, 12.35 (expired Jan. 1, 2010). The predecessor to Subchapter O of the BOC was the Texas Close Corporation Law found in Part 12 of the TBCA.

[55] TEX. BUS. ORGS. CODE §§ 8.051, 8.003; *see also* TEX. BUS. CORP. ACT art. 2.02-1H, U (expired Jan. 1, 2010).

[56] TEX. BUS. ORGS. 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).

[57] TEX. BUS. ORGS. CODE §§ 8.101, 8.102; *see also* TEX. BUS. CORP. ACT art. 2.02-1B, E (expired Jan. 1, 2010).

[58] TEX. BUS. ORGS. CODE § 8.101(a); *see also* TEX. BUS. CORP. ACT art. 2.02-1B (expired Jan. 1, 2010).

[59] TEX. BUS. ORGS. CODE § 8.102(b); TEX. BUS. CORP. ACT art. 2.02-1E (expired Jan. 1, 2010).

[60] TEX. BUS. ORGS. CODE §§ 8.003, 8.103(c); *see also* TEX. BUS. CORP. ACT art. 2.02-1G, U (expired Jan. 1, 2010).

[61] TEX. BUS. ORGS. CODE § 8.004; *see also* TEX. BUS. CORP. ACT art. 2.02-1M (expired Jan. 1, 2010).

[62] TEX. BUS. ORGS. CODE § 8.105(b), (c); *see also* TEX. BUS. CORP. ACT art. 2.02-1O (expired Jan. 1, 2010).

shareholders]; (4) contract; or (5) common law."[63] Insurance or other arrangements providing indemnification for liabilities not otherwise indemnifiable under Chapter 8 are expressly permitted.[64] Shareholder approval is required for self-insurance or another arrangement with a party other than a commercial insurer if the indemnification extends to liabilities the corporation would not otherwise have the power to indemnify.

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.[65] 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."[66] 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 Chapter 8 sets certain limits on the extent to which directors may be protected by the governing documents, more protective provisions are allowed pursuant to insurance, self-insurance, or other arrangements under Section 8.151. Additionally, indemnification beyond that permitted by Chapter 8 could possibly be achieved through a shareholders' agreement under Sections 21.101-21.109 of the BOC.[67] 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."[68] 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 Sections 21.714 and 21.719 of the BOC for "close corporations" that comply with Subchapter O of BOC Chapter 21.[69]

[63] TEX. BUS. ORGS. CODE § 8.105; *see also* TEX. BUS. CORP. ACT art. 2.02-1O, Q (expired Jan. 1, 2010).

[64] TEX. BUS. ORGS. CODE § 8.151; *see also* TEX. BUS. CORP. ACT art. 2.02-1R (expired Jan. 1, 2010).

[65] TEX. BUS. ORGS. CODE § 402.007.

[66] *Id.*

[67] *See also* TEX. BUS. CORP. ACT art. 2.30-1 (expired Jan. 1, 2010).

[68] TEX. BUS. ORGS. CODE § 21.101(a)(11); *see also* TEX. BUS. CORP. ACT art. 2.30-1A(9) (expired Jan. 1, 2010).

[69] *See also* TEX. BUS. CORP. ACT arts. 12.32, 12.35 (expired Jan. 1, 2010). 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. Indeed, when acting as an agent of the LLC, a manager or managing member owes a duty of care pursuant to basic agency principles.[70] Further, the agent status of a manager in a manager-managed LLC and a member in a member-managed LLC provides a basis under agency law to impose a duty of loyalty.[71] In *Johnson v. Brewer & Pritchard, P.C.*,[72] the Texas Supreme Court discussed the fiduciary nature of the agency relationship under Texas common law. Some cases have recognized agency law as well as analogies to corporate or partnership law as a basis to impose fiduciary duties in the LLC context.[73]

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.[74] 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.[75] Broad authorization to indemnify, insure, and advance expenses to members, managers, and other persons can be read to reflect some concern with liabilities to the LLC as well as to third parties.[76] Provisions outlining procedures applicable to derivative proceedings reflect an underlying assumption that members need a mechanism to hold management accountable and a concern for balancing the rights and powers of owners and management in these situations.[77] Finally, as

[70] RESTATEMENT (THIRD) OF AGENCY § 8.08; *see also* RESTATEMENT (SECOND) OF AGENCY § 379. The BOC characterizes governing persons of an LLC as agents of the company in TEX. BUS. ORGS. CODE § 101.254.

[71] *See* RESTATEMENT (THIRD) OF AGENCY §§ 8.01-8.06; *see also* RESTATEMENT (SECOND) OF AGENCY §§ 387-398.

[72] Johnson v. Brewer & Pritchard, P.C., 73 S.W.3d 193 (Tex. 2002).

[73] *See* ETRG Invs., LLC v. Hardee (*In re* Hardee), 2013 WL 1084494 (Bankr. E.D. Tex. 2013) (concluding managing member owed LLC formal fiduciary duties based on agency law; managing member owed formal fiduciary duties to LLC based on implication of Texas LLC law that managers and managing members owe fiduciary duties of care, loyalty, and obedience similar to corporate directors; managing member owed no fiduciary duties to other members); Zayler v. Calicutt (*In re* TSC Sieber Servs., LC), 2012 WL 5046820 (Bankr. E.D. Tex. 2012) (finding individual who took over managerial control of LLC but had no formal office or ownership interest owed LLC a formal fiduciary duty based on agency law and an informal fiduciary duty based on circumstances giving rise to control).

[74] *See* TEX. BUS. ORGS. CODE §§ 2.101(21), 101.255; *see also* TEX. REV. CIV. STAT. art. 1528n, art. 2.17 (expired Jan. 1, 2010); TEX. BUS. CORP. ACT art. 2.02(20) (expired Jan. 1, 2010) (applicable by virtue of TEX. REV. CIV. STAT. art. 1528n, art. 2.02A (expired Jan. 1, 2010)).

[75] TEX. BUS. ORGS. CODE § 3.102; *see also id.* at § 3.105 (reliance by officers on information in discharging a duty).

[76] TEX. BUS. ORGS. CODE § 101.402; *see also* TEX. REV. CIV. STAT. art.1528n, art. 2.20 (expired Jan. 1, 2010).

[77] TEX. BUS. ORGS. CODE §§ 101.451-101.463; *see also* TEX. BUS. CORP. ACT art. 5.14 (expired Jan. 1, 2010)

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.[78]

Many of the Texas cases in which fiduciary duties have been an issue involve claims by a member against a fellow member for breach of fiduciary duty rather than claims based on a breach of fiduciary duty to the LLC.[79] *Allen v. Devon Energy Holdings, L.L.C.*, contains the most extensive analysis to date of the question of whether members of a Texas LLC are in a formal fiduciary relationship *vis a vis* one another. Before *Allen*, a number of other courts in Texas had encountered breach-of-fiduciary-duty claims asserted by an LLC member against a fellow member, but the discussion of those claims tended to be relatively cursory or uninformative. In *Allen* (summarized in greater detail below),[80] a minority member of an LLC sued the LLC and its majority member and sole manager, alleging that the majority member/sole manager misrepresented and failed to disclose material facts in connection with the redemption of the minority member's interest in the LLC. The court declined to recognize a broad formal fiduciary duty on the part of a majority member to a minority member because Texas does not recognize such a relationship between majority and minority shareholders in closely held corporations, but the court concluded that corporate case law supported imposing a formal fiduciary duty in a situation like that at issue, i.e., that the majority member's position as the controlling member and sole manager was sufficient to create a formal fiduciary duty to the minority member in a transaction in which the minority member's interest was being redeemed (thus increasing the ownership of the majority member). The court also relied on the similarity of the relationship between the parties in the case at issue and the relationship between the general partner and a limited partner of a limited partnership as support for recognizing a fiduciary duty between the controlling member/manager and passive minority member with respect to the operation and management of the LLC. The court did not address the scope of the fiduciary duty that was owed in this case. The court also concluded that an exculpation provision in the articles of organization referring to the manager's "duty of loyalty to [the LLC] or its members" could be read to create a fiduciary duty to the members individually.

In *Cardwell v. Gurley*,[81] (summarized in greater detail below),[82] the court of appeals avoided the issue of whether a managing member owed the other member a fiduciary duty, but held that the managing member owed a fiduciary duty to the LLC and that the articles of organization, which contained an exculpatory clause referring to the statutory authorization to eliminate monetary liability of directors, did not eliminate the managing member's liability for breach of the duty of loyalty.

(applicable by virtue of TEX. REV. CIV. STAT. art. 1528n, art. 8.12 (expired Jan. 1, 2010)).

78 TEX. BUS. ORGS. CODE §§ 101.401, 101.052; *see also* TEX. REV. CIV. STAT. art.1528n, art. 2.20 (expired Jan. 1, 2010).

79 Allen v. Devon Energy Holdings, L.L.C., 367 S.W.3d 355 (Tex. App.—Houston [1st Dist.] 2012, pet. granted, judgm't vacated w.r.m.).

80 *See* text at n. 95.

81 Cardwell v. Gurley, 2018 WL 345800 (Tex. App.—Dallas 2018, pet. denied).

82 *See* text at n.114.

Before the Texas Supreme Court's opinion in *Ritchie v. Rupe*,[83] some courts had applied the shareholder oppression doctrine in the LLC context. As discussed above, the Texas Supreme Court defined oppression in very narrow terms and held that the remedy for oppression is limited to appointment of a receiver. Thus, *Ritchie v. Rupe* has virtually eliminated claims based on oppression in Texas.

In an unpublished opinion, the Dallas Court of Appeals concluded that members of an LLC do not necessarily owe other members fiduciary duties.[84] 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*,[85] a member of an LLC sued the other two members alleging various claims based on actions taken by the other two members, who amended the LLC's articles of organization to change the LLC from a member-managed LLC to a manager-managed LLC and excluded 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 permitted the regulations (i.e., company agreement) 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 claims. The court seemed to suggest that the duties of the defendants might be comparable to those of corporate directors and officers, but the court was not clear as to whether the presence of factors supporting an informal fiduciary relationship might be required.

In *Doonan v. Wood*,[86] 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*,[87] 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

[83] Ritchie v. Rupe, 443 S.W.3d 856 (Tex. 2014).

[84] Suntech Processing Sys., L.L.C. v. Sun Commnc'ns, Inc., 2000 WL 1780236 (Tex. App.—Dallas 2000, pet. denied).

[85] Pinnacle Data Serv., Inc. v. Gillen, 104 S.W.3d 188 (Tex. App.—Texarkana 2003, no pet.).

[86] Doonan v. Wood, 224 S.W.3d 271 (Tex. App.—El Paso 2005, no pet.).

[87] Lundy v. Masson, 260 S.W.3d 482 (Tex. App.—Houston [14th Dist.] 2008, pet. denied).

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*,[88] 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 did 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."

In *Entertainment Merchandising Technology, L.L.C. v. Houchin*,[89] the court, in responding to a claim that an individual owed a fiduciary duty by virtue of his status as officer of the LLC, stated that no Texas court has held that fiduciary duties exist between LLC members as a matter of law, and the court concluded that the statute of limitations barred the breach-of-fiduciary-duty claim in any event.

In *Mullen v. Jones (In re Jones)*,[90] the court discussed at length the current state of Texas partnership law with respect to fiduciary duties of general partners. In the course of that discussion, the court noted that shareholders of a corporation do not generally owe other shareholders fiduciary duties and further noted that the law also seems to be developing toward the notion that members of a limited liability company do not necessarily owe other members fiduciary duties.

In *Federal Insurance Company v. Rodman*,[91] the court stated that there is no formal fiduciary relationship created as a matter of law between members of an LLC, but the court recognized that an informal fiduciary relationship may arise under particular circumstances where there is a close, personal relationship of trust and confidence and concluded that an LLC member

[88] Gadin v. Societe Captrade, 2009 WL 1704049 (S.D. Tex. 2009).
[89] Entm't Merch. Tech., L.L.C. v. Houchin, 720 F. Supp. 2d 792 (N.D. Tex. 2010).
[90] Mullen v. Jones (*In re* Jones), 445 B.R. 677 (Bankr. N.D. Tex. 2011).
[91] Fed. Ins. Co. v. Rodman, 91 2011 WL 5921529 (N.D. Tex. 2011).

had sufficiently pled the existence of an informal fiduciary relationship with his fellow member based on an alleged long-standing friendship.

In *Cardwell v. Gurley*,[92] the federal district court recited findings and conclusions of a Texas district court in previous litigation in which the district court concluded that the managing member of an LLC owed the other member direct fiduciary duties of loyalty, care, and disclosure, as well as owing duties to the LLC. The federal district court in this case held that the bankruptcy court did not err in giving preclusive effect to the state court's findings and conclusions and further held that the fiduciary duty owed by a managing member to his fellow LLC member was similar to the trust-type obligation owed by partners and corporate officers and thus sufficient to support an exception to discharge under Section 523(a)(4) of the Bankruptcy Code. Several years later, a Texas appellate court affirmed the state trial court's judgment based on the derivative claims asserted by the plaintiff and avoided the question of whether the managing member owed a fiduciary duty to the other member.[93]

In *Haut v. Green Café Management, Inc.*,[94] Haut, a minority owner of a corporation and an LLC, was found liable for breach of fiduciary duty to the companies, and he argued on appeal that he owed no formal or informal fiduciary duty to the companies as a matter of law. The only argument Haut made regarding an informal fiduciary duty was that there was no trial evidence that he had a special relationship of trust and confidence prior to and apart from the agreement made the basis of the suit. Because Haut designated only a partial record for appeal, the court of appeals said that it must presume the omitted evidence was relevant and supported the trial court's judgment on the jury's findings. Furthermore, the court stated that Haut's argument lacked merit even if the partial record did not require the court to presume that the evidence supported the jury's finding because Haut did not timely object to the trial court's failure to include in the charge an instruction that a pre-existing relationship of trust and confidence was necessary to find a fiduciary relationship. The court also rejected Haut' s argument that the evidence did not support a finding that Haut breached his fiduciary duty.

Allen v. Devon Energy Holdings, L.L.C.,[95] dealt with a dispute arising from the redemption of a minority interest owned by Allen in a closely held limited liability company. Allen alleged that the LLC and Rees-Jones, the LLC's manager and majority owner, fraudulently induced him to redeem his interest. In addition to common-law and statutory fraud claims, Allen brought claims for breach of fiduciary duty, shareholder oppression, and violations of the Texas Securities Act. In a lengthy opinion analyzing numerous issues bearing on the various claims, the court held that some, but not all, of the statements relied upon by Allen were actionable, that release and disclaimer provisions in the redemption agreement did not bar Allen's claims based on the actionable statements, that there was a formal fiduciary duty owed by Rees-Jones as the majority member/sole manager of the LLC to Allen as a passive minority member in the context of the

[92] Cardwell v. Gurley, 2011 WL 6338813 (E.D. Tex. 2011), aff'd on other grounds, 487 F. App'x 183 (5th Cir. 2012).

[93] Cardwell v. Gurley, 2018 WL 3454800 (Tex. App.—Dallas 2018, pet. denied).

[94] Haut v. Green Café Mgmt, Inc., 376 S.W.3d 171 (Tex. App.—Houston [14th Dist.] 2012, no pet.).

[95] Allen v. Devon Energy Holdings, L.L.C., 367 S.W.3d 355 (Tex. App.—Houston [1st Dist.] 2012, pet. granted, judgm't vacated w.r.m.)

redemption of Allen's interest, that Rees-Jones did not conclusively establish that he owed no duty of loyalty to members individually under the terms of the exculpation clause in the LLC's articles of organization, that summary judgment was properly granted on Allen's shareholder oppression claim, that the defendants conclusively established that Allen had certain knowledge that barred his fraud claims relating to the value of the LLC or its assets or the appropriateness of the redemption price, that the defendants did not otherwise disprove justifiable reliance or establish a "knowledge" defense, and that the defendants did not establish that Allen's claims under the Texas Securities Act were barred by limitations or that Allen had no recoverable damages.

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

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

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

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

In *Zayler v. Calicutt*,[96] the bankruptcy court found that the defendant breached a fiduciary duty to the debtor LLC. The LLC was a family-owned LLC in which the defendant was not formally issued a membership interest or given an office to avoid entangling the family business with unrelated legal problems of the defendant and to protect the family from any negative ramifications that might arise from any known association with the defendant. When the defendant's sister was injured and could no longer provide day-to-day supervision of the business, the plan to conceal any involvement of the defendant was altered, and the defendant's father (who served as chairman of the LLC) and sister requested that the defendant take direct managerial control of the business. The defendant had no written employment or consulting agreement but received authorized compensation for his management services. Eventually, the defendant was terminated by his sister after an internal audit revealed he had misappropriated a significant amount of funds from the LLC in her absence. The court found that the defendant owed a formal fiduciary duty to the LLC because he was an agent of the LLC. In addition, the court found that the circumstances giving rise to the managerial control gave rise to an informal fiduciary duty pursuant to which the defendant was required to place the interest of the LLC above his own. Based on the defendant's repeated breaches of fiduciary duty, the trustee was entitled to actual damages and a

[96] Zayler v. Calicutt (*In re* TSC Sieber Serv., LC), 2012 WL 5046820 (Bankr. E.D. Tex. 2012).

constructive trust over a residence obtained by the defendant with funds he unlawfully diverted from the LLC.

In *Vejara v. Levior International, LLC*,[97] Vejara, appearing *pro se* on appeal, alleged that the jury erred in finding that she breached a fiduciary duty to her fellow member in an LLC and that the trial court abused its discretion by not reversing the jury's decision on Levior's breach-of-fiduciary-duty claim. Vejara argued that she owed no fiduciary duty to Levior because she was only a minority "shareholder" of the LLC. (The court referred to the owners or members of an LLC as "shareholders" throughout its opinion.) The first part of the jury question presupposed the existence of a fiduciary relationship between Vejara and Levior, and Vejara failed to object to the charge or request additional instructions. The appellate court held that Vejara waived her right to raise this complaint on appeal but went on to hold that the record showed the existence of a fiduciary duty on Vejara's part even if Vejara did not waive her right to complain about the existence of a fiduciary duty. The appellate court agreed that Vejara, as a minority shareholder of the LLC, did not owe a formal fiduciary duty to Levior as a matter of law since Texas does not recognize a broad formal fiduciary relationship between majority and minority shareholders in closely held companies. However, the court pointed out that Texas courts have recognized that the nature of the relationship between shareholders of an LLC may give rise to an informal fiduciary duty between the shareholders. Here, although not a majority shareholder, Vejara exhibited control and had intimate knowledge of the LLC's business affairs. Vejara created the company, entered leases on behalf of the company, held keys to the company's vans, and had exclusive access to the company's inventory held in storage. The appellate court concluded that Vejara's control and intimate knowledge of the LLC's affairs and plans gave rise to the existence of an informal fiduciary duty to Levior. The court of appeals concluded there was sufficient evidence to support the jury finding that Vejara breached her fiduciary duty to Levior and that the breach caused Levior injury.

In *ETRG Investments, LLC v. Hardee (In re Hardee)*,[98] an LLC and two of its members sought a determination that debts to them arising from activities of the debtor, Hardee, while he was managing member of the LLC were nondischargeable in Hardee's bankruptcy. The plaintiffs alleged that Hardee's debts to them were nondischargeable on the basis that the debts were obtained by actual fraud or false representations or as debts arising from a defalcation by a fiduciary and/or embezzlement. After the trial, the court concluded that a debt to the LLC representing over $250,000 in embezzled funds was nondischargeable as a debt arising from a defalcation by a fiduciary and embezzlement, and a debt to the LLC of approximately $248,000 arising from Hardee's failure to tender employment taxes owed to the IRS was nondischargeable as a debt arising from a defalcation by a fiduciary. The court concluded, however, that the two members who sought an exception to Hardee's discharge failed to establish that Hardee was in a formal or informal fiduciary relationship with them as would be required to render the debt to them for the unpaid tax liabilities nondischargeable as arising out of a defalcation by a fiduciary. The bankruptcy court's opinion consists of findings of fact and conclusions of law after the trial in the adversary proceeding.

[97] Vejara v. Levior Int'l, LLC, 2012 WL 5354681 (Tex. App.—San Antonio 2012, pet. denied).
[98] ETRG Inv., LLC v. Hardee (*In re* Hardee), 2013 WL 1084494 (Bankr. E.D. Tex. 2013).

The bankruptcy court determined that Hardee embezzled significant sums of money from the LLC and that his breaches of fiduciary duty included entering into an unauthorized lending relationship, not properly managing the LLC's affairs by diverting funds, and not tendering required tax payments to the IRS on behalf of the LLC. The failure to tender the required tax payments also clearly breached the regulations (i.e., company agreement) of the LLC. The court found that Hardee, as the sole person authorized to transact business and direct the financial activities of the LLC, including the payment of tax obligations, acted as an agent of the LLC and as such had a formal fiduciary relationship. The failure to tender the tax payments was a willful breach of duty and thus a defalcation while acting in a fiduciary capacity. As for Hardee's relationship to the other plaintiffs, Tomlin and Scott, the court found that these members failed to establish that Hardee had a formal fiduciary relationship with them. The company agreement governing the LLC did not impose or even address any fiduciary duties owed by and among the LLC members. Furthermore, the court found that Tomlin and Scott failed to establish that Hardee had an informal fiduciary relationship with them or a trust relationship that existed prior to the creation of the tax obligations at issue that would create fiduciary duties to the members.

In its conclusions of law, the bankruptcy court addressed the nondischargeability of debts arising from breach of fiduciary duties. The court addressed the concept of a fiduciary under federal bankruptcy law and the requirement that the relationship amount to a "technical" or "express" trust. The court then proceeded to set forth numerous conclusions of law regarding fiduciary duties as they related to this proceeding. The BOC, which governs LLCs, does not directly address or define the duties owed by managers and members but implies that certain duties may be owed and allows the contracting parties to specify the breadth of those duties in the LLC agreement. One type of fiduciary relationship recognized under Texas law is a formal fiduciary relationship that arises as a matter of law and includes relationships between principal and agent. An agent has authority to transact business or manage some affair for another person or entity and owes a duty of care. Texas law also recognizes that a fiduciary relationship exists between corporate officers or directors and the corporation they serve, and one of the duties imposed on corporate management is a duty of care that requires diligence and prudence in the management of the corporation's affairs. Although LLCs are not corporations in the strictest sense, Texas law implies that the fiduciary status of corporate officers and directors and their corresponding duties of care, loyalty, and obedience apply to managers and/or members governing the activities of an LLC. Thus, imposition of fiduciary duties on the management of an LLC under Texas law is appropriate and warranted, and Hardee acted in a fiduciary capacity as to the LLC. Hardee was charged with insuring that all required payments of employment taxes were made by the LLC to the appropriate taxing authorities, and Hardee's failure in each instance to make the tax payments on behalf of the LLC constituted a breach of the fiduciary duties he owed the LLC. Therefore, the debt owed by the LLC to the IRS to satisfy its tax obligations for the period in which the defendant was the managing member of the LLC constituted a defalcation by a fiduciary and was excepted from discharge in Hardee's bankruptcy proceeding.

As for the individual members' request that any amount they were required to pay to satisfy the accrued IRS tax liabilities should also be a nondischargeable debt, the court noted a significant difference between a manager's fiduciary relationship to the LLC and the manager's relationship to fellow members. Case law has recognized that there is no formal fiduciary relationship created

as a matter of law between members of an LLC. Thus, Hardee had no formal fiduciary relationship with either Tomlin or Scott. An informal fiduciary relationship is a confidential relationship arising from moral, social, domestic, or personal relationships in which one person trusts in and relies on another. The effect of imposing a fiduciary duty is to require the fiduciary party to place another's interest above its own, and a fiduciary relationship is thus not one that is created lightly. Hardee had no informal fiduciary relationship with either Tomlin or Scott. Any liability of Hardee to either Tomlin or Scott created by Hardee's failure to render tax payments on behalf of the LLC was not excepted from discharge as a result of a breach of fiduciary duties because the debtor owed no fiduciary duties to the members.

In *Kohannim v. Katoli*,[99] the former spouse of a member who was awarded the member's 50% interest in a divorce was unable to recover for breach of fiduciary duty against the remaining 50% member because the trial court did not make the requested finding that the remaining member owed the former spouse a fiduciary duty and breached that duty. The court of appeals discussed formal and informal fiduciary relationships and concluded that the trial court deliberately refrained from finding the existence of a fiduciary duty and breach. The trial court made a finding that the 50% member owed the LLC a fiduciary duty and that the member breached that duty. The former spouse also asserted an oppression claim, and the court of appeals affirmed the trial court's finding that the 50% member engaged in oppression based on the member's failure to make distributions to the former spouse where the LLC regulations (i.e., company agreement) provided for distributions of "available cash," more than $250,000 in undistributed profit had accumulated in the company's accounts, and the 50% member paid himself for management services that were not performed. In *Ritchie v. Rupe*,[100] the supreme court disapproved of the definition of oppression relied upon by the court of appeals in this case and held that a court is not authorized to employ remedies other than receivership for oppression.

In *Pacific Addax Co., Inc. v. Lau (In re Lau)*,[101] the debtors, John and Deborah Lau, were in the real estate business, and the plaintiffs sought a determination that the Laus' debts for the plaintiffs' losses in real estate ventures managed by the Laus were nondischargeable on various grounds, including as debts arising from fraud or defalcation in a fiduciary capacity. The plaintiffs' claims related to their investments in two real estate ventures, one of which was organized as an LLC. John and Deborah Lau were the sole members of an LLC that owned and sought to develop a tract of land. The plaintiffs purchased interests in the LLC and became members. John Lau exercised complete control over the LLC as the sole managing member. As the managing member of the LLC, John Lau issued capital calls, which were promptly paid by the plaintiffs. When the capital calls were made, John Lau supplied false information to the plaintiffs regarding the LLC, and the capital infusions made by the plaintiffs were diverted by John Lau for his own business purposes and those of another entity owed by the Laus. The plaintiffs received no return on their investments in the LLC. The court concluded that John Lau breached his fiduciary duties to the LLC and its members. The court noted that Chapter 101 of the BOC, like the predecessor TLLCA, does not directly address the duties owed by LLC managers and members but provides that the company agreement of an LLC may expand or restrict duties, including fiduciary duties, and

[99] Kohannim v. Katoli, 440 S.W.3d 798 (Tex. App.—El Paso 2013, pet. denied).
[100] Ritchie v. Rupe, 443 S.W.3d 856, 870-75 (Tex. 2014).
[101] Pacific Addax Co., Inc. v. Lau (*In re* Lau), 2013 WL 5935616 (Bankr. E.D. Tex. 2013).

related liabilities that a member, manager, officer or other person has to the company or to a member or manager. The court stated that the statute thus implies that certain duties may be owed without defining them and allows the contracting parties to specify the breadth of those duties in the company agreement. The regulations of the LLC conferred on John Lau as the manager-member the power and authority to act on behalf of the company subject to limitations set forth in the regulations and "the faithful performance of the Managers' fiduciary obligations to the Company and the Members." Thus, the court concluded that John Lau stood in a fiduciary relationship to the plaintiffs as members of the LLC. The court stated that recognition of this fiduciary duty was consistent with the degree of control exercised by John Lau as the managing member. The court also concluded that John Lau's representations and acts in connection with the capital calls were acts of fraud and constituted defalcations. Because John Lau's debts to the plaintiffs arose from fraud and defalcation in a fiduciary capacity they were excepted from discharge. Additionally, the court concluded that Deborah Lau knowingly participated in her husband's breach of fiduciary duty and ratified the breach of duty by knowingly accepting the benefits derived from the breach. Thus, Deborah Lau's liability for these debts was excepted from discharge as well.

In *Brickley v. Scattered Corporation (In re H & M Oil & Gas, LLC)*,[102] the bankruptcy court addressed the trustee's claims for breach of fiduciary duty against the former manager of the debtor LLC, an oil and gas company. The court stated that "[a]s its Manager, Greenblatt owed fiduciary duties to H & M, including the duties of care and loyalty." The court relied on case law in the corporate context in describing the standards of conduct required by these duties. Based on these precedents, the court analyzed whether Greenblatt breached the duties of loyalty and care owed to the debtor LLC as its manager by: (1) failing to timely pay drilling costs; (2) not requesting funds under the debtor-in-possession financing agreement (DIP agreement); and (3) not taking action against the LLC's post-petition lender related to the lender's breach of the DIP agreement.

The trustee argued that Greenblatt's repeated late payments of certain drilling costs and failures to request funds under the DIP agreement to prepay completion costs did not reflect the actions of a prudent manager in light of the attendant risks. The court disagreed. With respect to Greenblatt's decision to late-pay drilling costs, the court found no injury to the LLC resulted and that those late payments, even assuming they were imprudent, could not support a finding of breach of fiduciary duty without resulting injury. With respect to Greenblatt's decision not to prepay certain completion costs, the court concluded that Greenblatt correctly interpreted the consequences of prepaying versus not prepaying the costs at issue under the controlling joint operating agreement, and Greenblatt's decision was protected by the business judgment rule. The evidence did not show that Greenblatt's decision lacked a business purpose, was tainted by conflict of interest, or was the result of an obvious and prolonged failure to exercise oversight or supervision; therefore, the court concluded that Greenblatt's decision not to prepay completion costs based on his interpretation of the joint operating agreement was the result of an informed business judgment and was not a breach of the fiduciary duty of care owed to the LLC.

As to the allegation that Greenblatt breached his fiduciary duty by failing to take action on the LLC's behalf against the post-petition lender, the court concluded that the lender did not breach

[102] Brickley v. Scattered Corp. (*In re* H & M Oil & Gas, LLC), 514 B.R. 790 (Bankr. N.D. Tex. 2014).

the DIP agreement, and thus Greenblatt's alleged failure to take action against the lender for breach of the agreement could not constitute a breach of fiduciary duty.

Because the court found Greenblatt did not breach his fiduciary duty, the court rejected the trustee's claim that Greenblatt's wage claim should be equitably subordinated based on Greenblatt's alleged breaches of fiduciary duty. The court found no other conduct by Greenblatt that would warrant subordination, and the court stated that the record did not show any injury to the LLC or its creditors or any benefit to Greenblatt from any alleged improprieties even if Greenblatt participated in inequitable conduct.

Greenblatt prevailed on a claim for indemnification under the indemnification provision of the LLC's regulations (i.e., company agreement). The provision required the LLC to indemnify the manager "against loss, liability or expense, including attorneys' fees, actually and reasonably incurred, if he or it acted in good faith and in a manner reasonably believed to be in or not opposed to the best interests of the Company as specified in this section, except that no indemnification shall be made in respect of any claim, issue or matter as to which the [manager] shall have been adjudged to be liable for gross negligence, willful misconduct or breach of fiduciary obligation in the performance of his or its duty to the Company...." The trustee argued that Greenblatt did not meet the standard for indemnification, but the court stated that it could not find that Greenblatt's actions were grossly negligent or constituted willful misconduct in light of the court's finding that he acted within the scope of his fiduciary duties owed to the LLC and that his actions fell within the scope of the business judgment rule. Because the record showed that Greenblatt acted in good faith and in a manner not opposed to the LLC's best interests, Greenblatt was entitled to indemnification of his expenses incurred in defending the complaint. The court concluded that the indemnification claim under the LLC regulations should be allowed as a general unsecured claim in the LLC's Chapter 11 case. (The court also concluded that Greenblatt had a claim for indemnification under the DIP agreement and that the claim should be allowed as an administrative expense of the Chapter 11 case.)

In *Bazan v. Munoz*,[103] Munoz went into business with long-time friends, Carlo and Denise Bazan. The Bazans and Munoz made capital contributions to an LLC that purchased a night club, and the parties signed a company agreement under which Munoz and the Bazans each had a 50% interest in the business. Denise was designated the managing member, but she delegated the day-to-day operations to Carlo. Over time, Munoz became concerned about the finances of the business and eventually sued the Bazans for fraud by nondisclosure. Generally, no duty to disclose arises without evidence of a confidential or fiduciary relationship. The court stated that "Texas courts have not recognized a formal fiduciary relationship between majority and minority shareholders in a closely-held corporation, [but] they have recognized that—in the same manner that business partners owe each other and their partners a fiduciary duty—, the nature of the relationships between shareholders in a limited liability company sometimes gives rise to an informal fiduciary relationship between them." The jury found that the parties in this case had an informal fiduciary relationship, and the evidence supported that finding based on a long-standing friendship predating their business relationship and testimony by Carlo and Denise that Munoz went into business with them because of their personal relationship and gave them a great deal of control because of his

[103] Bazan v. Munoz, 444 S.W.3d 110, 118 (Tex. App.—San Antonio 2014, no pet.).

trust in them. The company agreement did not expressly disavow fiduciary duties, and Denise and Carlo even testified that they owed Munoz a duty of loyalty and were obligated to protect his financial interests in the business as they would protect their own.

In *Guevara v. Lackner*,[104] Dr. Guevara sued Mark Lackner and Robert Lackner, fellow members of an LLC in which Dr. Guevara invested, for breach of fiduciary duty. The trial court granted a no-evidence summary judgment on this claim in favor of the Lackners. Based on a provision of the company agreement vesting sole control of the LLC in the Lackners as managers, Dr. Guevara alleged that the Lackners owed fiduciary duties of loyalty, good faith, fair dealing, full disclosure, and to account for all profits and property. Dr. Guevara alleged that the Lackners breached their duties by taking his money as a loan to purchase merchandise, conspiring to keep the profits, and suppressing information related to the transaction. He also alleged that the Lackners failed to use any business judgment in their dealings related to obligations owed by another member to the LLC. Dr. Guevara asserted that he was injured by the loss of funds he provided for the purchase of merchandise for the LLC and funds provided for other expenses of the LLC. The court noted that "Dr. Guevara's status as a co-shareholder or co-member in a closely held corporation does not automatically create a fiduciary relationship between co-shareholders or co-members." The court stated that Texas courts have recognized that an informal fiduciary duty may exist between shareholders of a closely held corporation under particular circumstances even though Texas courts have declined to recognize a broad formal fiduciary duty between majority and minority shareholders in closely held corporations. The court of appeals concluded that there was more than a scintilla of evidence of the existence of an informal fiduciary duty between the Lackners and Dr. Guevara, the breach of that duty, and injury to Dr. Guevara. The court pointed to evidence of the Lackners' control based on the provision of the company agreement that vested sole control of the management, business, and affairs of the LLC in the Lackners as managers. There was also evidence that the Lackners' role as managers gave them intimate knowledge of the daily affairs of the LLC and that Dr. Guevara did not have extensive knowledge of the operations and was not involved in the day-to-day operations. The summary-judgment evidence showed the Lackners did not disclose certain information to Dr. Guevara and that the Lackners made decisions without knowledge of relevant facts. There was also evidence that the funds provided by Dr. Guevara to the LLC were lost. According to the court of appeals, this evidence amounted to more than a scintilla of evidence of the elements of a claim for breach of an informal fiduciary duty.

In *Macias v. Gomez*,[105] the minority members of an LLC obtained a summary judgment against Macias, the majority member, on Macias's claim against the minority members for breach of fiduciary duty. Macias argued on appeal that he at least raised a fact issue as to whether the minority members owed him a fiduciary duty based on their exercise of active control over the LLC. The court of appeals affirmed the trial court's summary judgment because Macias argued in the trial court that the minority members owed him a fiduciary duty as a matter of law, comparing the LLC to a partnership in which all partners owe one another a fiduciary duty. The court of appeals concluded that Macias did not fairly apprise the trial court of his "control" argument, and the summary judgment thus could not be reversed on that basis. The court stated in a footnote that it offered no opinion as to whether an LLC's members who control activities of the LLC owe a

[104] Guevara v. Lackner, 447 S.W.3d 566 (Tex. App.—Corpus Christi 2014, no pet.).
[105] Macias v. Gomez, 2014 WL 7011372 (Tex. App.—Corpus Christi 2014, no pet.).

fiduciary duty to majority members.

In *Bigham v. Southeast Texas Environmental, LLC*,[106] an LLC that was pursuing environmental contamination litigation sued two individuals, Bigham and Hollister, who were to receive a percentage of the proceeds of the litigation pursuant to a power-of-attorney agreement with Bigham. Under the power-of-attorney agreement, Bigham was to manage the litigation. The LLC alleged that Bigham and Hollister breached their fiduciary duties by sabotaging the litigation. The jury found that Bigham and Hollister had a relationship of trust and confidence with the LLC, that they failed to comply with their fiduciary duties, and that the breaches were committed with malice. The jury also found actual and exemplary damages. The court of appeals stated that it was undisputed that Hollister owed fiduciary duties as a member of the LLC. (Hollister's fiduciary duties were not based on the power of attorney because he was not a signatory to the power of attorney even though he was designated under the power of attorney to receive a percentage of the LLC's recovery in the environmental contamination litigation. Although the court referred to Hollister's duties as relating to his status as member, an earlier portion of the opinion indicated that the LLC was manager-managed and referred to a Texas Franchise Tax Public Information Report signed by Hollister and listing Hollister as managing member.) Bigham owed the LLC fiduciary duties solely based on the power of attorney. The court reviewed the evidence and concluded that it was sufficient to support the jury's finding that Bigham and Hollister did not comply with their fiduciary duties. Based on the evidence, the jury could have concluded that Bigham and Hollister violated their fiduciary duties by threatening to withhold Hollister's cooperation in the litigation when Hollister, as a member, had a duty to achieve an optimal result at trial, irrespective of whether he received any proceeds under the power of attorney.

In *Siddiqui v. Fancy Bites, LLC*,[107] two LLC members who asserted claims for breach of fiduciary duty against two other members relied on *Guevara v. Lackner* for the proposition that "Texas courts have . . . recognized that an informal fiduciary duty *may* exist between the shareholders in a closely held corporation, depending on the circumstances."[108] Although the court of appeals in *Siddiqui* acknowledged that some appellate courts have held that an informal fiduciary duty may arise between shareholders in a closely held corporation under certain circumstances in the absence of a pre-transaction relationship, the court stated that it had not adopted such an expansive view and "has consistently determined that informal fiduciary duties do not arise in business transactions . . . unless the special relationship of trust and confidence existed before the transaction at issue."[109] Moreover, the members in this case were each co-equal managers and owners of the LLCs with equal rights of control and access to books and records. Any control exercised by two of the members resulted because the other two members chose not to participate fully in the LLC's affairs. The two members who sought to hold the other two members liable for breach of fiduciary duty did not testify that they had any relationship other than a business relationship with the other two members, and they did not testify that they trusted or relied on the other two members in any particular respect to manage the venture for them. Thus, the court of appeals held that the trial court erred in rendering judgment based on breach of

[106] Bigham v. Se. Tex. Envtl., LLC, 458 S.W.3d 650 (Tex. App.—Houston [14th Dist.] 2015, no pet.).
[107] Siddiqui v. Fancy Bites, LLC, 504 S.W.3d 349 (Tex. App.—Houston [14th Dist.] 2016, pet. denied).
[108] *Guevara*, 447 S.W.3d at 581.
[109] *Siddiqui*, 504 S.W.3d at 366.

fiduciary duties.

In *Angel v. Tauch (In re Chiron Equities, LLC)*,[110] the court concluded that a manager/minority member owed the LLC, but not the other member, fiduciary duties.

In *B Choice Ltd. v. Epicentre Development Association LLC*,[111] the court concluded that a fact issue existed as to whether the officers and manager of an LLC owed a fiduciary duty to the plaintiff member. The court recognized that no Texas court has held that fiduciary duties exist between members of an LLC as a matter of law but stated that the recognition of a fiduciary duty in the LLC context is typically a question of fact. The court relied on *Allen v. Devon Energy Holdings, LLC*,[112] in which the court of appeals discussed the similarities between an LLC and a partnership. The manager of the LLC at issue in *B Choice Ltd.* was empowered by the operating agreement with "full and exclusive right, power, and authority to manage the affairs of the Company."[113] The court found this structure and the plaintiff's minority membership created a situation similar to a limited partnership. Thus, the court refused to grant summary judgment on the breach-of-fiduciary-duty claim against the LLC's officers and manager.

In *Cardwell v. Gurley*,[114] Gurley and Cardwell formed 121 Investments, LLC (121 Investments), of which they were each 50% members, to purchase real property and build an office building. Cardwell was the managing member with exclusive control and management of 121 Investments. Several years later, after the building was constructed and was generating a positive cash flow, Cardwell convinced Gurley to sell 121 Investments' property in exchange for cash and another tract of property (Tract 4). Cardwell claimed that Gurley convinced him to sell based on a plan to acquire a tract adjacent to Tract 4 (the Montgomery Tract) and build a new retail development. Unbeknownst to Cardwell, however, Gurley facilitated the purchase of the Montgomery Tract by another company, Hickory Creek at Preston, LLC (Hickory) and sold Tract 4 to Hickory. Gurley, individually and derivatively on behalf of 121 Investments, sued Cardwell and Hickory, asserting, among other claims, a cause of action for breach of fiduciary duty against Cardwell. After Gurley prevailed in a bench trial, Cardwell filed for bankruptcy, and the appeal was abated on two occasions due to the bankruptcy proceeding.

On appeal, Cardwell argued that the trial court erred in concluding that (1) Cardwell owed Gurley a fiduciary duty either as managing member of 121 Investments or informally, (2) Cardwell breached that duty, and (3) Cardwell was monetarily liable for the breach.

The court of appeals first reviewed the elements of a breach-of-fiduciary duty claim and the circumstances under which formal and informal fiduciary duties are owed under Texas law. The court observed that neither the TLLCA, which applied to this case, nor the BOC, directly address the duties owed by managers and/or members of LLCs, but the court stated that both

[110] Angel v. Tauch (*In re* Chiron Equities, LLC), 552 B.R. 674 (Bankr. S.D. Tex. 2016).

[111] B Choice Ltd. v. Epicentre Dev. Ass'n LLC, 2017 WL 1227313 (S.D. Tex. 2017), report and recommendation adopted, 2017 WL 1160512 (S.D. Tex. 2017).

[112] Allen v. Devon Energy Holdings, LLC, 367 S.W.3d 355, 392 (Tex. App.—Houston [1st Dist] 2012, pet. granted, judgm't vacated w.r.m.).

[113] *B Choice Ltd. v. Epicentre Dev. Ass'n LLC*, 2017 WL 1227313, at *16.

[114] Cardwell v. Gurley, 2018 WL 3454800 (Tex. App.—Dallas 2018, pet. denied).

statutes presumed the existence of such duties and allow expansion or restriction of any duties, including fiduciary duties, of a member, manager, officer, or other person.

Cardwell argued that the trial court erred in concluding that he owed Gurley a fiduciary duty, either as managing member or informally. Several of the trial court's findings and conclusions related to Cardwell's fiduciary duty to 121 Investments and Gurley. One such conclusion stated: "Cardwell, as managing member of 121 Investments, owed the LLC fiduciary duties of loyalty and care as a matter of law. Since Gurley was the only other member of the LLC, such fiduciary duties accrued, and were therefore also owed, directly to Gurley as a matter of law."[115] The court of appeals discussed the current and prior statutory provisions addressing derivative suits on behalf of closely held LLCs under which a court has discretion to treat a derivative action as a direct action and to order a recovery to be paid directly to a plaintiff. Because Cardwell did not challenge the trial court's conclusion that he owed 121 Investments a fiduciary duty as managing member and the trial court's findings and conclusions regarding Cardwell's fiduciary duty to the LLC were sufficient to independently support the trial court's judgment, the court of appeals found it unnecessary to address the sufficiency of the evidence to support the trial court's findings regarding Cardwell's fiduciary duty to Gurley individually.

The court of appeals next addressed Cardwell's argument that the trial court erred in finding that he breached a fiduciary duty. Cardwell asserted that 121 Investments' regulations (i.e., company agreement) authorized all his actions as managing member and pointed out that Cardwell and Gurley maintained ongoing business interests, including buying and selling real estate, outside of 121 Investments. The court stated that there was at least some evidence showing the following: (1) Cardwell knew Hickory investors were looking for properties like the Montgomery Tract and helped arrange for their purchase of that tract; (2) Cardwell received a fee for his services facilitating the Hickory purchase of the Montgomery Tract; (3) Cardwell wanted to sell the original property owned by 121 Investments and Gurley did not; (4) knowing the Montgomery Tract was already subject to an earnest money contract he helped arrange, and with no intention other than selling Tract 4, Cardwell convinced Gurley to go through with the sale of 121 Investments' property for the purpose of pursuing a development on Tract 4 and the Montgomery Tract; (5) Cardwell sold Tract 4 without telling Gurley and without obtaining an appraisal or advertising the tract; and (6) at the time of and following the transaction, Cardwell had other business dealings with the principals of Hickory. Cardwell disputed some of this evidence, but the trial court was the sole judge of the witnesses' credibility, and the court was free to believe the evidence showing that Cardwell was dishonest and self-interested *vis a vis* Gurley and 121 Investments. Although the LLC's regulations gave Cardwell broad authority as managing member, the court of appeals stated that he owed to the LLC a fiduciary duty of "strict good faith and candor and was prohibited from using the relationship to benefit his personal interests without the principal's full knowledge and consent."[116] Thus, the court of appeals concluded that the trial court's finding that Cardwell breached his fiduciary duty of loyalty to 121 Investments was not so contrary to the overwhelming weight of evidence as to be clearly wrong and unjust.

Next, the court of appeals addressed Cardwell's argument that 121 Investments' articles of

[115] *Id.* at *6.
[116] *Id.* at *8.

organization eliminated his liability for damages. The court began its discussion of this point by noting that, "[a]s with duties, a limited liability company also may expand and restrict a member's or manager's liability to the company or another member or manager."[117] The articles of organization of 121 Investments provided as follows:

> [N]o member of the Company shall be liable, personally or otherwise, in any way to the Company, its creditors or its members for monetary damages caused in any way by an act or omission occurring in the member's capacity as a member of the Company, except as otherwise provided by Article 1302-7 06 B, as amended or the Regulations of the Company.[118]

The court set forth the text of Article 1302-7.06(b), which was repealed in 2010 and carried forward in Tex. Bus. Orgs. Code-§7.001(c). Article 1302-7.06(B) allowed the articles of incorporation of a corporation to eliminate a director's liability for monetary damages to the corporation or shareholders except for certain types of misconduct, including breach of the director's duty of loyalty. The court of appeals stated that, "[b]y incorporating the terms of article 1302-7.06(b), the parties did not contract for 'zero liability' as Cardwell suggests. Liability for a breach of the fiduciary duty of loyalty is excepted from the provision's elimination or limitation of liability."[119] The court overruled Cardwell's issue on this point because the evidence supported the trial court's finding that Cardwell breached his duty of loyalty to 121 Investments.

Cardwell also argued that the trial court erred in failing to apply the business judgment rule to protect Cardwell from liability for his actions. The court of appeals relied on case law in the corporate context to describe the business judgment rule and pointed out that "[t]he rule does not protect a corporate officer or director from liability for dishonest, fraudulent, or self-dealing acts."[120] Based on the evidence supporting Cardwell's breach of fiduciary duty to 121 Investments, the court held that the trial court's failure to apply the business judgment rule was not error.

In *Higher Perpetual Energy, LLC v. Higher Power Energy, LLC*,[121] the court stated that a formal fiduciary duty does not exist between managers and members, but the court declined to dismiss the plaintiff's breach-of-fiduciary-duty claims because the existence of an informal fiduciary relationship "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."[122]

In *French v. Fisher*,[123] the court denied the motion of two defendant members to dismiss the third member's claims against them for breach of contract and breach of fiduciary duty, and the court granted the plaintiff's motion for a preliminary injunction prohibiting the defendants from competing with the LLC. The plaintiff's claims for breach of contract and breach of fiduciary duty were based on the defendants' usurpation of the LLC's business opportunities and payment

[117] *Id.*
[118] *Id.*
[119] *Id.* at *9.
[120] *Id.*
[121] Higher Perpetual Energy, LLC v. Higher Power Energy, LLC, 2018 WL 3020328 (E.D. Tex. 2018).
[122] *Id.* at *4.
[123] French v. Fisher, 2018 WL 8576652 (W.D. Tex. 2018).

of legal expenses from the LLC's funds. The defendants argued that these claims belonged to the LLC, but the court pointed out that the operating agreement (which expressly imposed and described duties of loyalty and care) stated that the defendants owed their duties of care and loyalty to both the LLC and the members. Thus, the court held that the member was entitled to bring a direct action against the defendants. The court granted the plaintiff's request for a preliminary injunction based on its finding that there was a substantial likelihood of plaintiff's success on the merits of his claim that the defendants breached their contractual duties of care and loyalty under the operating agreement by entering into a joint venture to which they diverted the LLC's business resources and personnel without the plaintiff's consent.

In *Recruiting Force, LLC v. Maintha Tech., Inc.*,[124] the magistrate judge concluded that the plaintiff member's claims for breach of fiduciary duty against the other member and its principal asserted injuries to the LLC and involved duties owed to the LLC. Thus, the claims were derivative in nature notwithstanding that the plaintiff asked the court to treat the claims as direct under Section 101.463 of the BOC. The court noted that every court that has considered the effect of a party's request that a court apply Section 101.463 has rejected the argument that the statute transforms an otherwise derivative claim into a direct claim. Because the claims were derivative in nature, the LLC was not merely a nominal party and its citizenship destroyed diversity and required remand of the action.

Bankruptcy courts in some cases have analyzed breach-of-fiduciary-duty claims against LLC members who were also officers of the LLC in terms of the duties of corporate officers without indicating any recognition that an LLC is not actually a corporation.[125]

[124] Recruiting Force, LLC v. Maintha Tech., Inc., 2020 WL 1698826 (W.D. Tex. 2020).

[125] *See* Floyd v. Option One Mortg. Corp. (*In re* Supplement Spot, LLC), 409 B.R. 187 (Bankr. S.D. Tex. 2009) (relying on corporate law for the proposition that corporate officers have fiduciary duties to creditors in analyzing fraudulent transfer of LLC funds to pay mortgage debts of LLC officer); Sherman v. FSC Realty LLC (*In re* Brentwood Lexford Partners, L.L.C., 292 B.R. 255 (Bankr. N.D. Tex. 2003) (discussing and relying on duties owed by corporate officers to corporation and creditors in analyzing claims against LLC officers arising from distributions while LLC was insolvent and officers' resignation from LLC and formation of new LLC to which some business was transferred); Anderson v. Mega Lift Sys., L.L.C. (*In re* Mega Sys., L.L.C.), 2007 WL 1643182 (Bankr. E.D. Tex. 2007) (citing corporate case law rejecting proposition that duties are owed to corporate creditors when debtor approaches zone of insolvency in addressing breach-of-fiduciary-duty claim against LLC's president/majority owner).

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

1. 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.[126] 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 was modeled after similar provisions in the Delaware LLC and limited partnership acts[127] and left the extent to which duties and liabilities may be limited or eliminated to be determined by the courts as a matter of public policy. The statute was amended in 2003 and now reads:

> The company agreement of a limited liability company 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.[128]

There is scant case law addressing this statutory power to limit duties and liabilities in Texas LLCs. Two cases in which Texas appellate courts interpreted exculpatory clauses contained in LLC articles of organization are *Cardwell v. Gurley*,[129] and *Allen v. Devon Energy Holdings, L.L.C.*[130]

In *Allen v. Devon Energy Holdings, L.L.C.*, the court noted that LLCs are expressly

[126] TEX. REV. CIV. STAT. art. 1302-7.06 (expired Jan. 1, 2010).

[127] 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 General Assembly to a Delaware Supreme Court opinion pointing out that the prior Delaware provision did not explicitly 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*).

[128] TEX. BUS. ORGS. CODE ANN. § 101.401.

[129] Cardwell v. Gurley, 2018 WL 3454800 (Tex. App.—Dallas 2018, pet. denied).

[130] Allen v. Devon Energy Holdings, L.L.C., 367 S.W.3d 355 (Tex. App.—Houston [1st Dist.] 2012, pet. granted, judgm't vacated w.r.m.).

excluded from the statutory restriction on the limitation or elimination of liability of governing persons in Section 7.001 of the BOC, and the court stated that the members of an LLC are "free to expand or eliminate, as between themselves, any and all potential liability" of a manager of the LLC as the members see fit.[131] The court also concluded that an exculpation provision in the articles of organization that largely tracked Section 7.001 of the BOC and referred to the manager's "duty of loyalty to [the LLC] or its members"[132] could be read to create a fiduciary duty to the members individually. Section 7.001(d) of the BOC was amended in 2013 to clarify that the company agreement may eliminate the liability of a manager or managing member to the LLC and the other members to the same extent that a corporation's certificate of formation may eliminate a director's liability under Section 7.001 and to such further extent allowed by Section 101.401. There are no express prohibitions or limitations in Section 101.401 with respect to the limitation or elimination of liability of a manager or managing member to the LLC or the members.

It should be noted that a distinction can be drawn between the limitation or elimination of duties and the limitation and elimination of liabilities. If the liability of a governing person is contractually eliminated, but the duty still exists, a breach of the duty could give rise to equitable relief (such as injunctive relief or receivership) even though the person could not be held liable for damages. Further, the manner in which a contractual provision expresses the exculpation may give rise to an issue regarding the scope of the liabilities that have been contractually eliminated. Contractual provisions that merely eliminate liability for "damages" may still expose the exculpated person to equitable remedies that involve monetary recovery even though these remedies are not technically "damages."[133] Redefining or eliminating duties, on the other hand, narrows or eliminates not only potential liability for damages by the party who would otherwise owe the duty, but determines whether there is a breach at all, thus affecting the availability of equitable relief as well.

In addition to permitting the expansion or restriction of fiduciary duties of members and managers in the company agreement,[134] an LLC also has the specific power to renounce company opportunities.[135]

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.[136] 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

[131] *Allen*, 367 S.W.3d at 397, citing TEX. BUS. ORGS. CODE ANN. § 101.401.

[132] *Allen*, 367 S.W.3d at 397.

[133] *See In re* Longview Energy Co., 464 S.W.3d 353, 361 (Tex. 2015) (characterizing disgorgement as equitable forfeiture of benefits wrongfully obtained and stating that disgorgement is compensatory but is not damages).

[134] TEX. BUS. ORGS. CODE § 101.401.

[135] *Id.* at § 2.101(21); *see also* TEX. REV. CIV. STAT. art. 1528n, art. 2.02A (expired Jan. 1, 2010) (pursuant to which TEX. BUS. CORP. ACT art. 2.02(20) (expired Jan. 1, 2010) applied to an LLC).

[136] McConnell v. Hunt Sports Enters., 725 N.E.2d 1193 (Ohio App. 1999).

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.[137]

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.

Relying on the strong policy favoring freedom to contract in Texas and statutory provisions in the partnership context, a Texas appellate court recently held that a limited partner's claim for breach of fiduciary duty was precluded by a provision in the limited partnership agreement that permitted the general partner and its representatives to pursue business opportunities that were competitive with the partnership.[138]

2. 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.[139]

Sections 8.002, 101.052, and 101.402 of the BOC generally carry forward this approach. The provisions of Chapter 8 do not apply to LLCs, but the governing documents "may" adopt

137 *Id.* at 1206.
138 Cruz v. Ghani, 2018 WL 6566642 (Tex. App.—Dallas 2018, pet. denied).
139 TEX. REV. CIV. STAT. art. 1528n, art. 2.20A (expired Jan. 1, 2010).

provisions of Chapter 8 or may contain other indemnification provisions.[140] Section 101.402 expressly provides that an LLC "may" indemnify a person, but Chapter 101 has no other default provisions specifying standards or procedures for indemnification.[141] 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, and there are no provisions that limit the ability of the members to provide for indemnification in the company agreement.[142] It will be left to the courts to determine the bounds equity or public policy will place on the obligation or power to indemnify.[143] 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 the other 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*.[144] Texas cases have reiterated the unyielding duty-of-loyalty standard set forth in that case.[145] 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

[140] TEX. BUS. ORGS. CODE § 8.002.

[141] TEX. BUS. ORGS. CODE § 101.402.

[142] *See* TEX. BUS. ORGS. CODE §§ 8.002, 101.052, 101.054, 101.402.

[143] There is little Texas case law exploring the parameters of the statutory provisions. In *L Series, L.L.C. v. Holt*, 571 S.W.3d 864 (Tex. App.—Fort Worth 2019, pet. denied), the court discussed the expansive nature of the statutory provisions in the LLC context and held that the contractual provisions at issue required advancement of the defendants' expenses even though the defendant would not be entitled to indemnity if the alleged misconduct was ultimately established. In *Equine Holdings, LLC v. Jacoby*, 2020 WL 2079183 (Tex. App.—Dallas 2020, no pet. h.), the court interpreted an indemnification provision in an LLC's articles of organization without referring to the LLC statute at all. The court held that an LLC member's claim for indemnification of attorney's fees incurred in a pending action was ripe, even though the action was not concluded, because the indemnification provision encompassed attorney's fees and did not condition indemnification on the outcome of an action but merely on the determination of the members that the indemnitee acted in good faith and in a manner reasonably believed to be in the best interest of the LLC. Because the members had previously made the requisite determination and the LLC had previously paid attorney's fees incurred by the member in the action, the court rejected the LLC's argument that the member's indemnification claim (which was based on the LLC's refusal to continue paying the member's attorney's fees) was premature.

[144] Meinhard v. Salmon, 249 NY 458, 164 N.E. 545 (1928).

[145] *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.).

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.[146] 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.[147] On the other hand, the statutes leave courts some flexibility because the duties are not listed or described in exclusive terms. Furthermore, as was the case under the TRPA, the BOC provides that every partner is an "agent" of the partnership.[148] An agent owes the principal fiduciary duties under Texas common law,[149] and the principles of law and equity supplement Chapter 152 of the BOC unless otherwise provided by Chapters 151, 152, and 154.[150]

Few cases have explored in any depth whether the duties as they are described under the TRPA and BOC differ significantly from the common-law duties. The Texas Supreme Court addressed Section 4.04 of the TRPA in one case and indicated in passing 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.[151] In *Johnson v. Brewer & Pritchard, P.C.,*[152] 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 *Ingram v. Deere*,[153] 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. In *Bombardier Aerospace Corp. v. SPEP Aircraft Holdings, LLC*,[154] the Texas Supreme Court listed a partnership among several legal relationships giving rise to a formal fiduciary duty.

In *Red Sea Gaming, Inc. v. Block Investments (Nevada) Co.*,[155] the court of appeals relied

[146] *See* TEX. REV. CIV. STAT. art. 6132b-4.04 (expired Jan. 1, 2010), Comment of Bar Committee–1993.
[147] *Id.* at art. 6132b-4.04(f) (expired Jan. 1, 2010); TEX. BUS. ORGS. CODE § 152.204(d).
[148] TEX. BUS. ORGS. CODE § 152.301; TEX. REV. CIV. STAT. art. 6132b-3.02(a) (expired Jan. 1, 2010).
[149] *See, e.g.*, Johnson v. Brewer & Pritchard, P.C., 73 S.W.3d 193 (Tex. 2002).
[150] TEX. BUS. ORGS. CODE § 152.003.
[151] *See* M.R. Champion, Inc. v. Mizell, 904 S.W.2d 617 (Tex. 1995).
[152] *Johnson v. Brewer & Pritchard*, 73 S.W.3d at 199-200.
[153] Ingram v. Deere, 288 S.W.3d 886, 892 n.1 (Tex. 2009).
[154] Bombardier Aerospace Corp. v. SPEP Aircraft Holdings, LLC, 572 S.W.3d 213, 220 (Tex. 2019).
[155] Red Sea Gaming, Inc. v. Block Inv. (Nev.) Co., 338 S.W.3d 562, 567-68 (Tex. App.—El Paso 2010, pet. denied).

upon the non-exclusive nature of the description of the duty of loyalty set forth in the TRPA to conclude that a jury instruction that included a requirement that a partner show it "fully and fairly disclosed all important information" concerning the purchase of the other partner's partnership interest was consistent with the statutory duties set forth in Section 4.04 of the TRPA.[156] In *American Star Energy and Minerals Corp. v. Stowers*,[157] the Texas Supreme Court cited *Zinda v. McCann Street, Ltd.*, for the proposition that the duty of care owed by a partner under Section 152.204(a)(2) of the BOC imposes a disclosure obligation in some circumstances. Specifically, the court suggested that "[w]hen a partnership is served with a lawsuit, [the duty of care] may require the partner served to apprise the other partners."

As pointed out by Judge Jernigan in a 2011 bankruptcy opinion, federal courts applying Texas law have generally assumed that partners' duties under the current statutes are consistent with their duties under common law without any analysis of the impact of the TRPA on partners' common-law duties.[158] In 2004, 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.[159]

Subsequent to *In re Gupta*, a number of federal courts, including the Fifth Circuit Court of Appeals itself, addressed duties of partners under Texas law without considering whether or to what extent the statutory changes affected the analysis of such duties. In *Wilson v. Cantwell*,[160] the district court cited Section 152.204 of the BOC for the proposition that partners owe the partnership and other partners the "fiduciary" duties of loyalty and care and that partners must discharge their duties in good faith and in the best interest of the partnership. Bankruptcy courts have cited both case law and Section 4.04 of the TRPA for the proposition that partners owe one another and the partnership "fiduciary" duties that include the duties of loyalty and care.[161]

[156] *See also* Zinda v. McCann St., Ltd., 178 S.W.3d 883, 890-91 (Tex. App.—Texarkana 2005, pet. denied) (citing case law and Section 4.04 of the TRPA and stating that partners owe one another "fiduciary" duties as a matter of law, including a duty to make full disclosure of all matters affecting the partnership, a duty to account for all partnership property and profits, and a strict duty of good faith and candor).

[157] Am. Star Energy and Minerals Corp. v. Stowers, 457 S.W.3d 427, 434-35 (Tex. 2015) (citing *Zinda v. McCann St., Ltd.*, 178 S.W.3d at 890, for the proposition that "[p]artners have a duty to one another to make full disclosure of all matters affecting the partnership....").

[158] Mullen v. Jones (*In re* Jones), 445 B.R. 677 (Bankr. N.D. Tex. 2011) (further discussed below).

[159] *See* Gupta v. E. Idaho Tumor Inst., Inc. (*In re* Gupta), 394 F.3d 347 (5th Cir.2004).

[160] Wilson v. Cantwell, 2007 WL 2285947 (N.D. Tex. 2007).

[161] *See* Wallace v. Perry (*In re* Perry), 423 B.R. 215, 285 (Bankr. S.D. Tex. 2010); Leal v. Mokhabery (*In re* Leal), 360 B.R. *231, *235-36 (Bankr. S.D. Tex. 2007); *see also* Trinkets and Tea, LLC v. Hunt (*In re* Hunt), 605 B.R. 758 (Bankr. W.D. Tex. 2019) (describing partner's duties under Sections 152.204 through 152.206 of the BOC and concluding that individual stood in a "fiduciary capacity" in his relationship to the partnership and "personally owed fiduciary duties" to the partnership and the other partner because of his control over an LLC that served as one of the two general partners of the general partnership); West v. Seiffert (*In re* Houston Drywall, Inc.), 2008 WL 2754526 (Bankr. S.D. Tex. 2008) (citing Section 152.205 of the BOC along with Texas case law for the proposition that partners owe one another "fiduciary" duties and stating 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).

In *McBeth v. Carpenter*,[162] 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* 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.[163]

The most extensive analysis to date of the impact of the statutory developments under Texas partnership law on the common-law fiduciary duties of partners is found in *Mullen v. Jones (In re Jones)*.[164] In determining whether the debtor owed a non-dischargeable debt to the plaintiff under Section 523(a)(4) of the Bankruptcy Code, the bankruptcy court first examined whether the debtor was acting in a fiduciary capacity *vis a vis* the plaintiff. After noting that the debtor, as an officer and director of the corporate general partner of a limited partnership, stood in a fiduciary relationship to the corporation and its shareholders under Texas corporate law, the court proceeded to analyze the nature of the relationship of the corporate general partner to the partnership and the limited partners under Texas partnership law. The court noted that a large amount of common law stands for the proposition that a general partner occupies a fiduciary role with respect to the limited partners, but the court recognized that significant amendments to the Texas partnership statutes in 1994 impact the analysis of fiduciary duties in the partnership context. The court summarized the statutory developments, explaining that the Texas Uniform Partnership Act only used the term "fiduciary" when referring to a partner's duty to account for any benefit and hold as trustee any profits obtained in connection with the partnership without the consent of other partners, but that case law under the Texas Uniform Partnership Act consistently referred to a partner as a fiduciary.

The bankruptcy court then discussed the approach taken in the TRPA, which rejected the notion of a partner as a trustee and specifically set forth the duties of partners in precise terms. The court noted that the Official Comments state that these changes were meant to reign in the loose use of fiduciary concepts. Finally, the court noted that the BOC contains language nearly identical to the TRPA. Despite these changes since the Texas Uniform Partnership Act, the court observed that very little case law has addressed the significance of the changes. The court pointed out that the Fifth Circuit case of *In re Gupta*[165] came closest to confronting the significance of the changes. As noted above, in that case, the Fifth Circuit did not tackle the meaning or ramifications of the new Texas partnership statute with respect to the notion of "fiduciary capacity" under Section 523(a)(4) but did note that partners still owe "special duties to each other," some of which "may rise to the level of a 'fiduciary' for purposes of § 523(a)(4)." A few years later, without

[162] McBeth v. Carpenter, 565 F.3d 171 (5th Cir. 2009).

[163] *See also* FNFS, Ltd. v. Harwood (*In re* Harwood), 637 F.3d 615 (5th Cir. 2011) (relying upon *In re Bennett*, a 1993 Fifth Circuit opinion, and *McBeth v. Carpenter* to conclude that an officer of a corporate general partner who is entrusted with the management of the limited partnership and who exercises control over the limited partnership in a manner analogous to those cases owes a fiduciary duty to the partnership that satisfies Section 523(a)(4) of the Bankruptcy Code).

[164] Mullen v. Jones *(In re* Jones*)*, 445 B.R. 677 (Bankr. N.D. Tex. 2011).

[165] Gupta v. E. Idaho Tumor Inst., Inc. (*In re* Gupta), 394 F.3d 347, 351 (5th Cir. 2004).

mentioning the statutory changes, the Fifth Circuit, in *McBeth v. Carpenter,*[166] held that all partners in a partnership are fiduciaries. Ultimately, the bankruptcy court in *Mullen v. Jones*[167] concluded that the changes in Texas statutory partnership law in recent years expunged the concept of a partner as a *per se* fiduciary but did not eliminate the fiduciary status of a managing general partner because of the control exercised by such a partner. The court reasoned that the new statutory language, which makes clear that a partner is not *per se* a fiduciary, puts partners and partnerships on a parity with shareholders and corporations in that shareholders do not generally owe fiduciary duties to other shareholders. Based on the roles in which fiduciary duties are owed in the corporate context and longstanding case law regarding the fiduciary duties of a managing partner in the partnership context, the court concluded that control is the key to determining whether a partner is a fiduciary. Thus, the court held that Texas case law holding that there is an express trust satisfying the strict test for "fiduciary capacity" under Section 523(a)(4) is still good law in the context of a managing general partner.

The court in *Jones* then looked at the two-tiered structure of the limited partnership to determine how it affected the fiduciary duties owed by the debtor. The debtor was president, a director, and 51% shareholder of the corporate general partner. The court relied on two Fifth Circuit cases, *LSP Investment Partnership v. Bennett (In re Bennett)*,[168] and *McBeth v. Carpenter*,[169] to conclude that the debtor, as manager of the managing general partner, owed fiduciary duties to the partnership and the partners. In *Bennett*, the Fifth Circuit held that the fiduciary obligations imposed on managing partners of a limited partnership under Texas law were sufficient to meet the Section 523(a)(4) test and that the same level of fiduciary duty should apply to the managing partner of a managing partner. *McBeth* was not a Section 523(a)(4) case, but the Fifth Circuit again held that a person or entity acting in complete control of a limited partnership stands in the same fiduciary capacity to the limited partners as a trustee stands to the beneficiary of a trust even in a two-tiered partnership structure. Thus, the court concluded that the debtor owed the plaintiff fiduciary duties through at least two avenues: (1) in his capacity as officer and director of the corporate general partner (since the plaintiff was a shareholder); and (2) in his capacity as the control person/manager of the general partner (since the plaintiff was a limited partner).[170]

The bankruptcy court next analyzed whether the debtor committed a defalcation in a fiduciary capacity, i.e., whether he breached or neglected fiduciary duties, whether he was at least reckless in doing so, and whether a reasonable person in the debtor's position reasonably should have known better. The court described the duties of loyalty and care and the obligation of good

[166] McBeth v. Carpenter*,* 565 F.3d 171 (5th Cir. 2009).

[167] *Mullen v. Jones*, 445 B.R. at 708-711.

[168] LSP Inv. P'ship v. Bennett (*In re* Bennett), 989 F.2d 779, 787 (5th Cir. 1993).

[169] *McBeth v. Carpenter,* 565 F.3d at 177.

[170] The question of whether an individual who controls an entity partner owes fiduciary duties to the partnership and the other partners based on the "multi-tier" structure of the partnership usually arises in the context of limited partnerships, but a bankruptcy court recently addressed this question in the context of a general partnership in Trinkets and Tea, LLC v. Hunt (*In re* Hunt), 605 B.R 758 (Bankr. W.D. Tex. 2019). In that case, the court concluded that Hunt, the individual sole member and manager of one of two LLC general partners of a general partnership, personally owed fiduciary duties to the partnership and the other partner because the LLC "would have 'no life' without Hunt." *Id.* at 777.

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

Finally, the court determined the amount of the "debt" to the plaintiff that had arisen as a result of the debtor's defalcation. The court measured this debt based on the amount of the misappropriated partnership funds. The court also awarded exemplary damages because Texas courts have held that breach of fiduciary duty is a tort for which exemplary damages may be recoverable and there was clear and convincing evidence that the standard for exemplary damages under the Texas Civil Practice and Remedies Code was met. Under the Texas Civil Practice and Remedies Code, exemplary damages may only be awarded if a claimant proves by clear and convincing evidence that the harm to the claimant resulted from actual fraud, malice, or gross negligence. Although the court concluded there was no actual fraud or malice on the part of the debtor, the court found the evidence did establish gross negligence as defined by the statute.

In the years since the bankruptcy court's analysis in *Mullen v. Jones (In re Jones)*, most courts in Texas have not specifically analyzed whether a partner's statutory duties under the TRPA and BOC are "fiduciary" in character. Many courts explicitly or implicitly characterize the statutory duties of partners as "fiduciary," citing Texas case law in addition to the duty provisions of the TRPA and BOC.[171] Some courts continue to discuss fiduciary duties of partners under Texas law without referring to the statutory provisions at all.[172] And some courts describe and apply the statutory duties without expressly characterizing the duties as "fiduciary."[173] In *Bruce v. Cauthen*,[174] the court held that a partner failed to preserve for appeal his argument that a partner's

[171] *See* Trinkets and Tea, LLC v. Hunt (*In re* Hunt), 605 B.R 758 (Bankr. W.D. Tex. 2019); Lopez v. Hernandez (*In re* Hernandez), 565 B.R. 367 (Bankr. W.D. Tex. 2017); Nguyen v. Hoang, 507 S.W.3d 360 (Tex. App.—Houston [1st Dist.] 2016, no pet.); Westergren v. Jennings, 441 S.W.3d 670 (Tex. App.—Houston [1st Dist.] 2014, no pet); SEC v. Helms, 2015 WL 1040443 (W.D. Tex. 2015); Drexel Highlander Ltd. P'ship v. Edelman (*In re* Edelman), 2014 WL 1796217 (Bankr. N.D. Tex. 2014), aff'd, 2015 WL 5714728 (N.D. Tex. 2015).

[172] *See* Houle v. Casillas, 594 S.W.3d 524 (Tex. App.—El Paso 2019, no pet.); Red Honor Ventures, Ltd. v. Edmonds (*In re* Edmonds), 2019 WL 4780921 (Bankr. N.D. Tex. 2019); Brown v. Outlaw, 2019 WL 2647791 (Tex. App.—Dallas 2019, pet. denied); Lopez v. Hernandez (*In re* Hernandez), 2019 WL 2402998 (Bankr. W. D. Tex. 2019); Home Comfortable Supplies, Inc. v. Cooper, 544 S.W.3d 899 (Tex. App.—Houston [14th Dist.] 2018, no pet.); Patel v. Harbor Hospice Beaumont, LP, 2017 WL 4296615 (Tex. App.—Corpus Christi 2017, pet. denied); CBIF Ltd. P'ship v. TGI Friday's Inc., 2017 WL 1455407 (Tex. App.—Dallas 2017, pet. denied); Thunder Rose Enters., Inc. v. Kirk, 2017 WL 2172468 (Tex. App.—Corpus Christi 2017, pet. denied); Art Midwest Inc. v. Atl. Ltd. P'ship XII, 742 F.3d 206 (5th Cir. 2014); Light v. Whittington (*In re* Whittington), 530 B.R. 360 (Bankr. W.D. Tex. 2014); Naples v. Lesher, 2014 WL 1856846 (Tex. App.—Texarkana 2014, no pet.); Serengeti Resort, LLC v. Esperanza, 2014 WL 235336 (Tex. App.—San Antonio 2014, no pet.); Pacific Addax Co., Inc. v. Lau (*In re* Lau), 2013 WL 5935616 (Bankr. E.D. Tex. 2013); United States v. Woodward, 2011 WL 13182857 (S.D. Tex. 2011), aff'd, 493 F. App'x 483 (5th Cir. 2012).

[173] *See* Jerry L. Starkey, TBDL, LP v. Graves, 448 S.W.3d 88 (Tex. App.—Houston [14th Dist.] 2014, no pet.).

[174] Bruce v. Cauthen, 515 S.W.3d 495 (Tex. App.—Houston [14th Dist.] 2017, pet denied).

statutory duties are not the equivalent of common-law fiduciary duties.

In *Cohen v. Flat Stone Development Co., Inc.*,[175] the court implicitly concluded that the statutory duties need not necessarily be characterized as fiduciary duties. The case involved a dispute among the general and limited partners of three limited partnerships, and each of the limited partnership agreements contained the following provision: "[T]he General Partner will not owe a fiduciary duty to the Partnership or any Partner. The General Partner will owe a duty of loyalty and a duty of care to the Partnership."[176] The court stated that "[t]he contract by its plain language distinguishes a fiduciary duty from duties of loyalty and care,"[177] and "[f]ailing to give effect to this distinction would fail to 'harmonize and give effect' to both sentences."[178] The court noted by way of footnote that each limited partnership agreement "[a]dditionally, . . . tracks the general meaning of the Texas statute governing the duties of general partners. *See* Tex. Bus. Orgs. Code Ann. § 152.204 (West Supp. 2018)".[179] The court held that the parties intended to disclaim any fiduciary duties, and the court granted summary judgment as to the breach-of-fiduciary-duty claims against the general partner and dismissed those claims.

1. Duty of Care

A partner owes a duty of care to the partnership and the other partners.[180] The duty is defined in BOC Section 152.206[181] 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.[182] 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.[183] It is unlikely the drafters intended to up the ante in this regard. On the other hand, the TRPA stopped short of expressly specifying gross negligence as the 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.

[175] Cohen v. Flat Stone Dev. Co., Inc., 2018 WL 6411410 (S.D. Tex. 2018).

[176] *Id.* at *2.

[177] *Id.*

[178] *Id*.

[179] *Id.* at *3, n.4.

[180] TEX. BUS. ORGS. CODE § 152.204(a); *see also* TEX. REV. CIV. STAT. art. 6132b-4.04(a) (expired Jan. 1, 2010).

[181] (*See also* TEX. REV. CIV. STAT. art. 6132b-4.04(c) (expired Jan. 1, 2010)).

[182] TEX. BUS. ORGS. CODE §§ 152.206, 152.204(b); TEX. REV. CIV. STAT. art. 6132b-4.04(c), (d) (expired Jan. 1, 2010).

[183] *See* Ferguson v. Williams, 670 S.W.2d 327 (Tex. App.—Austin 1984, writ ref'd n.r.e.).

According to the court, poor management performance, absent a showing of wrongful conduct, is not actionable.[184] 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 to the partner's poor recordkeeping as a breach of fiduciary duty.

Relying on the TRPA, a Texas bankruptcy court concluded a partner breached his duty of care in the winding up of a partnership by failing to honor an indemnification clause in an agreement with the other partners.[185] In the course of its discussion of the duty of care, the court stated that "the business judgment rule does not apply to partnership decisions made by partners in a partnership."[186] This assertion is patently at odds with the language of Section 4.04(c) of the TRPA (recodified in Section 152.206(b) and (c) of the BOC) and the Bar Committee Comment.[187] The more pertinent questions are what effect the business judgment rule has on the standard of liability of a partner and the circumstances under which it applies. Indeed, assuming the business judgment rule applies to a general partner, the court held in the alternative that the business judgment rule was not a valid defense because the partner was not disinterested in relation to his failure to indemnify the other partners.

In *American Star Energy and Minerals Corp. v. Stowers*,[188] the Texas Supreme Court cited *Zinda v. McCann Street, Ltd.*,[189] for the proposition that the duty of care owed by a partner under Section 152.204(a)(2) of the BOC imposes a disclosure obligation in some circumstances. Specifically, the court suggested that "[w]hen a partnership is served with a lawsuit, [the duty of care] may require the partner served to apprise the other partners."[190]

In *Shannon Medical Center v. Triad Holdings III, L.L.C.*,[191] the court of appeals held that the trial court did not err in submitting a jury question that described the managing general partner's duty of care to the partnership as described in Sections 152.204 and 152.206 of the BOC and inquired whether the managing general partner complied with its duty of care to the partnership. In view of the damages question that was predicated on the finding of a breach of the duty of care, the court of appeals concluded that the conduct at issue was the managing general partner's execution of a lease on behalf of the partnership that resulted in the payment of improperly charged rents to a subsidiary of the managing general partner. This conduct properly formed the basis of liability for a breach of the duty of care according to the court. The court also concluded that the jury question, which tracked the language of the statute, did not fail to

[184] Leal v. Mokhabery (*In re* Leal), 360 B.R. 231, 239 (Bankr. S.D. Tex. 2007).

[185] Wallace v. Perry (*In re* Perry), 423 B.R. 215, 285-86 (Bankr. S.D. Tex. 2010).

[186] *Id.* at 288.

[187] *See* TEX. REV. CIV. STAT. art. 6132b-4.04(c) (expired Jan. 1, 2010), Comment of Bar Committee–1993 ("This subsection, along with subsection (d), incorporates the so-called 'business judgment rule,'....").

[188] Am. Star Energy and Minerals Corp. v. Stowers, 457 S.W.3d 427, 435 (Tex. 2015).

[189] Zinda v. McCann St., Ltd., 178 S.W.3d 883, 890 (Tex. App.—Texarkana 2005, pet. denied).

[190] *Am. Star Energy*, 457 S.W.3d at 434-35 (citing *Zinda v. McCann St., Ltd.*, for the proposition that "[p]artners have a duty to one another to make full disclosure of all matters affecting the partnership....").

[191] Shannon Med. Center v. Triad Holdings III, L.L.C., __ S.W.3d __, 2019 WL 6606406 (Tex. App.—Houston [14th Dist.] 2019, no pet. h.).

adequately address alleged alterations of the statutory duty of care in the partnership agreement. Because the instruction made clear that a partner does not violate a duty or obligation merely because the partner's conduct furthers its own interest and an error in judgment does not alone constitute a breach of the duty of care, the court concluded that the charge correctly reflected the governing law and the terms of the partnership agreement, which authorized contracts between the partnership and a partner's affiliates but did not alter the requirement that a partner act in good faith and reasonably believe that the contract was in the partnership's best interest.

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.[192]

2. 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.[193]

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 the partner's conduct furthers the partner's own interest and that a partner is not a trustee and should not be held to a trustee standard.[194] 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

[192] TEX. BUS. ORGS. CODE § 3.102.
[193] *Id.* at § 152.205; *see also* TEX. REV. CIV. STAT. art. 6132b-4.04(b) (expired Jan. 1. 2010).
[194] *See* TEX. BUS. ORGS. CODE § 152.204(c), (d); *see also* TEX. REV. CIV. STAT. art. 6132b-4.04(e), (f) (expired Jan. 1, 2010).

that partners owe one another and the partnership "fiduciary" duties.[195] 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.[196] 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.[197] The principles of law and equity supplement the partnership statutes unless otherwise provided by the statutes.[198]

In *McBeth v. Carpenter*,[199] 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."[200] 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.[201] Numerous other courts have explicitly or implicitly characterized the statutory duty of loyalty under the TRPA or BOC as a fiduciary duty consistent with the common-law duty of loyalty owed by a partner.[202]

In a somewhat unusual application of the duty of loyalty, a court held that a partner dealt with the partnership in an adverse manner and thus breached his duty of loyalty under Section 4.04(b) of the TRPA when the partner cancelled partnership meetings that were necessary to determine the entity's direction and chose instead to go to the movies.[203] In *Mullen v Jones (In re Jones)*,[204] the bankruptcy court concluded that the changes in Texas statutory partnership law in recent years expunged the concept of a partner as a *per se* fiduciary but did not eliminate the fiduciary status of a managing general partner because of the control exercised by such a partner. The court reasoned that the new statutory language makes clear that a partner is not *per se* a

[195] *See* Leal v. Mokhabery (*In re* Leal), 360 B.R. 231 (Bankr. S.D. Tex. 2007).

[196] *Id.* at 235-36.

[197] *Id.* at 241. As noted above, a partner is by statute an "agent" of the partnership, and an agent owes a fiduciary duty to the principal under Texas common law. TEX. BUS. ORGS. CODE § 152.301; TEX. REV. CIV. STAT. art. 6132b-3.02(a) (expired Jan. 1, 2010); Johnson v. Brewer & Pritchard, P.C., 73 S.W.3d 193 (Tex. 2002).

[198] TEX. BUS. ORGS. CODE § 152.003.

[199] McBeth v. Carpenter, 565 F.3d 171 (5th Cir. 2009).

[200] Citing Section 4.04 of the TRPA. *See also* FNFS, Ltd. v. Harwood (*In re* Harwood), 637 F.3d 615 (5th Cir. 2011); Zinda v. McCann St., Ltd., 178 S.W.3d 883 (Tex. App.—Texarkana 2005, pet. denied); Wilson v. Cantwell, 2007 WL 2285947 (N.D. Tex. 2007).

[201] *See* West v. Seiffert (*In re* Houston Drywall, Inc.), 2008 WL 2754526 (Bankr. S.D. Tex. 2008).

[202] *See, e.g.,* Lopez v. Hernandez (*In re* Hernandez), 565 B.R. 367 (Bankr. W.D. Tex. 2017); Nguyen v. Hoang, 507 S.W.3d 360 (Tex. App.—Houston [1st Dist.] 2016, no pet.); Westergren v. Jennings, 441 S.W.3d 670 (Tex. App.—Houston [1st Dist.] 2014, no pet); SEC v. Helms, 2015 WL 1040443 (W.D. Tex. 2015); Drexel Highlander Ltd. P'ship v. Edelman (*In re* Edelman), 2014 WL 1796217 (Bankr. N.D. Tex. 2014), aff'd, 2015 WL 5714728 (N.D. Tex. 2015).

[203] Wallace v. Perry (*In re* Perry), 423 B.R. 215, 285-86 (Bankr. S.D. Tex. 2010).

[204] Mullen v. Jones (*In re* Jones), 445 B.R. 677, 708-711 (Bankr. N.D. Tex. 2011).

fiduciary and puts partners and partnerships on a parity with shareholders and corporations inasmuch as shareholders do not generally owe fiduciary duties to other shareholders. Based on the roles in which fiduciary duties are owed in the corporate context and longstanding case law regarding the fiduciary duties of a managing partner in the partnership context, the court concluded that control is the key to determining whether a partner is a fiduciary.

3. Duties Owed to Transferees of Deceased Partners

In 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.[205] 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.[206]

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 give rise to transferees of a deceased partner.[207] Rather, the deceased partner's personal representative, surviving spouse, heirs, and devisees are regarded as creditors until paid.[208] 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.[209]

4. 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.[210] Though courts may be tempted to elevate this language to 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.[211]

5. Duty to Provide or Disclose Information

[205] *See also* TEX. BUS. ORGS. CODE § 152.204(a).

[206] *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).

[207] *See* TEX. BUS. ORGS. CODE § 152.601; *see also* TEX. REV. CIV. STAT. art. 6132b- 7.01(a) (expired Jan. 1, 2010).

[208] TEX. BUS. ORGS. CODE § 152.406(a)(2)(A).

[209] *Id.* at § 152.406(a)(2)(B).

[210] *Id.* at § 152.204(b); *see also* TEX. REV. CIV. STAT. art. 6132b- 4.04(d) (expired Jan. 1, 2010).

[211] *See* TEX. REV. CIV. STAT. art. 6132b-4.04, Comment of Bar Committee–1993.

The BOC requires that partners be furnished complete and accurate information on request.[212] Furthermore, the partnership must provide access to its books and records to partners and their agents and attorneys for inspection and copying.[213] 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.[214]

In *American Star Energy and Minerals Corp. v. Stowers*,[215] the Texas Supreme Court suggested that there are circumstances in which a partner owes another partner a duty to disclose information. Specifically, the court suggested that "[w]hen a partnership is served with a lawsuit, [the duty of care] may require the partner served to apprise the other partners."[216]

In *Red Sea Gaming, Inc. v. Block Investments (Nevada) Co.*,[217] the court of appeals relied upon the non-exclusive nature of the description of the duty of loyalty set forth in the TRPA to conclude that a jury instruction that included a requirement that a partner show it "fully and fairly disclosed all important information" concerning the purchase of the other partner's partnership interest was consistent with the statutory duties set forth in Section 4.04 of the TRPA.[218]

[212] TEX. BUS. ORGS. CODE § 152.213(a); *see also* TEX. REV. CIV. STAT. art. 6132b-4.03(c) (expired Jan. 1, 2010).

[213] TEX. BUS. ORGS. CODE § 152.212(a)(c); *see also* TEX. REV. CIV. STAT. art. 6132b-4.03(b) (eff. Jan. 1, 2010).

[214] *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.).

[215] Am. Star Energy and Minerals Corp. v. Stowers, 457 S.W.3d 427 (Tex. 2015).

[216] *Am. Star Energy*, 457 S.W.3d at 434-35 (citing Zinda v. McCann St., Ltd., 178 S.W.3d 883, 890 (Tex. App.—Texarkana 2005, pet. denied) for the proposition that "[p]artners have a duty to one another to make full disclosure of all matters affecting the partnership....").

[217] Red Sea Gaming, Inc. v. Block Inv. (Nev.) Co., 338 S.W.3d 562 (Tex. App.—El Paso 2010, pet. denied).

[218] *See also* McBeth v. Carpenter, 565 F.3d 171 (5th Cir. 2009) (citing case law and the TRPA in discussing the duties of partners and concluding that the defendant partners had an affirmative duty to disclose material information to the plaintiff limited partners); Lopez v. Hernandez (*In re* Hernandez), 565 B.R. 367 (Bankr. W.D. Tex. 2017) (stating that partners in Texas owe duties of loyalty and care, that partners must discharge those duties in good faith, and that the duty of loyalty includes a duty to account to the partnership for property and profits pursuant to TEX. BUS. ORGS. CODE §§ 152.204, 152.205, and relying on case law for the proposition that partners owe one another a general duty of full disclosure with regard to matters affecting a partner's interests); Zinda v. McCann St., Ltd., 178 S.W.3d 883 (Tex. App.—Texarkana 2005, pet. denied) (citing case law and the TRPA and stating that partners owe one another fiduciary duties that include a duty to make full disclosure of all matters affecting the partnership and strict duty of good faith and candor).

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

1. General Partners

Case law has traditionally held general partners in a limited partnership to fiduciary standards.[219]

Though courts have been inclined to refer to a general partner of a limited partnership as a "trustee," a general partner is no longer automatically analogous to a trustee. 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.[220] 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).[221] Thus, a general partner in a limited partnership has the duties of care and loyalty and obligation of good faith set forth in Chapter 152 of the BOC (discussed above) but should no longer automatically 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*,[222] 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 the general partner of a limited partnership to a trustee.[223]

219 *See, e.g.,* 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).

220 TEX. BUS. ORGS. CODE § 153.152(a)(2); *see also id.* at § 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).

221 *See* TEX. REV. CIV. STAT. art. 6132a-1, § 4.03(b) (expired Jan. 1, 2010); *id*. at art. 6132a-1, § 13.03 (expired Jan. 1, 2010).

222 McBeth v. Carpenter, 565 F.3d 171, 177 (5th Cir. 2009).

223 *See also* FNFS, Ltd. v. Harwood (*In re* Harwood), 637 F.3d 615 (5th Cir. 2011) (stating individual who was director/officer of corporate general partner stood in same fiduciary capacity to limited partners as trustee to beneficiaries of trust); SEC v. Helms, 2015 WL 1040443 (W.D. Tex. 2015) (citing Sections 153.152(a) and 152.204 of the BOC for the proposition that the general partner of a limited partnership owes fiduciary duties to the partnership and the limited partners and citing case law for the proposition that a general partner acting in complete control stands in the same fiduciary capacity to the limited partners as a trustee stands to the beneficiaries of the trust); Pacific Addax Co., Inc. v. Lau (*In re* Lau), 2013 WL 5935616 at *25 (Bankr. E.D. Tex. 2013) (citing Texas case law for the proposition that a general partner of a limited partnership "owes trust obligations to the partnership" and "stands in the same fiduciary capacity to the limited partners as a trustee stands to the beneficiaries of a trust"); West v. Seiffert (*In re* Houston Drywall, Inc.), 2008 WL 2754526 (Bankr. S.D. Tex. 2008) (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

Not only the general partner, but those in control of the general partner have been held to fiduciary standards.[224] "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."[225]

In *FNFS, Ltd. v. Harwood (In re Harwood)*,[226] the Fifth Circuit Court of Appeals affirmed the district court's judgment affirming the bankruptcy court's judgment that the debtor's debts arising from loans obtained from a limited partnership managed by the debtor in his capacity as officer and director of the general partner were nondischargeable under Section 523(a)(4). The court of appeals agreed with the lower courts that Harwood, who was president, a director, and a 50% shareholder of the corporate general partner of a limited partnership, owed a fiduciary duty to the partnership and that he engaged in a defalcation in that capacity in connection with loans he obtained from the limited partnership. The court relied upon *In re Bennett* and *McBeth v. Carpenter* to conclude that an officer of a corporate general partner who is entrusted with the management of the limited partnership and who exercises control over the limited partnership in a manner analogous to those cases owes a fiduciary duty to the partnership that satisfies Section 523(a)(4). The court emphasized that it is not only the control that the officer actually exerts over the partnership, but also the trust and confidence placed in the hands of the controlling officer, that leads to a finding of a fiduciary relationship for purposes of Section 523(a)(4). Thus, the court examined the evidence regarding the control entrusted to and exercised by Harwood to ascertain whether he owed a fiduciary duty to both tiers of the organization.

Harwood did not dispute that he owed a fiduciary duty to the corporate general partner as an officer and director of the corporation but contended he owed no duty to the partnership since he was not a partner and did not exercise a level of control over its affairs to justify recognition of fiduciary obligations to the partnership. The court rejected Harwood's attempt to distinguish the cases relied upon by the court. Harwood relied on the fact that he was not the sole shareholder and sole director of the corporate general partner, whereas *In re Bennett* involved an individual who was managing partner of a limited partnership that was general partner of the limited partnership, and *McBeth v. Carpenter* involved the president and sole owner of the general partner of the limited partnership. The court focused on Harwood's control, and the court agreed with the

analogized a general partner's duty to a limited partner to that owed by a trustee to a beneficiary).

[224] *See, e.g.,* FNFS, Ltd. v. Harwood (*In re* Harwood), 637 F.3d 615 (5th Cir. 2011); LPS Inv. P'ship v. Bennett (*In re* Bennett), 989 F.2d 779 (5th Cir. 1993); Trinkets and Tea, LLC v. Hunt (*In re* Hunt), 605 B.R 758 (Bankr. W.D. Tex. 2019); Edelman v. Drexel Highlander Ltd. P'ship, 2015 WL 5714728 (N.D. Tex. 2015); Light v. Whittington (*In re* Whittington), 530 B.R. 360 (Bankr. W.D. Tex. 2014); Mullen v. Jones (*In re* Jones), 445 B.R. 677 (Bankr. N.D. Tex. 2011); Pacific Addax Co., Inc. v. Lau (*In re* Lau), 2013 WL 5935616 (Bankr. E.D. Tex. 2013); CBIF Ltd. P'ship v. TGI Friday's Inc., 2017 WL 1455407 (Tex. App.—Dallas 2017, pet. denied).

[225] FNFS, Ltd. v. Harwood (*In re* Harwood), 404 B.R. 366, 394-95 (Bankr. E.D. Tex. 2009), aff'd, 427 B.R. 392 (E.D. Tex. 2010), aff'd, 637 F.3d 615 (5th Cir. 2011).

[226] *Id.*

bankruptcy and district courts that the board's entrustment in Harwood of the management of the partnership's affairs combined with the practically complete control that Harwood actually exercised over the partnership's management compelled the conclusion that Harwood stood in the same fiduciary capacity to the limited partners as a trustee to beneficiaries of a trust. Thus, Harwood acted in a fiduciary capacity within the meaning of Section 523(a)(4).

As discussed above, the bankruptcy court in *Mullen v. Jones (In re Jones)*,[227] concluded that the changes in Texas statutory partnership law in recent years expunged the concept of a partner as a *per se* fiduciary but did not eliminate the fiduciary status of a managing general partner because of the control exercised by such a partner. The court reasoned that the new statutory language makes clear that a partner is not *per se* a fiduciary and puts partners and partnerships on a parity with shareholders and corporations in that shareholders do not generally owe fiduciary duties to other shareholders. Based on the roles in which fiduciary duties are owed in the corporate context and longstanding case law regarding the fiduciary duties of a managing partner in the partnership context, the court concluded that control is the key to determining whether a partner is a fiduciary. The court then looked at the two-tiered structure of the limited partnership to determine how it affected the fiduciary duties owed by the debtor, who was president, a director, and 51% shareholder of the corporate general partner. The court relied on *In re Bennett* and *McBeth v. Carpenter* to conclude that the debtor, as manager of the managing general partner, owed fiduciary duties to the partnership and the partners. The court concluded that the debtor owed the plaintiff fiduciary duties through at least two avenues: (1) in his capacity as officer and director of the corporate general partner (since the plaintiff was a shareholder); and (2) in his capacity as the control person/manager of the general partner (since the plaintiff was a limited partner).

Texas courts have recognized a tort cause of action for knowing participation in another person's breach of fiduciary duty, and this cause of action has been asserted against affiliates and third parties for knowingly participating in the breach of fiduciary duty owed by a general partner or other affiliate of a partnership.[228]

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.

[227] *Mullen v. Jones*, 445 B.R. at 708-711.

[228] *See, e.g.,* CBIF Ltd. P'ship v. TGI Friday's Inc., 2017 WL 1455407 (Tex. App.—Dallas 2017, pet. denied) (holding individual manager of entity general partner of limited partnership venturer in joint venture liable for participating in breaches of fiduciary duty owed by venturer; holding individual liable for participating in breaches of fiduciary duty owed by related entities who exercised control over limited partnership); Graham v. Mortg. Corp. v. Hall, 307 S.W.3d 472 (Tex. App.—Dallas 2010, no pet.) (concluding limited partner established a probable right of recovery against the partnership's lender for participating in breaches of duty owed by the general partner to the limited partners based on the general partner's use of partnership property to secure payment of loans to affiliates of the general partner).

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.[229] 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.[230]

2. 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 three appellate courts in Texas have so held.[231] The unpublished opinions by Texas Courts of Appeals lack precedential weight because the decisions were issued prior to 2003, but the more recent decision of the First District Court of Appeals in *Strebel v. Wimberly* at last provided precedent in Texas for the proposition that limited partners do not, solely based on their status as limited partners, owe other limited partners fiduciary duties under Texas law, refuting and distinguishing the *Zinda* and *McBeth* cases (discussed below) to the extent that they suggest otherwise.[232]

In *Zinda v. McCann Street, Ltd.*,[233] 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.

229 TEX. BUS. ORGS. CODE § 3.102.
230 *See id.* at § 2.101(21).
231 *See* Villa W. Assocs. v. Kay, 146 F.3d 798 (10th Cir. 1998); Herzog v. Leighton Holdings, Ltd. (*In re* Kids Creek Partners), 212 B.R. 898 (N.D. Ill. 1997); Strebel v. Wimberly, 371 S.W.3d 267 (Tex. App.—Houston [1st Dist.] 2012, pet. denied); AON Props. v. Riveraine Corp., 1999 WL 12739 (Tex. App.—Houston [14th Dist.] 1999, no pet.) (not designated for publication); Crawford v. Ancira, 1997 WL 214835 (Tex. App.—San Antonio 1997, no pet.) (not designated for publication).
232 *Strebel*, 371 S.W.3d at 279.
233 Zinda v. McCann Street, Ltd., 178 S.W.3d 883, 890-91 (Tex. App.—Texarkana 2005, pet. denied).

In *McBeth v. Carpenter*,[234] 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,[235] 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*,[236] 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 at 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 below) would have made any difference in the court's analysis if it had been applicable.

In *Strebel v. Wimberly*, the court addressed the argument of a limited partner that his fellow limited partner owed him fiduciary duties of loyalty and care under the Texas Revised Partnership Act because the Texas Revised Limited Partnership Act contains no provisions on duties of limited

[234] McBeth v. Carpenter, 565 F.3d 171, 177-78 (5th Cir. 2009).

[235] 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).

[236] Ins. Co. of N. Am. v. Morris, 981 S.W.2d 678, 674 (Tex. 1998).

partners. The court discussed the *Zinda* and *McBeth* cases as well as the unpublished *Crawford* and *AON Properties* cases in Texas and reconciled the cases as follows:

> [We hold] that status as a limited partner alone does not give rise to a fiduciary duty to other limited partners. That is not to say, however, that a party who is a limited partner does not owe fiduciary duties to other limited partners when that party, wearing a different hat, exerts operating control over the affairs of the limited partnership. For example, when a limited partner also serves as an officer of the limited partnership, as in *McBeth*, that partner may owe fiduciary duties based on his agency relationship to the partnership and the other limited partners, without regard to the limited partner role. The existence and scope of that duty will be defined not by the law governing limited partners, but rather by the relevant laws and contracts governing the role under which the party is exercising authority.[237]

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.[238] In *CBIF Limited Partnership v. TGI Friday's Inc.*,[239] the court stated that a limited partner owes a fiduciary duty to the partnership and the other partners if the limited partner exercises control over the operation of the business, and the jury's unchallenged findings of dominance and control by a limited partner provided the basis for recognizing a

[237] *Strebel*, 371 S.W.3d at 281.

[238] *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.

[239] CBIF Ltd. P'ship v. TGI Friday's Inc., 2017 WL 1455407 (Tex. App.—Dallas 2017, pet. denied).

fiduciary duty on the part of the limited partner. The court went on to affirm the liability of an individual's knowing participation in the limited partner's fiduciary duty based on the individual's knowledge of the fiduciary relationships and actual awareness of the breach. As noted above, there is also case law in Texas recognizing a fiduciary duty on the part of those who control the general partner.[240]

C. Statutory Authorization to Modify Duties and Liabilities of Partners

1. Modification of Duties and Liabilities 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.[241]

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."[242] 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 should.[243]

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."[244] 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. For example, in *Cruz v.*

[240] *See* FNFS, Ltd. v. Harwood (*In re* Harwood), 637 F.3d 615 (5th Cir. 2011); LPS Inv. P'ship v. Bennett (*In re* Bennett)*,* 989 F.2d 779 (5th Cir. 1993); Mullen v. Jones (*In re* Jones), 445 B.R. 677 (Bankr. N.D. Tex. 2011); *cf.* Strebel v. Wimberly, 371 S.W.3d 267 (Tex. App.—Houston [1st Dist.] 2012, pet. denied) (recognizing that limited partner may owe fiduciary duties to other limited partners by virtue of exerting control over limited partnership in other capacities).

[241] Tex. Bus. Orgs. Code § 152.002(b)(2), (3), (4); *see also* TEX. REV. CIV. STAT. art. 6132b-1.03(b)(2), (3), (4) (expired Jan. 1, 2010).

[242] TEX. BUS. ORGS. CODE § 152.002(b)(3); *see also* TEX. REV. CIV. STAT. art. 6132b-1.03(a)(3) (expired Jan. 1, 2010).

[243] *See* Jerry L. Starkey, TBDL, L.P. v. Graves, 448 S.W.3d 88 (Tex. App.—Houston [14th Dist.] 2014, no pet.) (acknowledging statutory prohibition on elimination of partner's duties of loyalty and care but stating that partnership agreement at issue did "not disclaim all such duties and liability" where it required plaintiff to prove fraud, gross negligence, or willful misconduct to establish failure to comply with duties).

[244] TEX. BUS. ORGS. CODE § 152.002(b)(2); *see also* TEX. REV. CIV. STAT. art. 6132b-1.03(a)(2) (expired Jan. 1, 2010).

Ghani,[245] the plaintiff claimed that the individual who controlled the general partner of a limited partnership breached his fiduciary duty to the limited partnership by pursuing a competing business opportunity. The court held that the plaintiff's claim was foreclosed by a provision in the limited partnership agreement that expressly permitted the general partner and the general partner's partners, directors, officers, employees, agents, and representatives to engage in competing businesses. The court relied on the strong policy favoring freedom of contract in Texas as well as the provisions of the BOC that permit the partnership agreement to "identify specific types of activities or categories of activities that do not violate the duty of loyalty if the types or categories are not manifestly unreasonable."[246] The court stated that the provision of the limited partnership agreement that permitted the general partner and any of its directors, officers, employees, agents, and representatives to "engage in business activities in addition to those relating to the Partnership, including business interests and activities in direct competition with the Partnership" was a provision that "identified a specific type of activity or category of activities that do not violate the duty of loyalty."[247] The court noted that the plaintiff did not argue that the type of activity or category of activities specified in the provision was manifestly unreasonable.[248]

Under the BOC, a domestic entity may "renounce, in its 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."[249] 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."[250] 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.

It should be noted that the BOC contains no express limitations on the extent to which the partnership agreement may eliminate a partner's liability to the partnership and the other partners.[251] In fact, in 2013, the legislature highlighted the expansive contractual freedom provided

[245] Cruz v. Ghani, 2018 WL 6566642 (Tex. App.—Dallas 2018, pet. denied).

[246] *Id.* at *13-14, citing TEX. BUS. ORGS. CODE § 152.002(b)(2).

[247] *Id.* at *14.

[248] *Id.*

[249] TEX. BUS. ORGS. CODE § 2.101(21).

[250] TEX. BUS. ORGS. CODE § 152.002(b)(4); *see also* TEX. REV. CIV. STAT. art. 6132b-1.03(a)(4) (expired Jan. 1, 2010).

[251] 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,

partners in this regard by amending Chapter 7 of the BOC to clarify that the partnership agreement may eliminate the liability of a partner to the partnership and the other partners to the same extent that a corporation's certificate of formation may eliminate a director's liability under section 7.001 and to such *further* extent allowed by Chapter 152 of the BOC.[252] Although Chapter 152 states that the duties of care and loyalty may not be completely eliminated, Chapter 152 does not address elimination of liability of partners *vis a vis* one another and the partnership. A distinction can be drawn between the elimination of *duties* and the elimination or indemnification of *liabilities*. If the *liability* of a general partner is contractually eliminated or indemnified, but the *duty* still exists, a breach of the duty could give rise to equitable relief (such as injunctive relief or receivership) even though the general partner could not be held liable or would be held harmless by the partnership. Further, the manner in which a contractual provision expresses the exculpation may give rise to an issue regarding the scope of the liabilities that have been contractually eliminated. Contractual provisions that merely eliminate liability for "damages" may still expose the partner to equitable remedies that involve monetary recovery even though these remedies are not technically "damages."[253] Redefining or eliminating duties, on the other hand, narrows or eliminates not only potential liability for damages by the partner who would otherwise owe the duty, but determines whether there is a breach at all, thus affecting the availability of equitable relief as well. While there are strong arguments for enforcing broad indemnification and exculpation provisions in view of the statutory scheme, a court might balk at enforcing contractual elimination of all remedies, including equitable remedies.

The statutory parameters around the contractual freedom to vary the partners' duties of loyalty and care have received relatively little attention by Texas courts, and Texas courts have not been consistent in describing the extent to which partners may contractually disclaim their duties. In *Jerry L. Starkey, TBDL, L.P. v. Graves*,[254] which involved alleged breaches of duties by the general partner and its affiliates in the limited partnership context, the court acknowledged the statutory prohibition on elimination of a partner's duties of loyalty and care but stated that the partnership agreement at issue "limits but does not disclaim all such duties and liability."[255] The court stated that the jury instructions, which required the plaintiff to prove fraud, gross negligence, or willful misconduct to establish a defendant's failure to comply with its duties, included the contractual language containing the limitation on the statutory duties.[256]

In *Strebel v. Wimberly*,[257] the court of appeals gave effect to a waiver of fiduciary duties in a limited partnership agreement (governed by the Texas Revised Limited Partnership Act) that provided: "The General Partner shall not have duties (including fiduciary duties) except as expressly set forth in this agreement."[258] Because the partnership agreement specified no fiduciary duties, the court concluded that the general partner had no fiduciary duties, relying on case law

(3) intentional adverse acts, and (4) reckless indifference with respect to the interest of the beneficiary. *Id*. at 343.

[252] TEX. BUS. ORGS. CODE § 7.001(d)(1).

[253] *See In re* Longview Energy Co., 464 S.W.3d 353, 361 (Tex. 2015) (characterizing disgorgement as equitable forfeiture of benefits wrongfully obtained and stating that disgorgement is compensatory but is not damages).

[254] Jerry L. Starkey, TBDL, L.P. v. Graves, 448 S.W.3d 88 (Tex. App.—Houston [14th Dist.] 2014, no pet.).

[255] *Id.* at 106.

[256] *Id.*

[257] Strebel v. Wimberly, 371 S.W.3d 267 (Tex. App.—Houston [1st Dist.] 2012, pet. denied).

[258] *Id*. at 283.

recognizing the broad freedom to contract possessed by sophisticated parties.[259] The court did not discuss the provisions of the Texas Revised Partnership Act that are now found in Section 152.002(b)(2), (3), and (4) of the BOC or the argument that these provisions applied to the limited partnership pursuant to the linkage of the general partnership and limited partnership statutes (as implicitly recognized in *Jerry L. Starkey, TBDL, L.P. v. Graves*,[260] and expressly recognized in *Cruz v. Ghani*[261]).

In *Cohen v. Flat Stone Development Co., Inc.*,[262] the court gave effect to a provision that disclaimed fiduciary duties but preserved the statutory duties of loyalty and care. The case involved a dispute among the general and limited partners of three limited partnerships, and each of the limited partnership agreements contained the following provision: "[T]he General Partner will not owe a fiduciary duty to the Partnership or any Partner. The General Partner will owe a duty of loyalty and a duty of care to the Partnership."[263] The court stated that "[t]he contract by its plain language distinguishes a fiduciary duty from duties of loyalty and care," and "[f]ailing to give effect to this distinction would fail to 'harmonize and give effect' to both sentences."[264] The court noted by way of footnote that each limited partnership agreement "[a]dditionally, . . . tracks the general meaning of the Texas statute governing the duties of general partners,"[265] citing Section 152.204 of the BOC. The court held that the parties intended to disclaim any fiduciary duties, and the court granted summary judgment as to the breach-of-fiduciary-duty claims against the general partner and dismissed those claims.[266]

In *Hardwick v. Smith Energy Co.*,[267] the parties to an oil and gas transaction entered into a series of agreements relating to a number of prospect areas, and each of the operating agreements disclaimed the creation of a partnership and fiduciary duties. The plaintiff argued that their activities under their agreements established a joint venture between the parties and that the defendant thus owed the plaintiff fiduciary duties regardless of the disclaimers. The court stated that, regardless of whether the disclaimers of joint venture were effective and without deciding whether the business arrangement constituted a joint venture, it was clear that the parties expressly disclaimed fiduciary duties. Citing Section 152.002(b)(2) of the BOC and *Strebel v. Wimberly*, the court of appeals stated that "[c]ourts must honor the contractual terms that parties use to define the scope of their obligations and agreements, including limiting fiduciary duties that might otherwise exist."[268] Further relying on *Strebel*, the court stated that "[t]his is especially true when the contractual limitation arises from an arms-length business transaction between sophisticated businessmen," and the court commented that "[t]his principle adheres to Texas's public policy of

[259] *Id.* at 284.
[260] *Starkey*, 448 S.W.3d at 106 n.23.
[261] Cruz v. Ghani, 2018 WL 6566642, at *13-14 (Tex. App.—Dallas 2018, pet. denied).
[262] Cohen v. Flat Stone Dev. Co., Inc., 2018 WL 6411410 (S.D. Tex. 2018).
[263] *Id.* at *1.
[264] *Id.* at *2.
[265] *Id.* at n.4.
[266] *Id.* at *3.
[267] Hardwick v. Smith Energy Co., 500 S.W.3d 474 (Tex. App.—Amarillo 2016, pet. granted, judgm't vacated w.r.m.).
[268] *Id.* at 485.

freedom of contract."[269]

In *Stephens v. Three Finger Black Shale Partnership*,[270] the court concluded that a disclaimer of fiduciary duties in a letter agreement (in which the parties agreed that they were not entering into a partnership relationship and did not owe one another a fiduciary duty or obligation) was effective to insulate the parties from liability for any breach of disclaimed fiduciary duties even assuming *arguendo* that the letter agreement created a partnership. Noting that the parties were "sophisticated businessmen" and relying on *Strebel v. Wimberly*, the court stated that it must honor the terms of the parties' contract. The court held "that any fiduciary duty that might have existed as a result of an alleged partnership growing out of the [letter agreement] was expressly disclaimed in that agreement and that no recovery may be had . . . in relation to those alleged fiduciary duties."

Responding to a managing general partner's argument that the jury charge did not adequately address alterations of the statutory duty of care in the partnership agreement, the court of appeals in *Shannon Medical Center v. Triad Holdings III, L.L.C.*,[271] made the broad pronouncement that, "[a]s a matter of law, . . ., the duty of care cannot be disclaimed," relying on Section 152.002(b)(3) of the BOC. The court quoted the statutory duty of care and obligation of good faith, stating that "[a] partner must conduct the partnership's business 'with the care an ordinarily prudent person would exercise in similar circumstances,'" and "must discharge the partner's duties 'in good faith' and 'in a manner the partner reasonably believes to be in the best interest of the partnership.'" Acknowledging that the partnership agreement authorized contracts between the partnership and a partner or a partner's affiliate, the court pointed out that the partnership agreement "did not purport to" change the statutory requirement that "a partner entering into such a contract still must comply with the duty of care by acting in good faith and in a manner the partner reasonably believes to be in the partnership's best interest." In addition, however, to pointing out that the partnership agreement "did not purport to" change this standard, the court stated that the partnership agreement "could not change this" statutory standard of partner conduct.

2. Modification of Duties and Liabilities 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.[272]

[269] *Id.*

[270] Stephens v. Three Finger Black Shale P'ship, 580 S.W.3d 687 (Tex. App.—Eastland 2019, pet. filed).

[271] Shannon Med. Center v. Triad Holdings III, L.L.C., __ S.W.3d __, 2019 WL 6606406 (Tex. App.—Houston [14th Dist.] 2019, no pet. h.).

[272] TEX. BUS. ORGS. CODE § 153.152(a)(2) (emphasis added); *see also* TEX. REV. CIV. STAT. art. 6132a-1, §

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 152.002 that prohibit elimination of duties and set a "manifestly unreasonable" floor for contractual variation.

Chapter 7 of the BOC was amended in 2013 to clarify that the partnership agreement may eliminate the liability of a general partner to the partnership and the other partners to the same extent that a corporation's certificate of formation may eliminate a director's liability under section 7.001 and to such further extent allowed by Chapters 152 and 153 of the BOC.[273] There are no express prohibitions or limitations in Chapter 152 or 153 with respect to the limitation or elimination of liability (as opposed to duties) of a general partner to the partnership or the partners. As noted above, a distinction can be drawn between the limitation or elimination of duties and the limitation and elimination of liabilities. If the liability of a general partner is contractually eliminated, but the duty still exists, a breach of the duty could give rise to equitable relief (such as injunctive relief or receivership) even though the general partner could not be held liable for damages. Further, the manner in which a contractual provision expresses the exculpation may give rise to an issue regarding the scope of the liabilities that have been contractually eliminated. Contractual provisions that merely eliminate liability for "damages" may still expose the partner to equitable remedies that involve monetary recovery even though these remedies are not technically "damages."[274] Redefining or eliminating duties, on the other hand, narrows or eliminates not only potential liability for damages by the partner who would otherwise owe the duty, but determines whether there is a breach at all, thus affecting the availability of equitable relief as well. While there are strong arguments for enforcing broad indemnification and exculpation provisions in view of the statutory scheme, a court might balk at enforcing contractual elimination of all remedies, including equitable remedies.

In *Shannon Medical Center v. Triad Holdings III, L.L.C.*,[275] the court of appeals responded to the managing general partner's argument that the jury charge did not adequately address alterations of the statutory duty of care in the partnership agreement. The court broadly pronounced that, "[a]s a matter of law, . . ., the duty of care cannot be disclaimed," relying on Section 152.002(b)(3) of the BOC. The court quoted the statutory duty of care and obligation of good faith, stating that "[a] partner must conduct the partnership's business 'with the care an ordinarily prudent person would exercise in similar circumstances,'" and "must discharge the partner's duties 'in good faith' and 'in a manner the partner reasonably believes to be in the best interest of the partnership.'" Acknowledging that the partnership agreement authorized contracts between the limited partnership and a partner or a partner's affiliate, the court pointed out that the partnership agreement "did not purport to" change the statutory requirement that "a partner entering into such a contract still must comply with the duty of care by acting in good faith and in a manner the

4.03(a) (expired Jan. 1, 2010).

[273] TEX. BUS. ORGS. CODE § 7.001(d)(2).

[274] *See In re* Longview Energy Co., 464 S.W.3d 353, 361 (Tex. 2015) (characterizing disgorgement as equitable forfeiture of benefits wrongfully obtained and stating that disgorgement is compensatory but is not damages).

[275] Shannon Med. Center v. Triad Holdings III, L.L.C., __ S.W.3d __, 2019 WL 6606406 (Tex. App.—Houston [14th Dist.] 2019, no pet. h.).

partner reasonably believes to be in the partnership's best interest." In addition, however, to pointing out that the partnership agreement "did not purport to" change this standard, the court stated that the partnership agreement "could not change this" statutory standard of partner conduct.

In *Jerry L. Starkey, TBDL, L.P. v. Graves,*[276] the court of appeals stated that Section 152.002(b) of the BOC does not permit the partnership agreement to disclaim the statutory duties of care and loyalty entirely, but the court stated that the limited partnership agreement did not disclaim all statutory duties and liability. Under the limited partnership agreement, the general partner was not liable in damages or otherwise for an act or omission unless such act or omission was performed or omitted fraudulently or constituted gross negligence or willful misconduct.

In *Cruz v. Ghani*,[277] the plaintiff claimed that the individual who controlled the general partner of a limited partnership breached his fiduciary duty to the limited partnership by pursuing a competing business opportunity. The court held that the plaintiff's claim was foreclosed by a provision in the limited partnership agreement that expressly permitted the general partner and its partners, directors, officers, employees, agents, and representatives to engage in competing businesses. The court pointed out that Chapter 153 does not directly address the extent to which duties and liabilities of general partners may be altered by agreement, but the court noted that Section 153.152 indicates that the partnership agreement may modify the liabilities of a general partner, and Section 153.003 provides that the provisions of Chapter 152 govern limited partnerships in a case not provided for by Chapter 153 and the other partnership provisions.[278] The court then discussed Texas's strong policy favoring freedom to contract and the provisions of Chapter 152 of the BOC that permit the partnership agreement to modify a partner's duties, including the duty of loyalty.[279] The court concluded that the provision of the limited partnership agreement that permitted the general partner and any of its directors, officers, employees, agents, and representatives to "engage in business activities in addition to those relating to the Partnership, including business interests and activities in direct competition with the Partnership"[280] was a provision that "identified a specific type of activity or category of activities that do not violate the duty of loyalty" as permitted by Chapter 152.[281] The court noted that the plaintiff did not argue that the type of activity or category of activities specified in the provision was manifestly unreasonable. (The court went on, however, to hold that there was some evidence to support the jury's findings that the defendant failed to comply with his fiduciary duties to the corporate general partner (of which he was an officer and director) by forming a new entity to serve as general partner of the new limited partnership that pursued the competing opportunity.)[282]

In *Cohen v. Flat Stone Develpment Co., Inc.*,[283] a case involving a dispute among the general and limited partners of three limited partnerships, each of the limited partnership agreements contained the following provision: "[T]he General Partner will not owe a fiduciary

[276] Jerry L. Starkey, TBDL, L.P. v. Graves, 448 S.W.3d 88 (Tex. App.—Houston [14th Dist.] 2014, no pet.).
[277] Cruz v. Ghani, 2018 WL 6566642 (Tex. App.—Dallas 2018, pet. denied).
[278] *Id.* at *13.
[279] *Id.* at *13-14.
[280] *Id.* at *13.
[281] *Id.* at *14, citing TEX. BUS. ORGS. CODE § 152.002(b)(2).
[282] *Id.* at *14.
[283] Cohen v. Flat Stone Dev. Co., Inc., 2018 WL 6411410 (S.D. Tex. 2018).

duty to the Partnership or any Partner. The General Partner will owe a duty of loyalty and a duty of care to the Partnership."[284] The court stated that "[t]he contract by its plain language distinguishes a fiduciary duty from duties of loyalty and care," and "[f]ailing to give effect to this distinction would fail to 'harmonize and give effect' to both sentences."[285] The court noted by way of footnote that each limited partnership agreement "[a]dditionally, . . . tracks the general meaning of the Texas statute governing the duties of general partners,"[286] citing Section 152.204 of the BOC. The court held that the parties intended to disclaim any fiduciary duties, and the court granted summary judgment as to the breach-of-fiduciary-duty claims against the general partner and dismissed those claims.

In *Strebel v. Wimberly*,[287] the court of appeals gave effect to a waiver of fiduciary duties in a limited partnership agreement (governed by the Texas Revised Limited Partnership Act) that provided: "The General Partner shall not have duties (including fiduciary duties) except as expressly set forth in this agreement."[288] The agreement did not specify any fiduciary duties. The general partner of the limited partnership was an LLC, and Wimberly argued that Strebel, the managing member of the LLC, took actions that breached a fiduciary duty to Wimberly as a limited partner. The court concluded that the actions of which Wimberly complained were all taken by Strebel in his capacity as managing member of the general partner and could not form the basis of a breach-of-fiduciary-duty claim because the fiduciary duties of the general partner had been expressly disclaimed in the limited partnership agreement. The court stated that general partners in a limited partnership owe fiduciary duties to the limited partners but noted that "the supreme court has emphasized the importance of honoring parties' contractual terms defining the scope of their obligations and agreements, including limiting fiduciary duties that might otherwise exist."[289] The court stated that "[t]his is especially true in arms-length business transactions in which the parties are sophisticated businessmen represented by counsel, as the parties were here."[290]

3. Indemnification Under General Partnership Statutes

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.[291] The BOC also 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."[292] The indemnification provisions of Chapter 8 of the BOC do not apply to a general partnership other than to specify that the

[284] *Id*. at *1.
[285] *Id*. at *2.
[286] *Id*. at *2, n.4.
[287] Strebel v. Wimberly, 371 S.W.3d 267 (Tex. App. — Houston [1st Dist.] 2012, pet. denied).
[288] *Id.* at 283.
[289] *Id.* at 284.
[290] *Id.*
[291] TEX. BUS. ORGS. CODE § 152.203(d); *see also* TEX. REV. CIV. STAT. art. 6132b-4.01(c) (expired Jan. 1, 2010).
[292] TEX. BUS. ORGS. CODE § 2.101(16); *see also* TEX. REV. CIV. STAT. art. 6132b-3.01(15) (expired 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").

partnership agreement of a general partnership may adopt provisions of Chapter 8 or include "other provisions" for indemnification, "which will be enforceable."[293] There are no specified limits on a general partnership's power to indemnify, 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).[294]

4. Indemnification Under Limited Partnership Statutes

In the BOC, one set of indemnification provisions governs both corporations and limited partnerships.[295] The TRLPA contained indemnification provisions patterned largely after the TBCA provisions.[296] 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.[297] The limited partnership is prohibited from indemnifying the general partner if the general partner was found liable to the limited partnership or for improperly receiving a personal benefit if the liability was based on the general partner's 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.[298] 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.[299] The BOC provides for such permissive indemnification without the necessity of any provisions in the partnership agreement.[300] 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.[301] If a general partner is found liable to the limited partnership or on the basis of improperly receiving a personal benefit, permissible indemnification is limited to reasonable expenses.[302] A general partner may only be indemnified to the extent consistent with the statutes.[303]

Limited partners, officers, employees, and agents who are not also general partners may be

[293] TEX. BUS. ORGS. CODE § 8.002.

[294] TEX. BUS. ORGS. CODE § 152.002(a); *see also* TEX. REV. CIV. STAT. art. 6132b-1.03(a) (expired Jan. 1, 2010).

[295] *See* TEX. BUS. ORGS. CODE §§ 8.001-8.152.

[296] *See* TEX. REV. CIV. STAT. art. 6132a-1, §§ 11.01-11.21 (expired Jan. 1, 2010).

[297] TEX. BUS. ORGS. CODE §§ 8.051, 8.003; *see also* TEX. REV. CIV. STAT. art. 6132a-1, §§ 11.08, 11.21 (expired Jan. 1, 2010).

[298] TEX. BUS. ORGS. 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).

[299] TEX. REV. CIV. STAT. art. 6132a-1, §§ 11.02, 11.05 (expired Jan. 1, 2010).

[300] TEX. BUS. ORGS. CODE §§ 8.102, 8.103.

[301] TEX. BUS. ORGS. CODE § 8.101; *see also* TEX. REV. CIV. STAT. art. 6132a-1, § 11.02 (expired Jan. 1, 2010).

[302] TEX. BUS. ORGS. CODE § 8.102(b); *see also* TEX. REV. CIV. STAT. art. 6132a-1, § 11.05 (expired Jan. 1, 2010).

[303] TEX. BUS. ORGS. CODE § 8.004; *see also* TEX. REV. CIV. STAT. art. 6132a-1, § 11.13 (expired Jan. 1, 2010).

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.[304] Insurance, self-insurance, or other arrangements providing indemnification for liabilities for which Chapter 8 does not otherwise permit indemnification are expressly permitted.[305]

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.[306] 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."[307] 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. Chapter 8 of the BOC contains provisions authorizing advancement of expenses in the corporate and limited partnership contexts pursuant to specific procedures. Chapter 8 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.[308] The written undertaking need not be secured and may be accepted by the entity without regard to the person's ability to make repayment.[309] 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.[310]

[304] TEX. BUS. ORGS. CODE § 8.105; *see also* TEX. REV. CIV. STAT. art. 6132a-1, §§ 11.15, 11.17 (expired Jan. 1, 2010).

[305] TEX. BUS. ORGS. CODE § 8.151; TEX. REV. CIV. STAT. art. 6132a-1, § 11.18 (expired Jan. 1, 2010).

[306] TEX. BUS. ORGS. CODE § 402.007.

[307] *Id*.

[308] TEX. BUS. ORGS. CODE § 8.104(a); *see also* TEX. BUS. CORP. ACT art. 2.02-1K (expired Jan. 1, 2010); TEX. REV. CIV. STAT. art. 6132a-1, § 11.11 (expired Jan. 1, 2010).

[309] TEX. BUS. ORGS. CODE § 8.104(c); *see also* TEX. BUS. CORP. ACT art. 2.02-1L (expired Jan. 1, 2010); TEX. REV. CIV. STAT. art. 6132a-1, § 11.12 (expired Jan. 1, 2010).

[310] TEX. BUS. ORGS. CODE § 8.104(b); *see also In re* Aguilar, 344 S.W.3d 41 (Tex. App. — El Paso 2011, no pet.) (applying TEXAS BUSINESS CORPORATION ACT advancement provisions and enforcing bylaw provision that stated corporation "shall" advance expenses); TEX. BUS. CORP. ACT art. 2.02-1K (expired Jan. 1, 2010); TEX. REV. CIV. STAT. art. 6132a-1, § 11.11 (expired 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.[311]

Chapter 8 does not apply to an LLC or general partnership unless the governing documents of such an entity adopt the provisions of Chapter 8.[312] In the LLC context, the BOC authorizes advancement of expenses without specifying procedures.[313] In *L Series, L.L.C. v. Holt*,[314] the court discussed the expansive nature of the statutory provisions in the LLC context and held that the contractual provisions at issue in that case required advancement of the defendants' expenses even though the defendant would not be entitled to indemnity if the alleged misconduct was ultimately established. The BOC does not specifically address advancement by a general partnership other than to authorize the partnership agreement to contain provisions on advancement.[315] There is no provision of the BOC that specifically limits the extent to which advancement could be provided by the partnership agreement.[316]

VI. CONCLUSION

Fiduciary-duty issues in the context of business organizations 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 certainly prove significant in particular cases.

[311] TEX. BUS. ORGS. CODE § 8.105; *see also* TEX. BUS. CORP. ACT art. 2.02-1P, Q (expired Jan. 1, 2010); TEX. REV. CIV. STAT. art. 6132a-1, §§ 11.15, 11.17 (expired Jan. 1, 2010).

[312] TEX. BUS. ORGS. CODE § 8.002.

[313] *See* TEX. BUS. ORGS. 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 Jan. 1, 2010) (referring to LLC's power to indemnify and provide insurance, but not explicitly mentioning advancement).

[314] L Series, L.L.C. v. Holt, 571 S.W.3d 864 (Tex. App.—Fort Worth 2019, pet. denied); *see also* Equine Holdings, LLC v. Jacoby, 2020 WL2079183 (Tex. App.—Dallas 2020, no pet. h.). In *Equine Holdings*, the court held that an LLC member's claim for indemnification of attorney's fees incurred in a pending action was ripe, even though the action was not concluded, because the indemnification provision in the LLC's articles of organization encompassed attorney's fees and did not condition indemnification on the outcome of an action but merely on the determination of the members that the indemnitee acted in good faith and in a manner reasonably believed to be in the best interest of the LLC. Because the members had previously made the requisite determination and the LLC had previously paid attorney's fees incurred by the member in the action, the court rejected the LLC's argument that the member's indemnification claim (which was based on the LLC's refusal to continue paying the member's attorney's fees) was premature.

[315] *See* TEX. BUS. ORGS. CODE § 8.002(b).

[316] *See* TEX. BUS. ORGS. CODE §§ 2.101, 8.002(b), 152.002.

Bumping Into Your Own Prior Art

BY: PETER L. BREWER

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Bumping Into Your Own Prior Art

BY: PETER L. BREWER*

I. Introduction

There are few things more annoying to an inventor (or his or her patent attorney) than to have the inventor's own prior art cited against them. Yet, it happens. Sometimes it happens during the prosecution of the patent application. Sometimes it occurs years later in litigation.

Here is a list of scenarios where the inventor may bump into their own prior art:

- an improvement application is filed after an earlier-filed patent issues;
- the inventor files a CIP patent application after the parent application has published;
- a divisional patent application issues before the parent application issues;
- a patent application is filed more than one year after a commercial sale, or an offer for sale;
- a patent application is filed more than one year after a so-called secret sale;
- a patent application is filed more than one year after a disclosing publication; and
- an improvement application is filed following a long period of secret use.

In this paper we will address these scenarios.

By way of background, and for those less familiar with the Patent Act, the term "prior art" generally refers to a U.S. or foreign patent, a published application, a printed publication (such as a published journal article), a public use of the invention, a public presentation, a product brochure, an offer for sale of the invention, an actual sale of a product claimed in a patent application, or anything that "otherwise makes available to the public" the invention disclosed by the inventor in their patent filing.[1]

The universe of materials allowed to be used as prior art is set by the priority date of the patent application: anything before that date may be used by the Patent Office to disqualify the inventor's patent from issuing. Anything occurring after the priority date is off-limits. The priority date can be either the filing date of the application itself or the filing date of an earlier application to which current the application claims priority. Hence, it is common practice to file applications, whether continuations,

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[1] 35 U.S.C. § 102(a) (2018).

divisionals, continuations-in-part, or international applications, and try to obtain the benefit of an earlier filing date by referring to an earlier application.

The earlier application is typically called the "parent" while the subsequent applications seeking to obtain the benefit of the earlier filing date are typically referred to as "children." 35 U.S.C. § 120 provides some rules governing the filing of a "child" application:

> An application for patent for an invention disclosed in the manner provided by section 112(a) (other than the requirement to disclose the best mode) in an application previously filed in the United States, or as provided by section 363 or 385 which names an inventor or joint inventor in the previously filed application shall have the same effect, as to such invention, as though filed on the date of the prior application, if filed before the patenting or abandonment of or termination of proceedings on the first application or on an application similarly entitled to the benefit of the filing date of the first application and if it contains or is amended to contain a specific reference to the earlier filed application.

This rather confusing paragraph can be distilled into roughly three requirements to claim priority:

(1) the subsequent application must disclose the same invention as the one previously disclosed in an earlier application meeting the written description requirements of 35 U.S.C. § 112(a),

(2) the subsequent application must contain a specific reference to the earlier-filed application, and

(3) the two applications must be co-pending, that is, they must both be open at the same time.

This becomes somewhat more complex when there is a string of child applications descending from a common parent application. In this instance, as long as one "older" child application is still pending at the time of the filing of the subsequent application, the subsequent child application may still claim priority to the original parent, even if it is no longer pending. However, as we shall see below, any new matter claimed in a continuation-in-part application filed long after a distant parent has issued, or even published, can create a scenario where the applicant "bumps into his own prior art."

II. The America Invents Act and The One-Year Grace Period

The Leahy-Smith America Invents Act (AIA) precludes a person from obtaining a patent on an invention that was disclosed before the effective filing date of the patent application. As found in 35 U.S.C. § 102(a)(1), the Act provides:

> A person shall be entitled to a patent unless . . . the claimed invention was patented, described in a printed publication, or in public use, on sale, or otherwise available to the public before the effective filing date of the claimed invention.

The AIA was signed into law on September 16th, 2011 and exactly 18 months later, it switched the United States from a first-to-invent system to a first-inventor-to-file system. The key difference between these two systems is that while the first-to-invent system gave priority to whichever inventor

conceived and diligently reduced his invention to practice, the first-inventor-to-file system gives priority to the first inventor to file a patent application regardless of who "conceived" first or who "reduced to practice" first. The first-inventor-to-file system focuses on the filing date of the patent application to determine which applicant receives the patent.

Under the old first-to-invent-system, conception and reduction to practice were the threshold inquiries when determining who gets a patent. "Conception has been defined as 'the complete performance of the mental part of the inventive act' and it is 'the formation in the mind of the inventor of a definite and permanent idea of the complete and operative invention as it is thereafter to be applied in practice….'[2] Reduction to practice can be satisfied by either making a working prototype or by filing a patent application (called "constructive reduction to practice"). Reduction to practice must be done with reasonable diligence with regards to the date of conception and other subsequent inventors.[3]

As long as the inventor satisfies the three requirements of conception, reduction to practice, and reasonable diligence, his (or her) date of conception will be credited as the date of invention. It will not matter who files a patent application first, the first inventor to conceive will get the patent. On top of this, under the old first-to-invent-system, the inventor had a one-year grace period from the date of any public disclosures they made within which to file the patent application. During this grace period, their own prior disclosures could not be used against them as prior art.

In a first-inventor-to-file system, it is simply a race to the patent office amongst bona fide inventors. Whoever files their application first, regardless of conception, reduction to practice or due diligence, will get the patent. That does not mean that anyone can simply take an idea they found and patent it, whether they invented the invention or not. (35 U.S.C. 101 begins with "Whoever invents…") This still has not changed and only inventors may get a patent (unlike some other countries, where ownership, not inventorship is what matters).

Most other nations around the world use some form of a first-to-file system, but usually provide for an absolute novelty requirement. In this system, any public disclosure prior to the filing date by an inventor or another becomes an absolute bar to patentability. Fortunately, the U.S. and Canada both offer a one-year grace period for inventor and inventor-derived disclosures.

Under the post-AIA first-inventor-to-file system, the U.S. retains the one-year grace period for inventor-originated disclosures, but it does not operate quite the same as before This may occasionally cause a loss of rights by inventors if the nuances of the new system aren't carefully understood. Under the new first-inventor-to-file system, any public disclosures by third-parties count as prior art and cannot be removed by showing prior conception. In other words, the inventor can no longer "swear behind the reference." The result is that if the inventor waits to file a patent application and a third party files an intervening patent application, then the third party is likely to be awarded the patent.

A more interesting issue is what happens when a third party publishes an intervening article describing the invention. Assuming that the third party acted independently of the inventor, then the

[2] MPEP § 2138.04, quoting *Townsend v. Smith*, 36 F.2d 292, 295, 4 USPQ 269, 271 (CCPA 1930).
[3] MPEP § 2138.05 and MPEP § 2138.06.

article becomes prior art that may be cited against the claims. Of course, that scenario would not involve the inventor "bumping into their own prior art."[4]

However, there is still a way to remove pre-filing third-party disclosures occurring as prior art, albeit a more limited way.[5] While an inventor may no longer swear behind a third party's patent application or other disclosures by showing an earlier date of conception (coupled with due diligence to reduction to practice), an inventor may remove prior art disclosed by a third-party if the inventor has already disclosed the same subject matter publicly[6]. As long as the inventor's disclosure (or the disclosure of a third party who obtained the material, either directly or indirectly from the inventor) does not occur more than one year before the filing of his patent application (causing him to "bump into his own prior art"), any subsequent disclosures of the same material by third-parties cannot be used as prior art against the inventor's application.[7]

One might then ask: Under the first-inventor-to-file system, what is the use of the one-year grace period if it is so hard to use against third-parties? Attorney James Yang has speculated that "the one-year grace period under the first inventor to file system is used to salvage unintended public disclosures. Under a pure first-to-file system, an inventor would be prohibited from seeking patent protection if he/she had publicly disclosed the invention. Under the U.S. version of the one-year grace period, the inventor can still file the patent application but could lose the patent if someone else had won the race to the patent office."[8]

III. The Problem of the Previously-Issued Patent

It is foundational knowledge to the patent attorney that an invention must be novel to be patentable.[9] Moreover, the invention must be non-obvious in view of the prior art.[10]

Because inventors (and their employers) tend to file multiple applications within the same general technical areas, the patent attorney should be aware of patents that have already been issued to the same

[4] 35 U.S.C. § 102(a)(2). This scenario is analogous to the old pre-AIA Section 102(e), which addressed so-called secret prior art. Under section 102(e), an application filed by a third party prior to the inventor's filing could become prior art once it is published. Any prior art within the scope of 35 U.S.C. § 102(a)(1) or (a)(2) (i.e., pre-AIA § 102(a), (b), (e), or (g)) may, in turn, be used in an obviousness analysis. See *Panduit Corp. v. Dennison Mfg. Co*., 810 F.2d 1561, 1568 (Fed. Cir. 1987); MPEP § 2141.01.
[5] See exceptions to 35 U.S.C. § 102(a) as listed in 35 U.S.C. § 102(b). See also MPEP § 2153.02.
[6] 35 U.S.C. § 102(b)(1)(B) and 35 U.S.C. § 102(b)(2)(B).
[7] *Id. See* MPEP § 2153.02 for a more detailed discussion of the inventor-originated prior public disclosure exception.
[8] James Yang, *Dangers of 1 yr grace period under first-inventor-to-file system*, OC PATENT LAWYER, (Nov. 7, 2014), https://ocpatentlawyer.com/dangers-of-1-yr-grace-period-under-first-inventor-to-file-system/. (Or, the author here might add, the race to the technical journal.)
[9] 35 U.S.C. § 102(a)(1).
[10] 35 U.SC. § 103.

filer.[11] Such patents, when issued before a new application is filed, represent prior art even if the inventor or owner is the same.[12] The same can be said of published applications. Once an application is published, it becomes prior art.

An exception to this rule arises where a new filing is made within one year of publication of the application that matures into the cited patent (or, in the rare instance that the patent issues before publication, within one year of issuance). Section 102(b)(1)(A) provides that a disclosure made one year or less before the effective filing date of a claimed invention shall not be prior art under section 102(a)(1) if "the disclosure was made by the inventor or joint inventor or by another who obtained the subject matter disclosed directly or indirectly from the inventor or a joint inventor."

But what happens where the published application does not have exactly the same inventors? In that case, section 102(b)(1)(B) provides that a disclosure made one year or less before the effective filing date of a claimed invention shall not be prior art under section 102(a)(1) if "the subject matter disclosed had, before such disclosure, been publicly disclosed by the inventor or a joint inventor or another who obtained the subject matter disclosed directly or indirectly from the inventor or a joint inventor." In other words, as long as there is at least one joint inventor, section 102(b)(2)(B) saves you.

Of course, a third scenario may arise, and that is a patent application publishes where there are no common inventors. In that case, the exceptions of section 102(b)(1) will not apply. However, 102(b)(2)(B) may save you if the inventor(s) publicly disclosed their invention before the filing of the prior-art application, as long as you are still within the one-year grace period of 102(b)(1). This public disclosure can serve to prevent subsequently filed patent applications and issued patents from being used as prior art. The lesson learned is that if you wish to file a new application on behalf of a corporation, consider claiming subject matter from the published application in the new application, and add one or more of the inventors from the published application – assuming they are still with the company. In this instance, there should be an obligation to assign both applications to the same company.[13]

It is noted that when examining the new application, the U.S. patent examiner will probably issue a rejection based on the previously-filed patent application. To overcome the rejection, the attorney may submit a statement of common ownership. The statement of common ownership will provide that "the disclosure of the subject matter on which the rejection is based and the claimed invention were owned by the same person or subject to an obligation of assignment to the same person not later than the effective

[11] As a matter of practice, when filing an application for a large corporation the author will conduct a search of prior patent applications naming the inventors, and include those applications in the Information Disclosure Statement, regardless of subject matter.
[12] *In re* Van Langenhoven, 458 F.2d 132, 136–37 (C.C.P.A. 1972) (allowing "appellant's own French patent" to be cited "to establish obviousness" of CIP claims for subject matter beyond the original disclosure, and remarking that "[i]t is of no avail to appellant that the Societe patent is his own"). *See also Santarus, Inc. v. Par Pharmaceutical, Inc.*, 694 F.3d 1344 (Fed. Cir. 2012) (an issued patent was deemed prior art even though the invalidated patent, which was filed after the parent application had issued, was listed as a CIP where the claims in the CIP were not supported by the original parent filing).
[13] This presents yet another reason why inventors should execute assignments as soon as the invention disclosure is created, or at least when the application is filed.

filing date of the claimed invention."[14] This may be placed in the remarks section of a Response to Office Action.

As a reminder, if the prior application's earliest date of publication was more than one year before the effective filing date of your new application, then there are no exceptions. Any application that was published or patented more than one year before a new application is filed will be prior art.

IV. The Problem of the Previous Publication

The America Invents Act (AIA) preserved the one year "grace period" for printed publications. Section 102(a)(1) states that a person shall be entitled to a patent unless "the claimed invention was patented, described in a printed publication, or in public use, on sale, or otherwise available to the public before the effective filing date of the claimed invention."[15] Once again, an exception is provided in section 102(b)(1)(A) where a disclosure is made "one year or less before the effective filing date of [the] claimed invention under subsection (a)(1)," and assuming the publication was made by the inventor or joint inventor or one who obtained the information either directly or indirectly from the inventor or joint inventor.[16] Prior publications need not be in English or even in this country to count as prior art.[17]

A potential problem arises during examination where a publication names more authors or contributors than are named on the subject patent application. In that case, an examiner will likely use the pre-one year reference as prior art, and it will be up to the applicant to discern whether that portion of the cited reference was truly authored by a named inventor only or whether the author of the cited portion obtained it from a named inventor.[18]

A prior publication can only serve as prior art to the current application if the subject matter was not obtained, either directly or indirectly, from the inventor or if it has been more than a year between the previous publication and the filing of the patent application in question.

V. The Problem of the Parent Patent Application

It is common practice in the United States for technology companies to file patent applications as part of a "family." As with your human family, a patent family will include a parent, followed by one or more children, followed possibly by one or more grandchildren. In some cases, the child is a divisional application or a continuation application. In those cases, no new matter is presented and the parent application is not considered prior art. Yet, some advance strategy is in order before the parent application is filed.

[14] 35 U.S.C. § 102(b)(2)(C).
[15] 35 U.S.C. § 102(a)(1).
[16] 35 U.S.C. § 102(b)(1)(A).
[17] *See* MPEP, § 2152.02.
[18] *See* MPEP, § 2153.01(a).

The most immediate problem of course is the one-year time bar. The parent application should be filed within one year of any commercial use or public disclosure. Where the applicant intends to file in Europe, the application should ideally be filed before any commercial use or public disclosure takes place. Failure to file before the time bar is the most classic case of "bumping into your own prior art."

But what happens when the inventor "keeps on inventing?" This is a frequent problem – the inventor asks the patent attorney to file a patent application, and three months later comes up with an even better solution to the problem that arguably renders the original application obsolete? If the original application was filed as a utility application then the attorney is left with the following options:

- prosecute the first application but file a continuation-in-part application, prosecuting the two applications in parallel; or
- abandon the first application and file the second application as a utility application.

In this first instance, the CIP should be filed within 30 months of the priority date for the first application (or within 12 months of the publication of the U.S. parent application); otherwise, the parent application will publish and any new matter will be examined in view of the disclosure of the parent application.[19]

But perhaps there is a third option:

- file the second application as a provisional application, preserving the priority date within 12 months of publication of the parent application, and then later file the second application as a CIP claiming priority to the parent utility application and also claiming the benefit of the provisional application.

This gives the inventor the best of both worlds – the ability to file a CIP later than 18 months after the earlier priority date while reaching back and claiming priority even to the "new matter" within 12 months of publication.

All of this raises another question, and that is the problem of filing the original application as a utility application in the first place. Inventors like to invent, and they particularly like to create new embodiments and solutions relative to the original problem to be solved. I virtually insist that every first application be filed as a provisional application. For all but the largest clients, the government filing fee

[19] Patent applications are published 18 months after filing. At publication, the clock for the one year time bar begins to tick. *See, e.g.*, Studiengesellschaft *Kohle, M.B.H. v. Shell Oil Co.*, 112 F.3d 1561, 1564 (Fed. Cir. 1997) (holding that an applicant must "meet the disclosure requirement of [35 U.S.C.] § 112, ¶ 1 in a single parent application in order to obtain an earlier filing date for individual claims"). See also Herbert F. Schwartz & Robert J. Goldman, *Patent Law & Practice* § 2.III.D.7.c (6th ed. 2008) ("A continuation-in-part is entitled to the parent's filing date as to any subject matter in common, but only to its own filing date as to the new matter."). This assumes that the applicant has not otherwise attempted to commercialize the invention prior to publication, which may itself be a lofty wish.

is only $140 and there is no limit to the claims that can be filed. For larger clients, they can afford the $280 filing fee and should file early and often.

Filing the provisional patent application gives the client the flexibility of adding "new matter" to the original application without incurring the choices outlined above. It also allows the patent attorney to file a patent application to obtain a priority date for the first filing even if the inventor anticipates adding new embodiments. In some cases, I have filed three provisional applications in series before finally filing a first utility patent application. More and more frequently I file my first draft of the application as a provisional application before the client even reviews it. This gives the client plenty of "breathing room" to review the application, knowing that a baseline priority date has been set.

VI. The Problem of the Continuation-In-Part Application

The continuation-in-part application is a creature that is unique to U.S. patent law. If you wish to file a CIP application in another country, it will be filed as an independent application. If at all possible, international applications should be filed within 12 months of the parent application being filed in the U.S.

The CIP is a wonderful thing. It allows the practitioner to "reach back" to an earlier priority date to defeat the on-sale bar, to avoid secret prior art, and to overcome the inventor's own ill-advised publications and disclosures. This, of course, is only helpful to the extent of common matter found between the two filings.[20] Any new matter will not enjoy the benefit of the earlier priority date. Specifically, only a claim with all of its limitations fully supported by the disclosure of the parent application is entitled to the parent's earlier priority date; all other claims are given the CIP application's later priority date. However, in my experience few examiners are willing to make that distinction.

But even in the U.S. there are downsides to the CIP. For one, any prior arguments and statements made in the parent application / patent can and will be used against the applicant to more narrowly interpret the claim language in the patent maturing from the subsequent CIP.[21]

In addition, the term of any patent maturing from the CIP application is calculated from the filing date of the earlier-filed original patent application.; it is not calculated from the filing date of the later-filed CIP application. Simply put, the patent term is "cut short" in a CIP.

But perhaps most troubling, the applicant's own disclosure can be used to find a claim in a CIP application obvious. If the CIP application's claim extends even slightly past what a published parent application disclosed more than a year earlier, the parent can be used as prior art against the CIP claim.[22]

[20] *Waldemar Link GmbH v. Osteonics Corp.*, 32 F.3d 556, 558-59 (Fed. Cir. 1994) ("A CIP application can be entitled to different priority dates for different claims…. The CIP application thus does not explicitly memorialize the filing date accorded particular claims").
[21] *Trading Techs. Int'l, Inc. v. Open E Cry*, LLC, 728 F.3d 1309, 1323 (Fed. Cir. 2013).
[22] *See*, e.g., *In re* Chu, 66 F.3d 292, 296–97 (Fed. Cir. 1995) (holding that even though Chu's "application claims to be a CIP of the Doyle patent," some claims were not supported by Doyle alone, so for those claims "the Doyle

Therefore, the applicant should strive to file the CIP (or at least a provisional application for the CIP) within one year of when the parent application publishes.

VII. The Problem of the Secret Sale, and the Not-So-Secret Sale

Every patent statute since 1836 has included an on-sale bar.[23] The on-sale bar precludes a person from receiving a patent on an invention that was "in public use, on sale, or otherwise available to the public before the effective filing date of the claimed invention."[24] The U.S. Supreme Court has held that the statutory on-sale bar applies whether the offer discloses each detail of the invention or not.[25] But what happens when the sale of the invention is secret?

A secret sale is a sale that happens under a private contract. Typically, the contract requires the buyer to keep the terms and conditions of the sale confidential. In addition, the product or technology that is the subject of the sale is not made available to the public. In some cases, the contract will prohibit the buyer from using the product outside of its own facilities.

Under pre-AIA cases, the Federal Circuit — which has "exclusive jurisdiction" over patent appeals,[26] —recognized that "secret sales" can invalidate a patent.[27] When the AIA was passed, it retained the on-sale bar but added the catchall phrase "or otherwise available to the public."[28] Many, including the U.S. Patent Office itself, interpreted this as an attempt by Congress to do away with the "secret sale" prohibition. However, in *Helsinn Healthcare S.A. v. Teva Pharmaceuticals USA, Inc*.,[29] the Federal Circuit determined: "after the AIA, if the existence of the sale is public, the details of the invention need not be publicly disclosed in the terms of sale" for the sale to be invalidating. In so reaching this ruling the Federal Circuit largely did away with the belief that the AIA created a safe harbor for sales that did not disclose the details of the claimed invention.

patent was properly relied on as prior art"); *Paperless Accounting v. Bay Area Rapid Transit System*, 804 F.2d 659, 665 (Fed. Cir. 1986) (for claims in a CIP with new matter, any patent issued or document published more than one-year before the CIP filing date would count as prior art under 35 U.S.C. 102(b)).

[23] *Pfaff v. Wells Electronics*, Inc., 525 U. S. 55, 65 (1998).

[24] 35 U. S. C. § 102(a)(1). *See Consolidated Fruit-Jar Co. v. Wright*, 94 U.S. 92, 94 (1877) ("[A] single instance of sale or of use by the patentee may, under the circumstances, be fatal to the patent . . . "); *Smith & Griggs Mfg. Co. v. Sprague*, 123 U. S. 249, 257 (1887) ("A single sale to another . . . would certainly have defeated his right to a patent . . . "); *Elizabeth v. Pavement Co*., 97 U. S. 126, 136 (1878) ("It is not a public knowledge of his invention that precludes the inventor from obtaining a patent for it, but a public use or sale of it").

[25] *Pfaff*, 525 U.S. at 67.

[26] 28 U. S. C. § 1295(a).

[27] *See, e.g., Special Devices, Inc. v. OEA, Inc.*, 270 F. 3d 1353, 1357 (2001) (invalidating patent claims based on "sales for the purpose of the commercial stockpiling of an invention" that "took place in secret"); *Woodland Trust v. Flowertree Nursery, Inc.*, 148 F. 3d 1368, 1370 (1998) ("Thus an inventor's own prior commercial use, albeit kept secret, may constitute a public use or sale under § 102(b), barring him from obtaining a patent").

[28] 35 U.S.C. § 102(a)(1) (2012) ("A person shall be entitled to a patent unless" the "claimed invention was . . . in public use, on sale, or otherwise available to the public . . .").

[29] 855 F.3d 1356, 1371 (Fed. Cir. 2017).

The Federal Circuit explained the rational for the expansive nature of the on-sale bar as follows:

> A primary rationale of the on-sale bar is that publicly offering a product for sale that embodies the claimed invention places it in the public domain, regardless of when or whether actual delivery occurs. The patented product need not be on-hand or even delivered prior to the critical date to trigger the on-sale bar. And, as previously noted, we have never required that a sale be consummated or an offer accepted for the invention to be in the public domain and the on-sale bar to apply, nor have we distinguished sales from mere offers for sale. We have also not required that members of the public be aware that the product sold actually embodies the claimed invention… . our prior cases have applied the on-sale bar even when there is no delivery, when delivery is set after the critical date, or, even when, upon delivery, members of the public could not ascertain the claimed invention.[30]

The case was taken to the U.S. Supreme Court. In an opinion written by Justice Thomas, the Supreme Court agreed with the Federal Circuit and affirmed a judgment invalidating the patent at issue. The Court held that a commercial sale to a third party who is required to keep the invention confidential may place the invention "on sale" under § 102(a), regardless of whether the disclosure actually places the public in possession of the invention or the ability to practice it. The additional language in the AIA version of section 102(a) "or otherwise available to the public" was deemed too subtle to effect a change in pre-AIA law.[31]

This raises the question: could there ever be a scenario where a "secret sale" made more than one year before a first patent application is filed is not prior art? This author believes so. The classic example is the "garage inventor" who works with a machine shop, an engineer, a 3D printing company or an illustrator to develop prototypes. Of course, this could also apply to the company that enters into a contract for manufacturing services. The Federal Circuit has held that "a contract manufacturer's sale to the inventor of manufacturing services where neither title to the embodiments nor the right to market the same passes to the supplier does not constitute an invalidating sale under [the on-sale bar]."[32]

The basis for this principle is that what the inventor is contracting for is not the sale or commercialization of the product itself, but only manufacturing services. The inventor (or owner of the invention) retains control of the invention, including its future distribution or sale. Of interest, the Federal Circuit noted that the inventor could even "stockpile" manufactured goods without encroaching upon the on-sale bar.

So, where did Helsinn Healthcare go wrong in its case? Helsinn Healthcare went beyond a mere manufacturing agreement and contracted for the distribution, promotion and marketing of a projected drug. Separately, Helsinn entered into a supply and purchase agreement. The agreements were the subject of press releases and Form 8-K filings. While none of the releases or filings "disclosed the

30 *Helsinn Healthcare S.A. v. Teva Pharm. USA, Inc.*, 855 F.3d 1356, 1370–71 (Fed. Cir. 2017) (internal citations omitted), *cert. granted*, 138 S. Ct. 2678 (2018), and *aff'd*, 139 S. Ct. 628 (2019).
31 *Helsinn Healthcare S.A. v. Teva Pharmaceuticals USA, Inc.*, 139 S. Ct. 628, 632 (2019).
32 *Medicines Co. v. Hospira*, Inc., 827 F.3d 1363, 1381 (Fed. Cir. 2016).

specific dosage formulations covered by the agreements," the agreements were clearly commercial in nature. Helsinn then waited two years two file its provisional patent applications.[33]

VIII. The Problem of Secret or Experimental Use

Under 35 USC 102(a), a public use, either by the inventor or another, more than one year before the filing date of the application, can be used as prior art against an application for patent. There are two exceptions to this statutory bar: the case where the use is not in fact "public" under the meaning of the statute, and the judicially created exception for "experimental use." "The public use bar is triggered where, before the critical date, the invention is in public use and ready for patenting."[34] These exceptions have come under fire recently and have lost significant ground.[35] Inventors commonly run into the problem of disqualifying prior art under the secret and experimental use exceptions because of a failure to either (1) maintain control and secrecy of the use while it is happening (in the case of secret use), or (2) engage in some sort of prohibited commercial transaction involving the invention, hence invalidating the "experimental" nature of the use.

In *Allen Engineering Corp. v. Bartell Industries*, the Federal circuit laid out a number of factors to use in determining whether or not a given use qualifies as experimental. These include:

> (1) the necessity for public testing, (2) the amount of control over the experiment retained by the inventor, (3) the nature of the invention, (4) the length of the test period, (5) whether payment was made, (6) whether there was a secrecy obligation, (7) whether records of the experiment were kept, (8) who conducted the experiment, ... (9) the degree of commercial exploitation during testing[,] ... (10) whether the invention reasonably requires evaluation under actual conditions of use, (11) whether testing was systematically performed, (12) whether the inventor continually monitored the invention during testing, and (13) the nature of contacts made with potential customers.[36]

In *Barry v. Medtronic, Inc.*, an orthopedic surgeon sued Medtronic in the Eastern District of Texas alleging infringement of two patents entitled "System and Method for Aligning Vertebrae in the Amelioration of Aberrant Spinal Column Deviation Conditions[37]." Dr. Barry designed a medical device and corresponding methods of use to correct spinal abnormalities. The issued patents both had a priority date of December 30, 2004, making December 30, 2003 the critical date for purposes of the public use bar. Medtronic alleged that Dr. Barry had invalidated his own patents with a disqualifying public use,

[33] *Helsinn,* slip op. at 2-3.
[34] *Barry v. Medtronic, Inc.*, 914 F.3d 1310, 1320 (Fed. Cir. 2019) (quoting Polara Eng'g Inc v. Campbell Co., 894 F.3d 1339, 1348 (Fed. Cir. 2018)).
[35] Kris J. Kostolansky, Daniel Salgado, *Does the Experimental Use Exception in Patent Law Have A Future?*, Colo. Law., January 2018.
[36] *Allen Eng'g Corp. v. Bartell Indus., Inc*., 299 F.3d 1336, 1353 (Fed. Cir. 2002) (quoting *EZ Dock v. Schafer Sys., Inc.*, 276 F.3d 1347, 1357 (Fed.Cir.2002)).
[37] *Barry v. Medtronic, Inc*., 914 F.3d 1310 (Fed. Cir. 2019).

namely three surgeries conducted in August and October of 2003, more than a year before the filing of his first patent application.

The Federal Circuit held that the surgeries themselves were an "experimental use" and did not meet the requirements of either the on-sale bar or the public use bar because the invention was not "ready for patenting." This fact was established by testimony and evidence from Dr. Barry himself that until a January 2004 follow up visit for the October surgery, he was not sure if the invention would work. To prove that an invention is "ready for patenting" requires showing that it is "shown or known to work for its intended purpose."[38] Since Dr. Barry did not possess this knowledge until examining all of the patients after three months and observing their recovery, his invention was not ready for patenting and consequently his public uses fell under the experimental use exception.

Not all plaintiffs are as fortunate as Dr. Barry however, and there is long history of quite obscure or hidden uses of an invention creating prior art headaches for the inventor when a patent application is filed. In *New Railhead Mfg., L.L.C. v. Vermeer Mfg. Co*, (another Texas case) the inventor of a patented drill bit and method for horizontal oil and gas drilling learned the hard way that "The statutory phrase 'public use' does not necessarily mean open and visible in the ordinary sense; it includes any use of the claimed invention by a person other than the inventor who is under no limitation, restriction, or obligation of secrecy to the inventor."[39] The patentee made the mistake of having a third party test his drill bit *and* method of drilling on public land at a commercial worksite, without any control over the confidentiality of the operation or any need or desire to experimentally test or improve the drilling method.[40] Given that the use was public and that the invented method needed no improvement and worked for its intended purpose, the Federal Circuit held that the invention had been reduced to practice and was ready for patenting, making the public use non-experimental.

Texas plaintiffs have made it to the Federal Circuit in several high-profile experimental or secret use cases. The Houston-based plaintiff in *Minton v. Nasdaq* similarly failed to meet the requirements of experimental use when he sold a license to use his TEXCEN software with a warranty of workability to a third party.[41] This transfer and guarantee of workability negated any argument of experimental use because it made it clear that the invention was "ready for patenting" and the release of the software to the public through a sale to a company with no obligation of confidentiality made it undeniable that the use was public.[42] Houston-headquartered Clock Spring, L.P. (a high pressure gas line repair company) similarly tried and failed to invoke the experimental use exception in *Clock Spring v. Wrapmaster*.[43] The Federal circuit held that 1) a public demonstration where all the limitations of the claims are not practiced

[38] *Id. at* 1321-22.
[39] *New Railhead Mfg., L.L.C. v. Vermeer Mfg. Co.*, 298 F.3d 1290 (Fed. Cir. 2002).
[40] *Id.* at 1298-99.
[41] *Minton v. Nat'l Ass'n of Sec. Dealers, Inc*., 336 F.3d 1373 (Fed. Cir. 2003).
[42] *Id.* at 1377-78. *See also Baker Oil Tools, Inc. v. Geo Vann, Inc*., 828 F.2d 1558 (Fed. Cir. 1987).
[43] *Clock Spring, L.P. v. Wrapmaster, Inc*., 560 F.3d 1317 (Fed. Cir. 2009).

can nevertheless be a disqualifying public use because public use encompasses obvious variants[44] and 2) that the use of an invention that is ready for patenting cannot be experimental.[45]

IX. The Problem of the Provisional Patent Application

As patent attorneys, we are fond of telling our clients that provisional patent applications are not published. While this is technically true, it is also true that provisional patent applications are available to the public when a utility application that claims the benefit of the provisional application is published.[46]

Typically, the contents of a provisional patent application are incorporated into the later utility application, both literally and via incorporation by reference.[47] But it is possible that a provisional patent application could delve into all manner of technical material that is not later incorporated into the utility application. In that case, assuming the utility application is published, the original provisional patent application becomes a published document that may serve as prior art for unrelated applications filed down the road.

X. The Problem of Trade Secrets

Trade secrets and patents are separate types of intellectual property. In 1974, the U.S. Supreme Court expressly recognized that the states may offer protection for trade secrets so long as state law does not conflict with the federal patent laws. [48] Many states, including Texas, have adopted the Uniform Trade Secrets Act.[49]

Under the Texas Uniform Trade Secrets Act, a trade secret is defined as any "information, including any… formula, . . . method, . . . process, . . . , or list of . . . customers . . . if:

> …derives independent economic value . . . from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use; and
>
> The owner of the trade secret has taken efforts that are reasonable under the circumstances to maintain its secrecy.[50]

[44] *Id.* at 1326.
[45] *Id.* at 1327-28.
[46] 37 C.F.R. § 1.14 (iii) - (vi) (2020).
[47] 37 C.F.R. § 1.14(a)(vi).
[48] *Kewanee Oil Co. v. Bicron Corp*., 416 U.S. 470, 479 (1974).
[49] Tex. Civ. Prac. & Rem. Code Ann. § 134A (West Supp. 2016). The Texas Uniform Trade Secrets Act ("TUTSA") was modeled after the Uniform Trade Secrets Act ("UTSA"). Almost all 50 states have passed trade secrets legislation based on the UTSA. Of interest, TUTSA was amended in 2017 to incorporate elements of the new Defend Trade Secrets Act (DTSA), which was passed into law in 2016 by the U.S. Congress.
[50] Tex. Civ. Prac. & Rem. Code Ann. § 134A.002(6).

To summarize, a trade secret is any information that is not generally known or readily ascertainable by people who could profit from it, and that is the subject of reasonable efforts to maintain its secrecy.

Trade secrets and patents are mutually exclusive. By definition, a trade secret must be kept secret to have value and to be a true trade secret. In contrast, for a patent to issue the inventor is required to disclose the invention to the government, who ultimately publishes the patent to the public in order to "promote the progress."[51] While it is no longer required that the inventor disclose the "best mode" of practicing the invention, the inventor must still provide a technical description of the invention that enables a person of ordinary skill in the art to make and to use it.[52] The inventor receives a patent whether it ultimately has any commercial value or not. Moreover, the patent grant conveys the right to exclude others from reverse engineering the invention or from independently developing the invention.

But what happens if the applicant takes a process that has been held by the owner as a trade secret, improves upon it, and then files a patent application?[53] Issues related to section 102 of the Patent Act suddenly arise. Has a product ever been sold that was made using the confidential process? If so, is the sale of the product also a commercial use of the process for purposes of 35 U.S.C. § 102? What if the secret process was the subject of any kind of technology-sharing arrangement?

Referring again to *Minton v. Nasdaq*, the Federal Circuit noted in that case that a license to certain software constituted an offer to sell the patented method.[54] The Federal Circuit distinguished Mr. Minton's situation with the earlier decision of *In re Kollar*.[55] In *In re Kollar*, a patent applicant sought a patent on a process for the preparation of dialkyl peroxide. The examiner refused to grant the patent on the ground that an agreement between Kollar's company and Celanese Corporation had been entered that constituted an offer for sale within the meaning of the on-sale bar.[56] The Federal Circuit reversed that decision because the Celanese agreement amounted only to a transfer of technical information about the claimed process and a license under any future patents to practice the process and sell the resulting products.[57] The appellate court held that the transfer of know-how regarding a claimed process is not a "sale" of the process within the meaning of the pre-AIA 35 U.S.C. § 102(b) because a know-how agreement "under which development of the claimed process would have to occur before the process is

[51] U.S. Const. art I, § 8, Cl. 8.
[52] 35 U.S.C. § 112.
[53] One might question the wisdom of filing a patent application based upon an existing trade secret, but business strategies change and a patent may be the best form of protection, particularly in view of the portability of employees who know the "secret sauce." For start-up companies or businesses that are seeking to raise new capital, it can be reassuring to see that patent applications are being filed. In some cases, patents are necessary part of securing investments.
[54] *Minton v. Nat'l Ass'n of Sec. Dealers, Inc*., 336 F.3d 1373, 1378 (Fed. Cir. 2003). ("Minton conveyed . . . a fully operational computer program implementing and thus embodying the claimed method.").
[55] *In re Kollar*, 286 F.3d 1326 (Fed. Cir. 2002).
[56] *Id.* at 1328-29.
[57] *Id.* at 1330.

successfully commercialized, is not a sale."[58] However, the court did recognize that "[a]ctually performing the process itself for consideration would trigger the application of § 102(b)."[59]

Section 2152.02(c) of the MPEP provides that "once an examiner becomes aware that a claimed invention has been the subject of a potentially public use, the examiner should require the applicant to provide information showing that the use did not make the claimed process accessible to the public." If the process itself cannot be discerned from an analysis or reverse engineering of the product, then one might argue with success that the process itself has not been commercialized.

But what about the inventor's duty of candor and good faith with the Patent Office? 37 C.F.R. § 1.56(a) provides in part:

> A patent by its very nature is affected with a public interest. The public interest is best served, and the most effective patent examination occurs when, at the time an application is being examined, the Office is aware of and evaluates the teachings of all information material to patentability. Each individual associated with the filing and prosecution of a patent application has a duty of candor and good faith in dealing with the Office, which includes a duty to disclose to the Office all information known to that individual to be material to patentability as defined in this section.

If the inventor is filing claims directed to improvements over an existing in-house method, should the inventor be compelled to disclose the trade secret as part of the information disclosure statement? The most conservative approach is to disclose the process, but then provide a separate statement explaining that the prior process has at all times been kept confidential. MPEP § 724.02 provides a procedure by which selected items of "prior art" may be submitted under seal.[60] Thus, the applicant may tender material claimed as a trade secret to the patent examiner without making the trade secret public knowledge.

[58] *Id.* at 1333.
[59] *Id.*
[60] Section 724.02 provides in part:

> Information which is considered by the party submitting the same to be either trade secret material or proprietary material, and any material subject to a protective order, must be clearly labeled as such and be filed in a sealed, clearly labeled, envelope or container. Each document or item must be clearly labeled as a "Trade Secret" document or item, a "Proprietary" document or item, or as an item or document "Subject To Protective Order." It is essential that the terms "Confidential," "Secret," and "Restricted" or "Restricted Data" not be used when marking these documents or items in order to avoid confusion with national security information documents which are marked with these terms (note also MPEP § 121). If the item or document is "Subject to Protective Order" the proceeding, including the tribunal, must be set forth on each document or item. Of course, the envelope or container, as well as each of the documents or items, must be labeled with complete identifying information for the file to which it is directed, including the Office or area to which the envelope or container is directed.

XI. The Problem of Double Patenting

Double patenting comes in two main types: statutory and non-statutory. To get a rejection based on double-patenting, there must be at least some form of shared or overlapping ownership or interest between two patent applications or a patent application and an issued patent.[61]

Statutory double patenting is based on 35 U.S.C. § 101 which states in the singular that an inventor "may obtain a patent" for an invention. Where a patent examiner perceives that claims are submitted in one application that are directed to more than one invention, then a so-called restriction requirement may be issued.[62]

Once an election of claims is made by the applicant, one or more divisional patent applications may be submitted. Once the claims in a divisional application are allowed, the examiner may issue a separate double-patenting rejection based on non-statutory double patenting. This is sometimes referred to as obviousness-type double patenting ("OTDP").

OTDP is a judicially created doctrine that was originally designed to prevent patent owners from extending patent protection beyond the statutorily fixed term. Prior to the Uruguay Round Agreements Act ("URAA") of 1994, which changed the term for a U.S. patent from seventeen years from patent issuance to twenty years from the earliest (non-provisional) filing date, patent applicants could theoretically extend their patent term without end. For example, a series of patent applications covering the same or similar subject matter, with slightly different claims could be filed, with each new application triggering a new seventeen year term.

Double patenting is explained by the U.S. Patent and Trademark Office in MPEP § 804, as follows:

> The doctrine of double patenting seeks to prevent the unjustified extension of patent exclusivity beyond the term of a patent. The public policy behind this doctrine is that: "The public should . . . be able to act on the assumption that upon the expiration of the patent it will be free to use not only the invention claimed in the patent but also modifications or variants which would have been obvious to those of ordinary skill in the art at the time the invention was made, taking into account the skill in the art and prior art other than the invention claimed in the issued patent." [quoting *In re Zickendraht*, 319 F.2d 225, 232 (CCPA 1963)]

"There are two justifications for obviousness-type double patenting. The first is to prevent unjustified timewise extension of the right to exclude granted by a patent no matter how the extension is brought about. The second rationale is to prevent multiple infringement suits by different assignees asserting essentially the same patented invention."[63]

[61] *In re Hubbell*, 709 F.3d 1140, 1146-47 (Fed. Cir. 2013).
[62] MPEP § 804.
[63] *In re Hubbell*, 709 F.3d 1140, 1145 (Fed. Cir. 2013) (Internal citations and quotations omitted).

Obviousness-type double-patenting can sometimes (though not always), be remedied by filing a terminal disclaimer to "give up" the portion of a patent's term that extends beyond the reference patents term. This ensures that although the patents are directed to patentably indistinct inventions (essentially the same), the public will receive the right to practice the entire invention at the same time, rather than piecemeal as the different patents expire. This fulfills the spirit of 35 U.S.C. 101: the implied rule of "one invention, one patent" and helps protect alleged infringers from being sued by multiple entities separately over the same invention.

Prior to the URAA, OTDP rejections were frequently and fairly straightforwardly employed against patents in the same family by examining the dates of issuance and requiring a terminal disclaimer such that all applications sharing a common invention ended their life on the same date. This all changed with *Gilead Sciences v. Natco Pharma*, as Ms. Baur and Ms. Doherty explain:

> The panel majority in *Gilead* found that the later-issued but earlier-filed '375 patent could, in fact, be an ODP reference against the earlier-issued '483 patent. This resulted in an unexpected reduction in the patent term of the '483 patent to that of the '375 patent. The panel majority pointed out that in prior cases where the expiration date was tied to the issue date, issue dates were used as stand-ins for expiration dates, but that, in this case, it did not matter which patent issued first. In the court's opinion, a focus on the issue date could lead to "gamesmanship during prosecution" (e.g., arranging for applications with later filing dates to issue first).[64]

The Federal Circuit reaffirmed that a later-issued patent could be used as a double-patenting reference against an earlier-issued patent in *Abbvie v. Mathilda & Terence Kennedy Inst. of Rheumatology*.[65] However, subsequent panels have narrowed the scope of the *Gilead* doctrine, placing some limitations on when and how a later patent can be used as a double-patenting rejection reference for an earlier-filed patent.[66] The Federal Circuit might be offering some balm to those patent owners smarting from the new expansion of the OTDP rules. In a Law360 article, David Manspeizer argued that the recently decided *Sanofi-Aventis v. Dr. Reddy's Labs*[67] may offer a new path to avoid OTDP through the reissue process.[68] Based on a fairly straightforward interpretation of *Sanofi*, Manspeizer argues that OTDP rejections could be solved by seeking reissue of the reference patent and cancelling the problematic claims. This offers a new mechanism to help patent owners avoid bumping into their own prior art.

[64] Amelia Feulner Baur, Elizabeth A. Doherty, NAVIGATING THROUGH THE OBVIOUSNESS-TYPE DOUBLE PATENTING MINEFIELD, 10 LANDSLIDE 48, 50–51 (2018) (citing *Gilead Sciences, Inc. v. Natco Pharma* Ltd.753 F.3d 1208, 1210 (Fed. Cir. 2014)).
[65] *Abbvie Inc. v. Mathilda & Terence Kennedy Inst. of Rheumatology Tr*., 764 F.3d 1366, 1374 (Fed. Cir. 2014).
[66] *See Novartis AG v. Ezra Ventures LLC*, 909 F.3d 1367, 1375 (Fed. Cir. 2018) and *Novartis Pharm. Corp. v. Breckenridge Pharm. Inc.*, 909 F.3d 1355, 1358 (Fed. Cir. 2018).
[67] *Sanofi-Aventis U.S., LLC v. Dr. Reddy's Labs., Inc*., 933 F.3d 1367, 1370-71 (Fed. Cir. 2019).
[68] David Manspeizer, *Fed. Circ. Offers Obviousness-Type Double Patenting Cure*, LAW360, (Nov. 5, 2019), https://www.law360.com/articles/1215824/fed-circ-offers-obviousness-type-double-patenting-cure.

XII. The Problem of the International Patent

After a U.S. patent application is filed, it is common for a client to request that reciprocal patent applications be filed in other countries. For those of us in Texas who provide patent services for companies in the upstream oil and gas industry, it is virtually automatic that applications be filed in Canada, the UK and Norway. For multinational companies the list will likely also include Argentina, Australia, China, one or more countries in Africa and one or more countries in the Middle East.[69]

None of these countries are known for speedy patent resolution. But what happens if the U.S. filing is accompanied by a request for expedited examination, and the U.S. patent issues within one year of the effective filing date? And further, what happens if the patent issues before a foreign application is actually filed? Is the issued patent prior art to the foreign application?[70] The author does not believe so.

The United States has entered into international treaties with numerous countries that affect patents and "industrial property." These include the Paris Convention for the Protection of Industrial Property of 1883, the WTO Agreement of Trade-Related Aspects of Intellectual Property Rights and the Patent Cooperation Treaty. Under the Paris Convention, "Any person who has duly filed an application for a patent, or for the registration of a utility model . . . in one of the countries of the Union, or his successor in title, shall enjoy, for the purpose of filing in the other countries, a right of priority during the periods hereinafter fixed."[71]

Assuming that the foreign country selected for filing is a member of the Paris Convention, an application may be filed in that country with a priority claim being made back to the original U.S. application even though a patent application for the same invention has already issued.[72] This would also be true for a PCT application itself. Under Article 4, the foreign application must be filed within 12 months of the "parent" application in the United States, and the priority claim must be made in the selected foreign country within four months of filing. [73]

A note of caution is in order concerning when the 12-month filing clock commences. According to Article 4 C(2), the 12–month period "shall start from the filing of the first application; the day of filing shall not be included in the period." Note the reference to the "first application." This means that a "second application" may not be validly claimed as a priority right. The term "second application" refers to any application that claims a right of priority back to an earlier application, even if that earlier

[69] Applications in the oil and gas industry are also sometimes filed in Columbia, China, Nigeria and Angola.
[70] MPEP § 706.02(e) mentions that "[i]n Belgium, for instance, a patent may be granted in just a month after its filing . . . ." I suspect few oil and gas patents get filed in Belgium, but other technical areas may be more appropriate.
[71] Paris Convention for the Protection of Industrial Property, art. 4 § A(1), Mar. 20, 1883, 21 U.S.T. 1583, 828 U.N.T.S. 305. (as revised at Stockholm July 14, 1967).
[72] Currently, there are over 170 countries who have signed on to the Paris Convention.
[73] According to Article 4 C(1), the "periods fixed" are 12 months for patents and 6 months for utility models, industrial designs and trademarks.

application is never published.[74] This means that the practitioner should endeavor to file the PCT (or other foreign) application within 12 months of the earliest parent application or risk losing the claim to priority.

This could have an impact on the U.S. practitioner who has filed more than one provisional application.[75] If, for some reason, the applicant wishes to file a utility application without claiming priority to the first provisional application (meaning that priority will be claimed to only the second provisional application), then the applicant should either expressly abandon the first provisional application, or wait until the date for converting the first provisional application has passed.[76] The second provisional application can then appropriately serve as the "first" priority document for the utility application under PCT Article 4.

An ancillary issue arises when the U.S. application publishes before a foreign application is filed. This may arise in one of two situations:

1) the applicant has requested early publication of the U.S. application;[77] or

2) the U.S. utility application has claimed the benefit of a provisional application that was filed more than six months before the filing date of the U.S. utility application.

Will the published application be prior art with respect to a later-filed foreign patent application? Again, the author does not believe so. The same international treaties should allow the applicant to claim priority back to the original filing date, ante-dating the date of publication. Again, this assumes that the application being cited in the priority claim is the "first application."

Finally, a common scenario in U.S. practice includes the filing of one or more CIP applications. A CIP application claims the benefit of an application having an earlier filing date based on common

[74] An exception to the "first application" rule applies where the applicant withdraws or abandons an earlier application before the earlier application is published and before the second application is filed. See also endnote 76, *supra*.

[75] With the advent of first-to-file in the United States under AIA, and with the government filing fee being so very low, it has become common to file more than one provisional application before any domestic or foreign utility applications are filed.

[76] Article 4 C(4) permits a subsequently filed application to serve as the basis of priority so long as certain conditions are met with respect to the "first application." Those conditions include:

> at the time of filing the subsequent application, the said previous application has been withdrawn, abandoned, or refused, without having been laid open to public inspection and without leaving any rights outstanding, and if it has not yet served as a basis for claiming a right of priority. The previous application may not thereafter serve as a basis for claiming a right of priority.

[77] 37 C.F.R. § 1.219 provides for the option of early publication of an application "at the request of the applicant." Such a request must be accompanied by a publication fee. MPEP § 1129.

subject matter, but typically includes additional matter.[78] If the applicant wishes to pursue a PCT / foreign patent application based on a CIP application, best practice is to file the foreign application within 12 months of the filing date of the parent application. Indeed, it is the author's practice to endeavor to file foreign applications for the CIP before a parent application in the U.S. publishes.

XIII. Claiming Priority

An issue closely related to the problem of prior art is the mechanics of claiming priority to an earlier application. A failure to properly claim priority to an earlier application can expose the claims to prior art that actually is not, e.g., your own prior art. There are several cringe-worthy decisions that have been written over the years by United States Courts of Appeals describing failures to claim priority, or inadvertent waivers of priority claims.[79]

It is beyond the scope of this article to discuss every aspect of claiming priority in the various PCT jurisdictions. However, it is critical for the U.S. patent practitioner to understand that any claim to priority must be presented to the Patent Office by means of an Application Data Sheet.[80] Merely including a priority claim in a patent specification or incorporating a parent application by reference is not adequate.[81] For applications filed on or after September 16, 2012, priority information must be included in an ADS to be given effect. See 37 CFR §§ 1.55, 1.78.

Cases have held that the burden is on the patent owner to provide "a clear, unbroken chain of priority."[82] The practitioner is cautioned to carefully study the priority claim recited in an Official Filing

[78] In CIP applications, priority is assessed on a claim-by-claim basis. *Transco Products, Inc. v. Performance Contracting, Inc*., 38 F.3d 551, 557 n.6 (Fed. Cir. 1994). An applicant can obtain an earlier filing date for claims in a CIP application only if those claims find support in an earlier-filed non-provisional application. *Id*. Claims reciting new matter are entitled to only the filing date of the CIP application and not to the filing date of the earlier-filed application. *Id*.

[79] One such case is *Natural Alternatives International, Inc. v. Iancu*, 904 F.3d 1375 (Fed. Cir. 2018). In that case, Natural Alternatives International ("NAI") filed a series of eight patent applications claiming priority to an original 1997 application, in series. NAI filed the fifth application, which was a continuation-in-part, in 2003 and the sixth application in 2008 while the fifth application was still pending. Four days after filing the sixth application, NAI amended the fifth application to delete the earlier priority claim. This resulted in a longer patent term for the fifth application. At the same time, the Federal Circuit held that this cut off any claim of priority back to the first through the fourth applications that might have been enjoyed by the sixth application. NAI was deemed to have "deliberately and expressly terminated [its] claim to the priority of the first four applications." See also *Encyclopaedia Britannica, Inc. v. Alpine Electronics of America, Inc*., 609 F.3d 1345, 1350 (Fed. Cir. 2010) (because an intermediary application failed to specifically reference an earlier filed application, a new application was not entitled to the priority date of the prior application).

[80] In *Droplets, Inc. v. E*Trade Bank*, 887 F.3d 1309 (Fed. Circ. 2018), the Federal Circuit held that a failure to properly include a priority claim in an Application Data Sheet was fatal to the claim. In that case, the Application Data Sheet failed to make specific mention of an earlier provisional patent filing. See also *Medtronic CoreValve, LLC v. Edwards Lifesciences Corp*., 741 F.3d 1359 (Fed. Circ. 2014) (holding that the patent at issue was invalid because of a defective priority claim to an earlier French application).

[81] *Id*.

[82] *Id*. at 1321. See also *Sticker Industrial Supply Corp. vs. Blaw-Knox Co.*, 405 F.2d 90, 93 (7th Cir. 1968) noting that it is "no hardship to require [the patent owner] to disclose this information [pertaining to priority]."

Receipt after a patent application is filed to ensure that the proper chain of title is presented. The practitioner is also cautioned that amending an earlier-filed parent application "may affect the priority of its child applications."[83]

Finally, a pitfall that can arise in connection with priority relates to the identity of the applicant in an international application. Under Article 4, the priority right is enjoyed by the applicant or his successor in title. This generally requires an identity of applicant as between the priority application and the subsequently filed application within the 12–month time period. The problem arises when, for example, the priority application filed in the United States names the inventor(s) as the applicant, but the later foreign application names the inventor's employer as the applicant. To avoid a discrepancy in applicant, the practitioner should obtain an assignment of the patent rights from the inventor(s) to the employer within the 12-month time period, and more preferably before the PCT application is filed.

IX. Conclusion

There are a number of instances in which an inventor may have his or her own prior art cited against them, either during prosecution of a patent application or during enforcement of an issued patent. The inventor himself likely will not tell the patent attorney about such prior art. Therefore, the diligent attorney will want to raise the issue with the client at the time the application is being drafted or filed.

The author wishes to express gratitude to Adam J. Woodward for his assistance in the preparation of this article. Adam resides in Knoxville, Tennessee. He holds a B.S. degree in chemical engineering from Cornell University, and a law degree from Emory University School of Law in Atlanta. Adam has passed the patent bar and is awaiting his USPTO registration number. He will be taking the Tennessee bar examination in September of 2020.

[83] *Natural Alternatives International, Inc. v. Iancu*, 904 F.3d at 1381. See also *In re Janssen Biotech, Inc*., 880 F.3d 1315 (Fed. Cir. 2018) (observing that a removal of subject matter, including a priority claim, in a parent application may affect the patentability of claims in child applications); and *Searle LLC v. Lupin Pharmaceuticals, Inc*. 790 F.3d 1349,1355 (Fed. Cir. 2015)(noting that if a patent owner had obtained foreign patent protection based on a Patent Cooperation Treaty ("PCT") application, altering the scope of the PCT application could call into question the proper scope of those foreign patents).

PARTNERSHIP FORMATION LAW – DOES TEXAS LAW PERMIT CONTRACTUAL CONDITIONS PRECEDENT TO PRECLUDE PARTNERSHIP FORMATION?

By Madison Hastings*

Energy Transfer Partners, L.P. v. Enter. Prods. Partners, L.P., 593 S.W.3d 732 (Tex. 2020).

In *Energy Transfer Partners, L.P. v. Enter. Prods. Partners, L.P.*,[1] the Supreme Court of Texas recently affirmed a decision of the Court of Appeals for the Fifth District of Texas, in which the Court of Appeals held Texas law permits parties to conclusively agree that certain contractual conditions must be satisfied before a partnership can form.[2] The Supreme Court of Texas's opinion is significant because it instructs lower courts that an agreement not to be partners unless certain conditions are met will be conclusive on the issue of partnership formation as between the parties.[3] Importantly, before this opinion, the Court had never "squarely addressed whether parties' freedom to contract for conditions precedent to partnership formation can override the statutory default test, in which intent is a mere factor."[4]

Energy Transfer Partners, L.P. and Energy Transfer Fuel, L.P. (together, "ETP") as well as Enterprise Products Partners, L.P. and Enterprise Products Operating LLC (together, "Enterprise") are among the ten largest energy companies in the United States.[5] In 2011, Enterprise and ETP agreed to explore the viability of converting a pipeline called Old Ocean into one that would transport natural gas from Cushing, Oklahoma, to Houston, Texas.[6] In three separate written agreements, ETP and Enterprise expressed their intent that neither party would be bound to proceed without the execution of a formal contract approved by each company's board of directors.[7] First, in a Confidentiality Agreement, signed in March 2011, ETP and Enterprise agreed:

> [U]nless and until a definitive agreement between the Parties with respect to the Potential Transaction has been executed and delivered, and then only to the extent of the specific terms of such definitive agreement, no Party hereto will be under any legal obligation of any kind whatsoever with respect to any transaction by virtue of this Agreement or any written or oral expression with respect to such a transaction by any Party or their respective Representatives, except, in the case of this Agreement, for the matters specifically agreed to herein . . . .[8]

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[1] Energy Transfer Partners, L.P. v. Enter. Prods. Partners, 593 S.W.3d 732 (Tex. 2020).
[2] *Id*. at 734.
[3] *Id.* at 741.
[4] *Id.* at 739.
[5] *Id*. at 734.
[6] *Id*. at 734-35.
[7] *Id*. at 734.
[8] *Id*. at 734-35.

Second, in April 2011, ETP and Enterprise executed a Letter Agreement including a "Non-Binding Term Sheet" envisioning a "mutually agreeable Limited Liability Company Agreement would be entered into" to govern the joint venture.[9] The Letter Agreement stated:

> [N]o binding or enforceable obligations shall exist between the Parties with respect to the Transaction unless and until the Parties have received their respective board approvals and definitive agreements memorializing the term and conditions of the Transaction have been negotiated, executed and delivered by both of the Parties. Unless and until such definitive agreements are executed and delivered by both of the Parties, either [Enterprise] or ETP, for any reason, may depart from or terminate the negotiations with respect to the Transaction at any time without any liability or obligation to the other, whether arising in contract, tort, strict liability or otherwise.[10]

Third, in April 2011, ETP and Enterprise also signed a Reimbursement Agreement providing the terms by which ETP would reimburse Enterprise for the cost of half of the project's engineering work.[11] The Reimbursement Agreement stated ETP and Enterprise were "in the process of negotiating mutually agreeable definitive agreements" and that nothing should "be deemed to create or constitute a joint venture, a partnership, a corporation, or any entity taxable as a corporation, partnership or otherwise."[12]

By May 2011, ETP and Enterprise began seeking sufficient shipping commitments.[13] The project was marketed to potential customers as a "50/50 JV."[14] For the project to be viable, ETP and Enterprise needed shipping commitments of at least 250,000 barrels a day for ten years at a tariff of $3.00 per barrel.[15] Initially, ETP and Enterprise were unable to secure these commitments.[16] They continued their attempts and on August 12, 2011, received a commitment for 100,000 barrels daily.[17] ETP hoped other commitments would follow, but Enterprise had already resumed negotiations with another entity and prepared to exit.[18] On August 15, 2011, Enterprise orally terminated its relationship with ETP.[19] A few days later, Enterprise confirmed this termination in writing.[20] Ultimately, Enterprise and another entity invested billions of dollars into the pipeline, now called "Wrangler."[21] Wrangler opened in 2012, achieving great financial success.[22] ETP brought suit against Enterprise.[23]

9 *Id*. at 735.
10 *Id*.
11 *Id*.
12 *Id*.
13 *Id*.
14 *Id*.
15 *Id*. at 736.
16 *Id*.
17 *Id*.
18 *Id*.
19 *Id*.
20 *Id*.
21 *Id*.
22 *Id*.
23 *Id*.

At trial, ETP argued that despite the disclaimers in the parties' written agreements, they formed a partnership through their conduct for the purpose of marketing and pursuing a pipeline.[24] Further, ETP argued Enterprise breached its statutory duty of loyalty by pursuing the Wrangler project with another entity.[25] The jury agreed with ETP, answering "yes" to whether "ETP and Enterprise [had] create[d] a partnership to market and pursue a pipeline project to transport crude oil from Cushing, Oklahoma to the Gulf Coast."[26] The jury further agreed that Enterprise breached its duty of loyalty to ETP.[27] The jury found ETP should recover $319,375,000.00 in damages and that Enterprise should be disgorged of the benefit gained as a result of misconduct in the amount of $595,257,433.00.[28] The trial court rendered judgment on the verdict in the amount of $535,794,777.40 plus prejudgment interest (after reducing the disgorgement amount to $150,000,000.00).[29]

The Court of Appeals reversed and rendered judgment for Enterprise.[30] The Court of Appeals held the Texas Business Organizations Code ("TBOC") allows parties to contract for conditions precedent to partnership formation.[31] Further, the Court of Appeals held the Letter Agreement created two unmet conditions precedent to partnership formation.[32] First, the Letter Agreement required the execution of "definitive agreements memorializing the terms and conditions of the Transaction."[33] Second, the Letter Agreement required that these definitive agreements receive each party's "respective board approvals."[34] The court concluded that because these conditions were unmet and ETP did not prove waiver of these conditions, ETP could not recover.[35] The Supreme Court of Texas granted ETP's petition for review.[36]

The Supreme Court of Texas agreed with the Court of Appeals' conclusion that the Letter Agreement imposed two unmet conditions precedent to the formation of a partnership between ETP and Enterprise, and that ETP failed to establish any waiver of these conditions.[37]

The Supreme Court of Texas began its analysis with TBOC § 152.051(b), providing "an association of two or more persons to carry on a business for profit as owners creates a partnership, regardless of whether: (1) the persons intended to create a partnership; or (2) the association is called a 'partnership,' 'joint venture' or other name."[38] The Court then discussed the non-exclusive factors indicating partnership formation under TBOC § 152.052(a),[39] emphasizing "'expression of

24 *Id*.
25 *Id*.
26 *Id*.
27 *Id*.
28 *Id*.
29 *Id*.
30 *Id*.
31 *Id*.
32 *Id*.
33 *Id*.
34 *Id*.
35 *Id*. at 736-37.
36 Energy Transfer Partners, L.P. v. Enter. Prods. Partners, L.P., 593 S.W.3d 732, 737 (Tex. 2020).
37 *Id.* at 742.
38 *Id*. at 737.
39 TBOC § 152.052(a) ("Factors indicating that persons have created a partnership include the persons': (1) receipt of right to receive a share of profits of the business; (2) expression of an intent to be partners in the business; (3)

an intent to be partners in the business' is just one factor within the totality-of-the-circumstances test."[40] The Court highlighted the reality that pursuant to TBOC § 152.051(b), "persons can create a partnership regardless of whether they intend to."[41] However, the Court then referenced *Ingram v. Deere*,[42] where it expressed skepticism that the Legislature "intended to spring surprise or accidental partnerships on independent business persons."[43]

The Court turned to TBOC § 152.003, asserting, "[t]he principles of law and equity" are properly considered in the partnership-formation analysis.[44] The Court reasoned the "well-developed body of common law" strongly supporting parties' freedom of contract, "decades older than the TBOC or its predecessor statute," should govern.[45] In support of this notion, the Court emphasized, "perhaps no principle of law is as deeply engrained in Texas jurisprudence as freedom of contract."[46]

Finally, the Court held parties can contract for conditions precedent to preclude the unintentional formation of a partnership because the Legislature did not intend parties to end up in surprise or accidental partnerships and TBOC § 152.003 expressly authorizes "principles of law and equity" such as freedom of contract to supplement the partnership-formation analysis.[47]

The Court concluded, as a matter of law, ETP and Enterprise did not create a partnership because the conditions precedent in their contract remained unmet.[48] The Court went on the hold these conditions precedent could be waived or modified by word or deed of the party to whom the obligation was due.[49] However, ETP did not provide any evidence that Enterprise specifically disavowed or acted inconsistently with the Letter Agreement's requirement of definitive, board-of-directors-approved agreements.[50] Therefore, ETP provided no evidence of waiver of the conditions precedent.[51]

participation or right to participate in the control of the business; (4) agreement to share or sharing: (A) losses of the business; or (B) liability for claims by third parties against the business; and (5) agreement to contribute or contributing money or property to the business.").

40 *Energy Transfer Partners, L.P.*, 593 S.W.3d at 737.

41 *Id*. at 737-38 and nn.12 & 13 (noting comment 1 to the Revised Uniform Partnership Act § 202(a), serving as the basis for the relevant TBOC provisions, provides parties "may inadvertently create a partnership despite their expressed subjective intention not to do so.").

42 Ingram v. Deere, 288 S.W.3d 886 (Tex. 2009).

43 *Energy Transfer Partners, L.P.*, 593 S.W.3d at 738.

44 *Id*.

45 *Id*.

46 *Id*. at 740.

47 *Id*.

48 *Id*.

49 *Id*. at 741.

50 *Id*.

51 *Id*. at 742.