

2019

## Partnership Law

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### Recommended Citation

Matthew Schindel et al., *Partnership Law*, 5 SMU ANN. TEX. SURV. 273 (2019)  
<https://scholar.smu.edu/smuatxs/vol5/iss1/12>

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# PARTNERSHIP LAW

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## I. INTRODUCTION

Over the Survey period, Texas courts presided over cases that further refined the realm of partnership law. Courts were generally strict inter-

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preters of statutes, dissecting and focusing on the language of the law. Courts highlighted the need to focus on the basics, be it on contract formation, documentation of contributions, or corporate formalities. Courts further stressed the importance in adhering to the exact statutory language (including defining the continuity of ownership status), a type of judgment—for or against a partnership—and even what constitutes a person. These details can have a drastic effect on the distributions, liability, or the very existence of the entity. Practitioners must heed the warnings of these cases as they strive to carefully study and respect statutory requirements, ensuring that their clients' positions are furthered and not lost. This article is divided into four sections that will discuss partnership law cases concerning (1) partnership formation and profit share allocations; (2) veil piercing; (3) personal liability of a venture; and (4) derivative suit standing.

## II. PARTNERSHIP FORMATION AND RECORD KEEPING REQUIREMENTS

### A. PARTNERSHIP FORMATION AND TERM SHEETS

*Rainier Southlake DST v. Woodbury Strategic Partners Fund, LP*<sup>1</sup> presents a reminder of the requirements for an enforceable term sheet and its use in proving the formation of a partnership. Rainier Southlake DST (Rainier) purchased a twenty-one building portfolio in Southlake, Texas, with a \$15,400,000.00 loan from Midland Loan Services (Midland) on which Rainier later defaulted.<sup>2</sup> Rainier began negotiating with Midland to restructure the loan by discounting the outstanding principal balance, and by Quarter Circle Capital investing in the loan collateral.<sup>3</sup> Quarter Circle Capital identified Woodbury Strategic Partners Fund, L.P., as a potential investor to purchase the loan at a discounted price for a preferred return (together with Quarter Circle Capital, the Investors).<sup>4</sup>

The Investors sent a term sheet to Rainier that set out the terms for purchase of the loan on February 15, 2012.<sup>5</sup> The term sheet stated that the deadline for Rainier to accept was February 17, 2012; otherwise, it would automatically be voided.<sup>6</sup> The Investors signed the term sheet and so did Rainier; however, Rainier never returned the term sheet to the Investors as required, and after signing Rainier proceeded to make material changes to certain provisions.<sup>7</sup>

Rainier also began negotiating with another entity and sent Midland a different proposed term sheet with the new party.<sup>8</sup> Due to the multiple,

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1. No. 02-16-99263, 2017 WL 6047725, at \*7-9 (Tex. App.—Fort Worth 2017, no pet.).

2. *Id.* at \*1.

3. *Id.*

4. *Id.*

5. *Id.*

6. *Id.* at \*1-2.

7. *Id.* at \*2.

8. *Id.* at \*3.

unsettled deals, Midland decided to sell the loan at an auction.<sup>9</sup> The Investors purchased the loan through a subsidiary and Rainier sued, alleging that the term sheet constituted a partnership agreement between Rainier and the Investors that imposed fiduciary duties on the Investors that were breached by the sale.<sup>10</sup>

The Fort Worth Court of Appeals first analyzed the term sheet under contract formation principles.<sup>11</sup> The court held that when Rainier failed to accept by the deadline (i.e., did not return the term sheet) the power of acceptance terminated.<sup>12</sup> Even if the deadline had not lapsed, there was no acceptance later because the term sheet was materially altered by Rainier; it was a counteroffer and not an acceptance of the term sheet.<sup>13</sup> This was a particularly influential factor because Rainier was the one trying to enforce the term sheet. Thus, there was no delivery and no acceptance, so the term sheet was not an enforceable contract.<sup>14</sup>

The court next looked at whether a partnership was formed. A written partnership agreement is not required to form a partnership.<sup>15</sup> Instead, the Texas Business Organizations Code (TBOC) Section 152.052(a) sets out five factors which, viewed in light of the totality of the circumstances, determine if a partnership exists: (1) a right to share in the profits; (2) intent to be partners; (3) participation in the control of the business; (4) agreement to share losses or liabilities; and (5) agreement to contribute money or property.<sup>16</sup> Since the term sheet was unenforceable, it could not be used to prove any of the partnership factors.<sup>17</sup> For example, for the right to share in the profits factor, while the term sheet did set out a profit split, it could not be used as evidence of an agreement to share profits.<sup>18</sup> Similarly, the term sheet was not evidence of an intent to be partners because it was unenforceable.<sup>19</sup> Rainier could not use the term sheet to show an agreement to contribute money or property to the business either.<sup>20</sup> Nor was deposition testimony by the investors about anticipated or projected contributions evidence, as such contributions did not

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9. *Id.*

10. *Id.*

11. *Id.* at \*5 (citing *Brown v. Sabre, Inc.*, 173 S.W.3d 581, 588 (Tex. App.—Fort Worth 2005, no pet.)).

12. *Id.* at \*6.

13. *Id.*

14. *See id.* at \*7.

15. *See id.* (citing *Ingram v. Deere*, 288 S.W.3d 886, 891 (Tex. 2009)).

16. *Id.*; TEX. BUS. ORGS. CODE ANN. § 152.052(a) (“(a) Factors indicating that persons have created a partnership include the persons’: (1) receipt or right to receive a share of profits of the business; (2) expression of an intent to be partners in the business; (3) participation or right to participate in 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.”). Rainier did not argue factors three and four, as there was no evidence to support either, and the term sheet explicitly negated any control by Rainier. *Rainier Southlake DST*, 2017 WL 6047725, at \*9.

17. *See Rainier Southlake DST*, 2017 WL 6047725, at \*7–9.

18. *Id.* at \*8.

19. *Id.*

20. *Id.* at \*9.

show actual agreement.<sup>21</sup> The court also noted that Rainier providing confidential information and due diligence to the Investors during deal negotiations was not evidence of an agreement to contribute.<sup>22</sup> Therefore, viewing the totality of the circumstances, the court held that there was no partnership.<sup>23</sup>

This case makes clear the threshold requirements for all of those looking to create an enforceable term sheet and to use a term sheet to satisfy the partnership factors. A term sheet must be accepted according to traditional contract principles (i.e., signed by both parties and delivered). Practitioners should be careful to obey all contract formation principles to ensure an effective term sheet if they intend to rely solely on that term sheet as proof of a partnership. Practitioners must be equally careful if they do not want a term sheet to be enforceable and should so provide specifically in the term sheet.

#### B. PARTNERSHIP RECORD-KEEPING REQUIREMENTS AND PROFIT-SHARE ALLOCATION

In *Sohani v. Sunesara*,<sup>24</sup> the First Houston Court of Appeals outlined the requirements for determining a member's share of the profits of a limited liability company. Partners Anis Virani (Virani) and Nizar Sunesara (Sunesara) sold smoking accessories and devices, first at flea markets then in a stand-alone store called Zig Zag Smoke Shop (Zig Zag) starting in 2003, of which Virani was general manager.<sup>25</sup> Manisch Sohani (Sohani) owned a general merchandise wholesale business, Mike's Worldwide Imports (MWI), and was one of the vendors for Virani and Sunesara, contributing inventory to Zig Zag on credit.<sup>26</sup> In exchange, Virani and Sunesara offered Sohani an ownership share of Zig Zag and agreed to split the profits three ways.<sup>27</sup> By 2008, Sunesara was no longer involved in the daily operations of Zig Zag and was instead serving as chief financial officer of MWI.<sup>28</sup> Virani also worked for MWI but still managed Zig Zag.<sup>29</sup> In 2012, Sunesara and Virani opened a second location, Burn Smoke Shop (Burn I), with Sohani contributing inventory.<sup>30</sup> Later that year, when another smoke shop decided to sell its business, Sunesara, Virani, and Sohani acquired it, opening Burn Smoke Shop Two (Burn II).<sup>31</sup>

In 2007, Sunesara incorporated SSV Corporation (SSV), which owned

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21. *Id.*

22. *Id.*

23. *Id.* at \*10.

24. 546 S.W.3d 393, 407 (Tex. App.—Houston [1st Dist.] 2018, no pet.).

25. *Id.* at 396.

26. *Id.*

27. *Id.* at 396–97.

28. *Id.* at 397.

29. *Id.*

30. *Id.*

31. *Id.*

the assets of Zig Zag and later Burn I.<sup>32</sup> Sunesara and Virani each owned fifty percent of SSV, but monthly profits were split equally between Sunesara, Virani, and Sohani.<sup>33</sup> Before acquiring Burn II, Sohani and Virani asked Sunesara to form limited liability companies for each of the smoke shops.<sup>34</sup> Sunesara signed the certificates of formation for each LLC and filed them with the Texas Secretary of State, listing himself, Virani, and Sohani as members of each LLC.<sup>35</sup> Sunesara also set up bank accounts for each of the LLCs.<sup>36</sup> Sunesara, Virani, and Sohani all signed the signature cards as members.<sup>37</sup> Virani testified that he did not see the certificates before filing and instructed Sunesara that only Virani and Sohani would be the owners of the LLCs, and that Sunesara should not have been listed as a member.<sup>38</sup>

In 2013, Virani and Sohani realized that the LLCs needed operating agreements.<sup>39</sup> Soon after, Virani and Sohani drafted and signed operating agreements for each of the LLCs.<sup>40</sup> The agreements included only Virani and Sohani as members and listed each as having made fifty percent of the contributions and owning fifty percent of the profits and assets.<sup>41</sup> Sunesara claimed to be a member of each LLC, testified that he contributed \$10,000 to both Burn I and Burn II, and agreed to deferred profits until the inventory from MWI was paid off. However, there was no receipt or record of his contribution or the profit sharing arrangement.<sup>42</sup> Virani testified that Sunesara did not contribute anything to Burn I, Burn II, or Zig Zag.<sup>43</sup> Virani and Sohani filed suit, claiming that Sunesara improperly listed himself as a member of the LLCs and was not entitled to any share of the LLCs' profits.<sup>44</sup>

The TBOC defines a member as someone admitted under the governing documents of the LLC.<sup>45</sup> Members are not required to make contributions;<sup>46</sup> however, all entities are required to keep "books and records

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32. *Id.* at 398.

33. *Id.*

34. *Id.*

35. *Id.*

36. *Id.*

37. *Id.*

38. *Id.* at 398–99.

39. *Id.* at 400.

40. *Id.*

41. *Id.*

42. *Id.* at 397.

43. *Id.*

44. *Id.* at 400.

45. *Id.* at 404; *see also* TEX. BUS. ORGS. CODE ANN. § 1.002(53)(A) (“(53) ‘Member’ means: (A) in the case of a limited liability company, a person who is a member or has been admitted as a member in the limited liability company under its governing documents”).

46. *Sohani*, 546 S.W.3d at 405; *see also* TEX. BUS. ORGS. CODE ANN. § 101.102(b)(1) (“(b) A person is not required, as a condition to becoming a member of or acquiring a membership interest in a limited liability company, to: (1) make a contribution to the company”).

of accounts”<sup>47</sup> and LLCs must include a written account of “the amount of a cash contribution and a description and statement of the agreed value of any other contribution made or agreed to be made by each member.”<sup>48</sup> The TBOC provides that absent a written partnership agreement that sets out the members’ share of profits and losses, the LLC profits and losses are allocated to each member based on the agreed value of members’ contributions as shown in the LLCs’ records.<sup>49</sup>

The court interpreted these sections as a requirement to keep written records of contributions.<sup>50</sup> Absent a written partnership agreement that lays out ownership percentages, such contribution records establish each member’s share of profits and losses.<sup>51</sup> In this case, because there was no specific writing or documentary evidence of the members’ contributions or Sunesara’s profit share, the court held that he was not entitled to a share of the LLCs’ profits.<sup>52</sup> Oral testimony of Sunesara’s contributions alone was insufficient.<sup>53</sup> Nor could the tax records of previous entities showing Sunesara’s profit shares serve as evidence of the LLC records, as records do not carry over between new entities.<sup>54</sup>

This case serves as a warning. The partnership agreement determines members’ percentage interests. Absent a written partnership agreement that specifically states members’ ownership interests, however, profit and loss shares are based on capital contributions. Thus, such contributions must be carefully documented. If members cannot prove their capital contributions, then they will receive no shares of the profits. Counsel should ensure that steps are taken to adequately document each member’s share of an LLC’s profits.

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47. *Sohani*, 546 S.W.3d at 405 (citing TEX. BUS. ORGS. CODE ANN. § 3.151(a) (“(a) Each filing entity shall keep: (1) books and records of accounts”)).

48. *Id.* (citing TEX. BUS. ORGS. CODE ANN. § 101.501(a)(7) (“(a) In addition to the books and records required to be kept under Section 3.151, a limited liability company shall keep at its principal office in the United States, or make available to a person at its principal office in the United States not later than the fifth day after the date the person submits a written request to examine the books and records of the company under Section 3.152(a) or 101.502: . . . (7) except as provided by Subsection (b), a written statement of: (A) the amount of a cash contribution and a description and statement of the agreed value of any other contribution made or agreed to be made by each member; (B) the dates any additional contributions are to be made by a member; (C) any event the occurrence of which requires a member to make additional contributions; (D) any event the occurrence of which requires the winding up of the company; and (E) the date each member became a member of the company.”)).

49. *Id.* (citing TEX. BUS. ORGS. CODE ANN. § 101.201 (“ALLOCATION OF PROFITS AND LOSSES. The profits and losses of a limited liability company shall be allocated to each member of the company on the basis of the agreed value of the contributions made by each member, as stated in the company’s records required under Section 101.501.”)).

50. *Id.* at 407.

51. *Id.*

52. *Id.*

53. *Id.*

54. *Id.* at 407–08.

## III. VEIL PIERCING

## A. REVERSE VEIL PIERCING TO RECOVER FOR MEMBER'S FRAUD

In *Clement v. Blackwood*, the Eastland Court of Appeals considered whether a partnership was liable for a husband and wife's fraudulent actions related to the partnership's cattle operation.<sup>55</sup> Kyle and Valerie Clements (the Clements) convinced David and Sharon Blackwood (the Blackwoods) to invest in a cattle and ranching operation operated by Rimrock Land & Cattle Co., LLC (Rimrock), leading them to expect a twenty percent return on their investment.<sup>56</sup> It was orally agreed that the Blackwoods would provide capital and the Clements would operate the business through Rimrock.<sup>57</sup> However, after the Blackwoods' capital contribution was deposited into Rimrock's account, the Clements used much of that money for personal use and the management of Clement Cattle Co. L.L.C., (Clement Cattle), the Clements' family company.<sup>58</sup> Later, Kyle Clements convinced David Blackwood to lend him an additional \$240,000 to avoid foreclosure on the Clements' ranch, which was owned by Clement Cattle, promising a quick and valuable return after all of the cattle on the ranch were sold.<sup>59</sup> However, when the cattle were sold and the business of Rimrock ended, the Blackwoods received very little return, and suffered a loss of approximately \$750,000, including the loan which the Clements said they could not repay.<sup>60</sup>

The Blackwoods filed suit alleging several causes of action, including fraud, conversion and misappropriation, and alter ego.<sup>61</sup> The Blackwoods argued that they should be able to recover damages from the assets of Clement Cattle, which included a personal cattle herd and the Clements' ranch that the Blackwoods' loan saved from foreclosure.<sup>62</sup> The jury found, and the court of appeals affirmed, that the Clements committed fraud against the Blackwoods in securing the investment in Rimrock and the loan to Clement Cattle.<sup>63</sup> Further, the jury found that the Clements were personally responsible for the conduct of Clement Cattle and Rimrock under the theory of alter ego.<sup>64</sup>

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55. *Clement v. Blackwood*, No. 11-16-00087-CV, 2018 WL 826856, at \*4 (Tex. App.—Eastland 2018, pet. denied).

56. *Id.* at \*1.

57. *Id.*

58. *Id.*

59. *Id.* at \*2.

60. *Id.*

61. *Id.*

62. *Id.*

63. *Id.* at \*4–5. The court of appeals held that there was sufficient evidence to show (1) the Clements intended to perpetrate a fraud when they induced the Blackwoods to invest in Rimrock; (2) the Clements did not intend to use the Blackwoods' capital contribution as promised; and (3) the loan was secured through fraudulent misrepresentations that David Blackwood relied on to his detriment. *Id.*

64. *Id.* at \*3. A court will disregard a corporate fiction on the basis of alter ego if there is such a "unity" between an entity and an individual that the entity's "separateness has ceased." See *Doyle v. Kontemporary Builders, Inc.*, 370 S.W.3d 448, 458 (Tex. App.—Dallas 2012, pet. denied).



The court considered whether there was sufficient evidence to support the jury's finding that Clement Cattle was an alter ego of the Clements that could be held liable for the Clements' fraud.<sup>65</sup> Under Texas law, the traditional veil piercing doctrine can be applied in reverse to hold a company's assets accountable for the debts of individuals who treated that company as their alter-ego.<sup>66</sup> In making this determination, the court will consider the entity's "total dealings" with the individual, which includes the amount of control the individual exercises over the entity and the degree of financial interest and ownership, among other considerations.<sup>67</sup> In addition, to pierce the company's liability shield there must be evidence that the individuals perpetrated actual fraud which "directly and personally benefitted" the individuals.<sup>68</sup>

Clement Cattle and the Clements argued that the Blackwoods could not recover damages from Clement Cattle's assets because those assets belonged to the company, not the Clements as individuals. They reasoned that there was not enough evidence to pierce the corporate veil because the Clements did not receive a direct benefit from the fraud. They additionally insisted that the only benefit the Clements received—avoiding foreclosure on the ranch and continuing to live on it—was incidental and not sufficient to establish a direct benefit because it was "akin to a shareholder receiving property or a corporation reducing its debt."<sup>69</sup>

The court rejected this argument, noting a significant distinction. In this case, the purpose of Clement Cattle was to own the family ranch for the personal use of Clements and not for a business purpose. Additionally, the assets of the company were all used for personal reasons. In light of this high degree of personal use, the court found that the benefit of living and running a business on the ranch was in no way incidental, it was the sole purpose of the entity's creation. Therefore, all of the money that Clement Cattle received from the Blackwoods' investments directly benefitted the Clements. The court held that this was sufficient evidence that the Clements' fraud resulted in a direct, personal benefit to the Clements. Thus, the court of appeals affirmed the trial court's decision to allow the Blackwoods to recover damages from Clement Cattle's assets.<sup>70</sup>

Here, the court sharply rejected a married couple's attempt to hide behind the limited liability shield to escape liability for fraud. Further, it

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65. *Clement*, 2018 WL 826856, at \*5. The Clements did not challenge the finding that Rimrock was their alter-ego. *Id.*

66. *Id.* (citing *Wilson v. Davis*, 305 S.W.3d 57, 70–71 (Tex. App.—Houston [1st Dist.] 2009, no pet.); *Dillingham v. Dillingham*, 434 S.W.2d 459, 462 (Tex. Civ. App.—Fort Worth 1968, writ dismissed)).

67. *Id.* at \*5 (citing *Seghers v. El Bizri*, 513 F. Supp. 2d 694, 703 (N.D. Tex. 2007) (applying Texas law)).

68. *Id.* at \*6; TEX. BUS. ORGS. CODE ANN. § 21.223(b).

69. *Clement*, 2018 WL 826856, at \*6; see *Solutioneers Consulting Ltd. v. Gulf Greyhound Partners, Ltd.*, 237 S.W.3d 379, 388–89 (Tex. App.—Houston [14th Dist.] 2007, pet. dismissed); *Scott v. McKay*, No. 12-02-00195-CV, 2003 WL 21998629, at \*2 (Tex. App.—Tyler Aug. 20, 2003, no pet.) (mem. op.).

70. *Clement*, 2018 WL 826856, at \*6; see *Solutioneers Consulting Ltd.*, 237 S.W.3d at 388–89; *Scott*, 2003 WL 21998629, at \*2.

highlighted a distinction between a legitimate incidental benefit a shareholder receives and the direct benefit an individual receives from an entity that is created for no purpose other than to serve that individual's interests. An individual should be aware that the limited liability shield of a partnership is not absolute, especially when the partnership is created to directly benefit an individual perpetrating a fraud.

B. PIERCING THE VEIL OF AFFILIATED ENTITIES  
WITH CENTRALIZED CONTROL

In *U.S. KingKing, LLC v. Precision Energy Services, Inc.*, the First Houston Court of Appeals considered whether a member of a limited liability company could be held liable for the limited liability company's debts because the two entities were under centralized control, had a mutual purpose, and shared finances.<sup>71</sup> Amerril Energy, LLC (Amerril) acted as operator on an oil and gas lease held by U.S. KingKing, LLC (King).<sup>72</sup> King was a member of Amerril.<sup>73</sup> In connection with the well operation, Amerril took out a line of credit with several suppliers of goods and services (collectively, Weatherford) and identified King as Amerril's "principal owner" on its credit application.<sup>74</sup> When the well was unsuccessful, Amerril failed to pay Weatherford for labor performed and materials furnished.<sup>75</sup>

Weatherford sued Amerril for breach of contract and fraud, and also sought to hold King liable for Amerril's obligations under an alter ego theory.<sup>76</sup> Weatherford alleged that King purposely perpetrated actual fraud by creating Amerril "as a shell entity with no control of any funds" and "by failing to disclose the extent of King's control."<sup>77</sup>

In its motion for summary judgment on the alter ego issue, Weatherford relied on depositions from former employees of King and Amerril that claimed: (1) King was the subsidiary of a corporation that also controlled Amerril's bank account; (2) Amerril's funds were "filtered" through King so that Amerril "had actually no local control"; (3) King and Amerril had the same mailing address, with offices in different suites; (4) the two companies shared two officers; (5) one employee of Amerril helped prepare King's tax returns; and (6) King "contributed" properties to Amerril for no consideration.<sup>78</sup> King did not file a response to Weatherford's motion, and the trial court granted summary judgment.<sup>79</sup> King then moved for a new trial, claiming that, among other things, Weather-

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71. *U.S. KingKing, LLC v. Precision Energy Servs., Inc.*, 555 S.W.3d 200, 214 (Tex. App.—Houston [1st Dist.] 2018, no pet.).

72. *Id.* at 204.

73. *Id.*

74. *Id.* at 204–05.

75. *Id.* at 205.

76. *Id.* at 206.

77. *Id.*

78. *Id.* at 207–09.

79. *Id.* at 209.

ford failed to meet its burden to establish that Amerril was King's alter ego.<sup>80</sup>

On appeal, the court began with the principle that parties are not "jointly liable for a [partnership's] obligations merely because they were part of a single business enterprise that is, merely because of centralized control, mutual purposes, and shared finances."<sup>81</sup> Thus, in considering whether Weatherford conclusively established that Amerril was the alter ego of King, the court assessed the relationship between the entities, using several factors, to determine whether there was evidence of abuse of Amerril's corporate structure.<sup>82</sup> The court noted that, while there was evidence of shared control and finances, the Texas Supreme Court had held that the "[c]reation of affiliated corporations to limit liability while pursuing common goals lies firmly within the law and is commonplace."<sup>83</sup> Moreover, "courts have 'never held corporations liable for each other's obligations merely because of centralized control, mutual purposes, and shared finances.'"<sup>84</sup>

Considering this, the court held that the evidence Weatherford presented at summary judgment was not sufficient to establish alter ego.<sup>85</sup> First, the fact that the companies shared a mailing address was outweighed by the fact that they had different business names and maintained offices in different suites.<sup>86</sup> Second, while there was evidence of one employee of Amerril performing administrative tasks for King, this was outweighed by the fact that this was the only instance of such conduct, and there was no evidence that either entity paid the wages of employees of the other entity.<sup>87</sup> Therefore, there was not sufficient evidence to establish Weatherford's claim that Amerril's employees were routinely handling the duties of the King.<sup>88</sup> Finally, contrary to Weatherford's claims of "undocumented transfers of funds" between the two entities, the contribution of assets from one entity to the other for purposes related to the common enterprise were well documented, and no evidence was presented that suggested this practice was routine.<sup>89</sup> Thus, there was no evidence that King was improperly using any funds that Amerril col-

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80. *Id.* at 210–11. At trial, Weatherford had the burden to prove that "no genuine issues of material fact" existed and to "conclusively prove all essential elements of its claim." TEX. R. CIV. P. 166a(c); *Cleveland v. Taylor*, 397 S.W.3d 683, 696–97 (Tex. App.—Houston [1st Dist.] 2012, pet. denied).

81. *U.S. KingKing*, 555 S.W.3d at 213 (citing *Tryco Enters.*, 390 S.W.3d 497, 508 (Tex. App.—Houston [1st Dist.] 2012, pet. dismissed) (internal quotations omitted)).

82. *Id.* at 213–14 (These factors include "the degree to which corporate and individual property have been kept separate, the amount of financial interest, ownership, and control the individual maintains over the corporation, and whether the corporation has been used for personal purposes.") (citing *Tryco Enters.*, 390 S.W.3d at 508).

83. *Id.* at 215 (internal quotations omitted); *SSP Partners v. Gladstrong Invs. Corp.*, 275 S.W.3d 444, 455 (Tex. 2008).

84. *U.S. KingKing*, 555 S.W.3d at 215; *SSP Partners*, 275 S.W.3d at 455.

85. *U.S. KingKing*, 555 S.W.3d at 216–17.

86. *Id.* at 215.

87. *Id.*

88. *Id.*

89. *Id.* at 215–16.

lected.<sup>90</sup> Therefore, the court held that Weatherford had not established, as a matter of law, that Amerril was the alter ego of King.<sup>91</sup>

This case offers a detailed application of the rule that centralized control, mutual purpose, and shared finances, on their own, do not constitute alter ego for the purposes of piercing a partnership's/LLC's limited liability shield. This is a helpful reminder for those counseling two entities that share a common business purpose to be cautious in maintaining corporate formalities. Having different names, offices, and employees can help a member avoid claims that it is the alter-ego of its partnership. Further, counsel should advise clients to document all transfers of funds between two commonly owned entities and to only use funds in line with their common purpose.

#### IV. PERSONAL LIABILITY OF A MEMBER

##### A. LIABILITY FOR ACTIVE PARTICIPATION THAT VIOLATES REGULATIONS

In *State v. Morello*, the Texas Supreme Court considered whether a limited liability company can shield its members from liability for a violation of environmental regulations that apply to persons in their individual capacities.<sup>92</sup> Bernard Morello (Morello) entered into a contract to buy land that was subject to a hazardous waste permit and compliance plan issued by the predecessor to the Texas Commission on Environmental Quality (TCEQ) because of groundwater contamination.<sup>93</sup> After discovering the contamination, but before acquiring the property, Morello formed White Lion Holdings, L.L.C. (White Lion) to acquire title to the land.<sup>94</sup> At closing, the seller transferred the property, along with the permit and compliance plan, directly to White Lion, and TCEQ approved the transfers.<sup>95</sup> In the two years after White Lion's acquisition of the land, TCEQ sent multiple notices to White Lion and Morello of violations of the compliance plan, including failure to (1) perform groundwater monitoring programs; (2) comply with reporting requirements; and (3) provide assurance of financial capability to fulfill the compliance plan.<sup>96</sup>

The State of Texas (State) filed suit against White Lion and later added Morello as a defendant, alleging failure to comply with the compliance plan.<sup>97</sup> After the trial court granted summary judgment against White Lion, the State moved for summary judgment against Morello, alleging that because Morello was personally involved with the operation and management of the property, he was also liable for the violation of the

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90. *Id.* at 216.

91. *Id.* at 216–17.

92. *State v. Morello*, 547 S.W.3d 881, 885 (Tex. 2018).

93. *Id.* at 883.

94. *Id.*

95. *Id.*

96. *Id.*

97. *Id.*

same permit under the Texas Water Code (Water Code).<sup>98</sup> The trial court granted the motion for summary judgment and awarded civil penalties against Morello, but the Austin Court of Appeals reversed.<sup>99</sup> The State appealed to the supreme court, arguing that the plain language of the Water Code shows the legislature intended for individuals, not just corporations, to be liable for environmental violations.<sup>100</sup> On appeal, Morello argued that he could not be held liable because TBOC Section 101.114 says that a member or manager of a company is not personally liable for a debt, obligation, or liability of the company.<sup>101</sup>

The supreme court began by examining the language of the Water Code. Section 7.101 of the Water Code provides that a “person may not cause” a violation of a TCEQ statute or permit, and Section 7.102 provides for civil penalties against “[a] person who causes” a violation of a TCEQ statute or permit.<sup>102</sup> The code does not define the word “person.”

First, in considering what the term “person” meant in this context, the supreme court looked to the rules of grammar and common usage, and rejected Morello’s attempt to use the same defined term from another statute.<sup>103</sup> The supreme court held that the term “person” in the Water Code includes individuals, along with corporations, organizations, and other legal entities, because the definition did not expressly exclude individuals and the common usage of the term references an individual.<sup>104</sup> Thus, the State could assess a penalty against Morello as an individual.<sup>105</sup> Second, the supreme court held that nothing in the Water Code limited the State from assessing a penalty against both White Lion and Morello, because the section broadly referred to “a” person and did not restrict the scope of liability to “the” one person responsible for the violation.<sup>106</sup>

Next, the supreme court considered whether the language used in the Water Code applied to Morello’s personal actions. Morello argued that it didn’t, insisting that he was only acting as an agent of White Lion.<sup>107</sup> The supreme court rejected this argument and analogized this case to a previous supreme court decision, which held a corporate officer liable for personally participating in a violation of the Texas Deceptive Trade Practices

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98. *Id.* at 884.

99. *Id.*; see *Morello v. State*, 539 S.W.3d 330, 341 (Tex. App.—Austin 2016), *rev’d*, 547 S.W.3d 881 (Tex. 2018).

100. *Morello*, 547 S.W.3d at 885.

101. *Id.* (citing TEX. BUS. ORGS. CODE ANN. § 101.114).

102. *Id.* at 886; TEX. WATER CODE ANN. § 7.101-102.

103. *Morello*, 547 S.W.3d at 886 (citing *Cadena Commercial USA Corp. v. Tex. Alcoholic Beverage Comm’n*, 518 S.W.3d 318, 325 (Tex. 2017)). Morello argued that the definition of “person” from the Solid Waste Disposal Act (1) did not include individuals and (2) should apply in this case. However, the court refused to decide whether or not the Solid Waste Disposal Act definition applied because, either way, that definition did not expressly exclude individuals. See TEX. HEALTH & SAFETY CODE ANN. § 361.003(23).

104. *Morello*, 547 S.W.3d at 886 (citing *Black’s Law Dictionary* 1324 (10th ed. 2014) (defining “person” as “[a] human being”).

105. *Id.*

106. *Id.* at 886.

107. *Id.*

Act, even though he was acting in the scope of his employment.<sup>108</sup> The supreme court also took note that another Texas Court of Appeals had interpreted the legislative intent of the Water Code “to impose more stringent standards when dealing with hazardous waste disposal and to assure that each person be held accountable for his actions that violate the code.”<sup>109</sup> Further, the supreme court held that an officer cannot be shielded from liability as an agent where a statute applies directly to a “person” in their individual capacity.<sup>110</sup> Thus, the supreme court concluded that when an individual has personally participated in violative conduct under an environmental regulation applicable to a “person,” the corporate shield cannot protect that individual from personal liability for such conduct.<sup>111</sup>

The supreme court rebutted Morello’s other arguments and reasoned that Morello’s liability was not a “debt, obligation, or liability” that would be prohibited under the TBOC.<sup>112</sup> Instead, the liability was based on his “individual, personal” actions as officer of White Lion that caused the permit to be violated, including failure to comply with the reporting, monitoring and financial assurance requirements of the compliance plan, even after multiple notifications from TCEQ.<sup>113</sup> The supreme court reversed the court of appeals decision and held Morello liable for civil penalties under the Water Code.

The Texas Supreme Court’s decision in *Morello* significantly broadens the potential liability of members personally involved in the operations and management of a partnership that violates environmental regulations. Further, this case could provide precedent for future courts to disregard the shield from personal liability in a wide variety of other contexts. The statutory analysis that the court performed in *Morello* could easily translate to any other provision of the Texas code that provides for liability for a “person” and does not define that term to exclude individuals. Practitioners should be mindful of *Morello*’s holding and consider this case in a variety of contexts beyond the Water Code.

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108. *Miller v. Keyser*, 90 S.W.3d 712, 719–20 (Tex. 2002). The supreme court’s decision was also bolstered by two similar lower court cases and multiple federal court cases. *See Ex parte Canady*, 140 S.W.3d 845, 850–51 (Tex. App.—Houston [14th Dist.] 2004, no pet.) (concluding that employees of a company that paid an administrative penalty for Water Code violations could be prosecuted individually); *State v. Malone Serv. Co.*, 853 S.W.2d 82, 85 (Tex. App.—Houston [14th Dist.] 1993, writ denied) (concluding that the president and plant manager of a company could be held individually liable for Water Code violations even though they did not hold the permit); *see also Riverside v. Mkt. Dev. Corp. Int’l Bldg. Prods., Inc.*, 931 F.2d 327, 330 (5th Cir. 1991) (concluding that individuals could not hide behind the corporate shield when they “actually participate in the wrongful conduct”).

109. *Ex parte Canady*, 140 S.W.3d at 850–51.

110. *Morello*, 547 S.W.3d at 886–88.

111. *Id.* at 888.

112. *Id.* (citing TEX. BUS. ORGS. CODE ANN. § 101.114).

113. *Id.* at 888, 883.

## B. LIABILITY FOR DEBT INCURRED BEFORE CHARTER FORFEITURE

In *Haynes v. Gay*, the Dallas Court of Appeals considered an individual's liability for a partnership debt that was created prior to the forfeiture of the company's charter. Richard Gay (Creditor) filed a petition against Willie and Brita Haynes (Members) claiming that the Members owed him \$1,257.40 for breach of a property management agreement (Agreement), which had terminated on February 24, 2014, between Sky Group, LLC (Sky Group) and the Creditor.<sup>114</sup> At trial, evidence was presented that the Members were the sole members of Sky Group and that Sky Group had forfeited its certificate of charter with the state on August 7, 2015.<sup>115</sup> Creditor argued that because Sky Group's charter had been forfeited prior to his claim, the Members were personally liable for Sky Group's debt.<sup>116</sup> In response, the Members argued that they were not personally liable because (1) the contract was only with Sky Group and not the Members in their personal capacity; and (2) the contractual obligations arose before Sky Group's charter was forfeited.<sup>117</sup> The trial court found for Creditor, and the Members appealed.<sup>118</sup>

The court of appeals reversed the trial court's judgment, holding that the Members could not be held personally liable for Sky Group's debt.<sup>119</sup> While a member is generally shielded from personal liability for a limited liability company's debts, if the limited liability company's charter is forfeited, its members are liable for the debts incurred in Texas after the due date and before revival of the corporate privileges.<sup>120</sup> Further, "where a debt arises out of the performance or implementation of the provisions of a contract," courts have held that the debt is "created or incurred" on the date the parties entered into the contract.<sup>121</sup> Considering this, the court held that even though the date of the property management agreement was not apparent in the record, it was clear that the debt was "created or incurred" before the agreement terminated in February 2014.<sup>122</sup> Therefore, because the debt was "created or incurred" prior to the 2015 forfeiture of Sky Group's charter, the Members were protected by the shield of the limited liability company and could not be held personally liable for Sky Group's debt.

In *Haynes*, the Dallas Court of Appeals clarified when the limited liability shield of a limited liability company is effective. While the court

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114. *Haynes v. Gay*, No. 05-17-00136-CV, 2018 WL 774334 at \*1 (Tex. App.—Dallas 2018, no pet.).

115. *Id.*

116. *Id.*

117. *Id.*

118. *Id.*

119. *Id.* at \*2–3.

120. *Id.* at \*2; TEX. BUS. ORGS. CODE ANN. § 101.114; TEX. TAX CODE ANN. § 171.255(a).

121. *Haynes*, 2018 WL 774334, at \*2; *Rossmann v. Bishop Colo. Retail Plaza, L.P.* 455 S.W.3d 797, 804 (Tex. App.—Dallas 2015, pet. denied); *see also Hovel v. Batzri*, 490 S.W.3d 132, 138–44 (Tex. App.—Houston [1st Dist.] 2016, pet. denied).

122. *Haynes*, 2018 WL 774334, at \*2.

held that the liability shield was effective under the circumstances, the *Haynes* decision should serve to remind members of a limited liability company to fulfill all requirements under the TBOC to ensure that the charter of the limited liability company is not forfeited.

## V. DERIVATIVE SUIT STANDING

### A. DERIVATIVE SUIT STANDING OF LIMITED PARTNERS

*In re Marriage of Dilick*<sup>123</sup> explored the limits of limited partner standing to bring a derivative claim on behalf of a partnership. Jay Cohen (Cohen) and Matthew Dilick (Dilick) formed three limited partnerships to develop certain real property owned by Cohen. Dilick owned nineteen percent of each partnership as a limited partner and one percent of each partnership as the general partner and Cohen owned eighty percent of each partnership as a limited partner.<sup>124</sup> In 2010, Cohen sued Dilick derivatively on the partnerships' behalf, alleging misuse of partnership assets.<sup>125</sup> Cohen accused Dilick of improperly using partnership assets for Dilick's personal benefit.<sup>126</sup> Before the case went to trial, the partnerships filed for bankruptcy and a bankruptcy trustee was appointed for the partnerships (Trustee), who took over Cohen's claims and instituted an adversary proceeding.<sup>127</sup> Concurrently, Dilick was in the midst of a divorce.<sup>128</sup> The Trustee intervened in the divorce case to preserve the partnership property that was community property and to prevent the divorce judgment from unfavorably impacting the adversary proceeding.<sup>129</sup> The Trustee alleged that partnership property was used as collateral to acquire loans in violation of the Texas Uniform Fraudulent Transfers Act (TUFTA).<sup>130</sup> Dilick counterclaimed under TUFTA for attorneys' fees for the Trustee's petition in intervention.<sup>131</sup> The Trustee settled with Mrs. Dilick and a final order nonsuiting the Trustee's claims was entered, but the divorce court left outstanding Dilick's claim for attorneys' fees under TUFTA.<sup>132</sup> Three months later, the court entered an order awarding Dilick \$123,000 in attorneys' fees.<sup>133</sup> The Trustee appealed the award, but before perfecting the appeal the partnerships' bankruptcy proceedings were dismissed.<sup>134</sup> On the appeal of the attorneys' fees award, Dilick argued that the Trustee lost standing when the bankruptcy cases were dismissed.<sup>135</sup> Cohen sought to be substituted for the Trustee as a limited

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123. 550 S.W.3d 766, 772 (Tex. App.—Houston [14th Dist.] 2018, pet. denied).

124. *Id.*

125. *Id.* at 769.

126. *Id.*

127. *Id.*

128. *Id.*

129. *Id.* at 769–70.

130. *Id.* at 770.

131. *Id.*

132. *Id.*

133. *Id.* at 770–71.

134. *Id.* at 771.

135. *Id.*



partner bringing suit on behalf of the partnerships or alternatively to intervene in the appeal by virtual representation.<sup>136</sup>

The Fourteenth Houston Court of Appeals found that there was no authority to support that a Trustee lacks standing to appeal a judgment signed when the Trustee did have standing.<sup>137</sup> However, the court did not rule on this issue because, regardless, Cohen lacked standing to substitute for the Trustee.<sup>138</sup> Limited partners do not have standing to assert claims that belong to the partnership.<sup>139</sup> The TBOC, however, allows a limited partner to sue on behalf of a partnership to recover a judgment in the partnership's favor if the general partner refuses or is unlikely to do so.<sup>140</sup> Crucially the court distinguished this case, noting that Cohen was trying to appeal a judgment *against* the partnership not recover one in its favor.<sup>141</sup> Thus, Cohen could not substitute in the appeal since the statutory requirements were not met.<sup>142</sup>

Nor could Cohen appeal under virtual representation.<sup>143</sup> The first requirement of virtual representation is that the party be bound by the judgment.<sup>144</sup> A key aspect of a limited partnership, however, is that limited partners are not liable for the obligations of the partnership.<sup>145</sup> As a limited partner, therefore, Cohen was not bound by the judgment against the partnership and so could not assert virtual representation.

Here, the court limited a limited partner's standing to bring a derivative suit. The court interpreted the TBOC to only allow limited partners to appeal judgments against the partnership, differentiating appeals in favor of the partnership. The court similarly interpreted the doctrine of virtual representation to eliminate standing because limited partners cannot be bound by a judgment. Limited partners should be aware of the narrow category of appeals for which they have derivative standing and include provisions in the governing documents of their partnership that

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136. *Id.*

137. *Id.* at 772.

138. *Id.*

139. *Id.* at 773 (citing, as applied to appellate standing, *Spates v. Office of Attorney Gen.*, 485 S.W.3d 546, 550–51 (Tex. App.—Houston [14th Dist.] 2016, no pet.)).

140. *Id.* at 773–74 (citing TEX. BUS. ORGS. CODE ANN. § 153.401 (“RIGHT TO BRING ACTION. A limited partner may bring an action in a court on behalf of the limited partnership to recover a judgment in the limited partnership's favor if: (1) all general partners with authority to bring the action have refused to bring the action; or (2) an effort to cause those general partners to bring the action is not likely to succeed.”)).

141. *Id.* at 774.

142. *Id.*

143. *Id.* The doctrine of virtual representation is an exception to the rule that only a party to the judgment may appeal. *City of San Benito v. Rio Grande Valley Gas Co.*, 109 S.W.3d 750, 754–55 (Tex. 2003). Virtual representation allows a “deemed party” to appeal if (1) the party is bound by the judgment; (2) there is privity of estate, title, or interest on the record; and (3) there is identity of interests between the party and a party to the judgment. *Motor Vehicle Bd. v. El Paso Indep. Auto Dealers Ass'n*, 1 S.W.3d 108, 110 (Tex. 2015).

144. *Marriage of Dilick*, 550 S.W.3d at 774 (citing *Motor Vehicle Bd.*, 1 S.W.3d at 110).

145. *Id.* (citing TEX. BUS. ORGS. CODE ANN. § 153.102(a) (“(a) A limited partner is not liable for the obligations of a limited partnership . . .”)).

grant the limited partners the authority to bring a broader set of derivative claims.

#### B. DERIVATIVE SUIT STANDING FORMER MEMBERS

The Austin Court of Appeals sharply rejected derivative suits by former members in *In re LoneStar Logo & Signs, LLC*<sup>146</sup> and demanded present ownership status to meet standing requirements. In 2006, Media Choice, LLC (Media Choice) and Quorum Media, LLC (Quorum) were jointly awarded the Texas Department of Transportation's (TxDOT) ten-year contract for logo signs along Texas highways.<sup>147</sup> Media Choice and Quorum together formed LoneStar Logos & Signs, LLC (LoneStar 1) to perform their duties under the logo sign contract.<sup>148</sup> In 2016, TxDOT began soliciting bids for a new logo sign contract.<sup>149</sup> Media Choice bid on and was awarded the new contract.<sup>150</sup> Media Choice created another entity to perform the contract obligations, LoneStar Logos Management Company, LLC (LoneStar 2).<sup>151</sup> LoneStar 1 had six members, including Media Choice and Dunster Live, LLC (Dunster).<sup>152</sup> LoneStar 2 had five members, all of which were the same as LoneStar 1, excluding only Dunster.<sup>153</sup> It was on this basis that Dunster sued, asserting individual claims and a derivative claim on behalf of LoneStar 1 that the members wrongfully used the assets of LoneStar 1 to benefit LoneStar 2.<sup>154</sup> While the other members admitted to intentionally excluding Dunster from LoneStar 2, they refuted Dunster's claims and challenged Dunster's standing, claiming Dunster ceased to be a member of LoneStar 1 before filing suit.<sup>155</sup> The other members asserted that Dunster was no longer a member of LoneStar 1 after LoneStar 1's managers caused LoneStar 1 to redeem Dunster's interest for failure to pay a capital call.<sup>156</sup> Dunster disputed the validity of such redemption and also maintained that membership in LoneStar 1 was only required at the time the claim accrued.<sup>157</sup>

In analyzing this case, the court examined corporate shareholder derivative action principles, noting that such principles are "materially identical extensions or analogues" of the principles of LLC derivative claims.<sup>158</sup> The court stated the rule that members must have continuing ownership status throughout the prosecution, otherwise they do not have standing to bring a derivative suit on behalf of the entity.<sup>159</sup>

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146. 552 S.W.3d 342, 343 (Tex. App.—Austin 2018, no pet.).

147. *Id.* at 343.

148. *Id.* at 343–44.

149. *Id.* at 344.

150. *Id.*

151. *Id.*

152. *Id.*

153. *Id.*

154. *Id.*

155. *Id.* at 345.

156. *Id.*

157. *Id.* at 346.

158. *Id.* at 347.

159. *Id.*

Under the statutory standing<sup>160</sup> provisions of the TBOC, a member must have been a member at the time of the act or omission at issue in order to bring a derivative claim.<sup>161</sup> Section 101.463, however, provides that closely held LLCs are subject to different requirements and that the statutory standing sections, among others, do not apply.<sup>162</sup> This exemption was included in order to make it easier for such members to bring a derivative suit.<sup>163</sup> While seemingly broad, the court interprets this exemption narrowly, holding that a derivative suit must still be derivative and that it is a “fundamental” characteristic that a member have a “present ownership interest in the entity on whose behalf it purports to sue.”<sup>164</sup> Both Section 101.452’s statutory standing and Section 101.463, according to the court, still intended that derivative suits be brought by a *member* and imply that member status must be maintained for the duration of the suit.<sup>165</sup> The court found that Dunster was a former member and as such had not maintained membership during the suit so Dunster could not meet the standing requirements.<sup>166</sup>

The decision in this case significantly narrows derivative suit standing. Membership is not only required at the time the claim arose, but it must also be maintained in order to sue on behalf of an entity. This holding could eliminate claims of former members and narrows statutory standing. LLC members should consider this case when determining if derivative standing exists.

## VI. CONCLUSION

This selection of cases underscores the need to carefully read and respect statutory requirements. From the enforceability of term sheets to the documentation of entities to the definition of “person,” the theme of this Survey period was careful adherence to the letter of the law. Cases hinged on the differentiation between judgments for or against a partnership and incidental versus direct benefits. Courts parsed these fine distinctions to present highly relevant examples and warnings for counsel. This Survey period further emphasizes the ever-changing nature of partnership law, and the importance of monitoring developments as courts continue to expound upon the principles illustrated here.

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160. *Id.* at 348 (quoting *Sneed v. Webre*, 465 S.W.3d 169, 181 (Tex. 2015)).

161. *Id.* (citing TEX. BUS. ORGS. CODE ANN. § 101.452).

162. *Id.* at 349.

163. *Id.*

164. *Id.* at 350 (internal quotations omitted).

165. *Id.* at 351.

166. *Id.* at 352–53.