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Partnership Law

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PARTNERSHIP LAW

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I. INTRODUCTION

During the Survey period, in the context of joint venture agreements, Texas courts issued decisions that emphasized the content of or the ex-

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press terms of agreements over circumstantial evidence to the contrary, stressed the importance of adhering to corporate formalities in various contexts, and protected the rights of limited partners. Courts stressed the need for careful drafting, contemplated the post-divorce ramifications of holding assets in a limited liability company, and explored the recovery of attorney's fees. This Article is divided into five sections that will discuss cases concerning (I) partnership formation; (II) the power to bind a partnership; (III) fiduciary duties; (IV) community property interests; and (V) recovery of attorney's fees and advancement costs.

II. PARTNERSHIP FORMATION

*Lost Maples General Store, LLC v. Ascentium Capital, LLC*¹ is a sober reminder to read the entirety of a contract carefully before signing. In this case, a grocer, Lost Maples General Store, LLC (Lost Maples), and a purveyor of culinary equipment, Argosy Foodservice (Argosy), entered into an agreement with respect to the purchase by Lost Maples of an ice machine from Argosy.² To assist Lost Maples in the funding of the transaction, Argosy directed Lost Maples to a third-party lender, Ascentium Capital, LLC (Ascentium).³ Ascentium agreed to finance the purchase of the ice machine for a grand total of \$36,495.12 over the course of two years.⁴ Under the terms of the credit agreement, Ascentium stood to gain \$4,744.00 from a separately negotiated "blind" discount on the purchase price between Ascentium and Argosy.⁵

While this blind discount was conspicuously absent from the finance agreement between Lost Maples and Ascentium, there was an accompanying agreement between the two entities containing a provision whereby Lost Maples agreed to commence immediate payments irrespective of whether the ice machine was delivered.⁶ Despite Argosy never having delivered the ice machine as agreed, Lost Maples dutifully paid the first three payments on the two-year note, but stopped making payments when Argosy announced it was going out of business.⁷ Lost Maples asked for a refund but Ascentium insisted Lost Maples honor its "unconditional promise to pay."⁸

Lost Maples sued Ascentium on multiple claims of common law fraud

1. No. 14-18-00215-CV, 2019 WL 1966671 (Tex. App.—Houston [14th Dist.] May 2, 2019, no pet.) (mem. op.).

2. *Id.* at *1.

3. *Id.*

4. *Id.*

5. *Id.* Under the separate agreement between Ascentium and Argosy, Argosy received only \$31,750.65 from Ascentium as payment in full for the ice machine; while Ascentium was still entitled to payment of the full \$36,495.12 from Lost Maples. *See id.* at *9. Testimony from a representative of Ascentium asserted such arrangements, especially with 0% financing offers, are quite common in the financing industry. *Id.* at *10.

6. *Id.* at *1.

7. *Id.*

8. *Id.*

and conspiracy.⁹ Lost Maples also asserted that Argosy's non-delivery of the ice machine constituted a failure of consideration attributable to Ascentium, based on the premise that Ascentium and Argosy were partners by estoppel.¹⁰ Ascentium counterclaimed for breach of contract.¹¹

In order to establish partnership by estoppel, it must be shown that: (1) the party sought to be bound represented themselves to be a partner; and (2) the party making the claim of partnership by estoppel relied upon that representation.¹² In this case, Lost Maples claims to have relied on the following representations: (1) the credit application containing both Argosy's and Ascentium's company logos; (2) conversations with Ascentium's vice president of franchise sales in which he stated there was a partnership with Argosy; (3) Argosy's press releases and website describing itself as Ascentium's partner; and (4) the vendor agreement between Argosy and Ascentium containing a section titled "Partnership."¹³

The trial court and appellate court were unpersuaded by these arguments. The Fourteenth Houston Court of Appeals held the credit agreement to be primarily a marketing device.¹⁴ The conversations with Ascentium's vice president in which he supposedly referenced a "partnership" amounted only to generic business terminology commonly used in the vernacular but possessing no special legal significance.¹⁵ And while Argosy's press releases and website could conceivably bind Argosy, they could not bind Ascentium because Ascentium did not make those representations.¹⁶ This last argument was supported by the same reasoning used to undercut the assertion that the vendor's agreement is proof of a partnership—the inclusion of a separate paragraph explicitly stating that neither company was an agent for the other.¹⁷

The final blow to Lost Maples' assertions of partnership by estoppel was its own failure to conduct an inquiry into the truth of the statements it supposedly relied on.¹⁸ Citing case law from the Texas Supreme Court,¹⁹ the appellate court concluded that Lost Maples was not justified

9. *Id.*

10. *Id.* at *5.

11. *Id.* at *1.

12. *Id.* at *5; see *CCR, Inc. v. Chamberlain*, No. 13-97-312-CV, 2000 WL 35721225, at *10 (Tex. App.—Corpus Christi—Edinburg June 1, 2000, pet. denied) (citing *Paramount Petrol. Corp. v. Taylor Rental Ctr.*, 712 S.W.2d 534, 538 (Tex. App.—Houston [14th Dist.] 1986, writ ref'd n.r.e.), *abrogated by SSP Partners v. Gladstrong Invs. (USA) Corp.*, 275 S.W.3d 444 (Tex. 2008)).

13. *Lost Maples*, 2019 WL 1966671, at *5–6.

14. *Id.* at *5.

15. *Id.* at *6.

16. *Id.* at *5. At trial, an employee of Ascentium testified that Ascentium had not authorized Argosy's press releases. *Id.*

17. *Id.* at *6.

18. *Id.*

19. *Barfield v. Howard M. Smith Co.*, 426 S.W.2d 834, 838 (Tex. 1968) (citing case law establishing that parties who rely on theories of estoppel must show that they sought diligently to discover the truth of the matters upon which they rely, were unable to do so, and cannot claim they were misled or deceived when the actual circumstances were plainly ascertainable).

in its reliance on the existence of a partnership because the financing agreement it signed clearly stated that Argosy and Ascentium were not agents of one another.²⁰

This case demonstrates that Texas courts will give far greater deference to the uncontroverted words of the contract in question than to potentially contravening circumstantial evidence. Practitioners would do well to closely scrutinize the express terms of their client's contractual obligations and the representations of the parties thereunder.

III. POWER TO BIND

A. CONFLICT OF INTEREST MAY BE WAIVED BY A LIMITED PARTNER

*In re Luecke*²¹ stands for the proposition that disqualification of an attorney is a severe remedy that should be avoided in the majority of cases, even where a conflict of interest to a partnership may exist. In 1987, Jimmie Luecke filed for divorce from his wife, Dorothy.²² The Lueckes had two children, Fred and Susan.²³ As a result of the divorce, two partnerships were created with Jimmie as the general partner, and Jimmie, Fred, and Susan as the limited partners.²⁴ Later, conflict between the family members arose when Fred alleged that Jimmie failed to disclose ownership of and proceeds from a tract of land that rightfully belonged to one of the partnerships.²⁵ Jimmie came to own the land when it was conveyed to him by Bennie Jaehne during the course of his marriage to Dorothy.²⁶ As it turns out, Fred was not the only person who took issue with Jimmie's handling of this asset.²⁷ The trust that succeeded Jaehne sued Jimmie as well.²⁸

The conflict of interest at the center of this case was that the attorney who represented the Jaehne trust was the same attorney who later represented Fred Luecke and the partnerships in their suit against Fred's father.²⁹ Thus, Jimmie filed a motion to disqualify Fred's attorney on the basis of an outstanding conflict of interest to the partnership.³⁰ Although Fred personally submitted a waiver of such conflict, Jimmie argued that Fred, as limited partner of the partnerships, did not have the necessary authority to waive a potential conflict of interest on behalf of the partnership.³¹ The district court agreed and granted the motion to disqualify.³²

20. *Lost Maples*, 2019 WL 1966671, at *6.

21. 569 S.W.3d 313 (Tex. App.—Austin 2019, orig. proceeding).

22. *Id.* at 315.

23. *Id.*

24. *Id.*

25. *Id.*

26. *Id.*

27. *Id.*

28. *Id.* The trust alleged in their petition that Jimmie was also a trustee for the trust's mineral interest in the land. *Id.* at 318.

29. *Id.* at 316.

30. *Id.*

31. *Id.*

32. *Id.* at 317.

Upon review, the Third Austin Court of Appeals rejected Jimmie's argument that a limited partner does not have authority to waive a conflict of interest on behalf of the partnership, and held that the trial court abused its discretion in granting the motion.³³ The court reasoned that because disqualification of an attorney is a severe remedy which can result in severe harm, the requesting party has the burden to show that the attorney's conduct caused actual prejudice which would justify a disqualification.³⁴

The court of appeals determined that because a limited partner has an established statutory authority to bring a derivative suit in Texas, it follows that the limited partner would also have a right to waive a conflict of interest for purposes of a derivative suit.³⁵ With this issue decided and no evidence of actual prejudice caused by the attorney's representation of Fred, the court ordered the district court to vacate its decision.³⁶ The *Luecke* court's reasoning demonstrates the need for practitioners to support allegations of conflict of interest or attempts to disqualify with ample case law or other compelling evidence, especially when bearing the burden of proof on a matter.

B. JOINT VENTURE LIABILITY IMPOSED ON AGREEMENTS SIGNED IN INDIVIDUAL CAPACITY

*Ecofriendly Water Co., LLC v. Mercer*³⁷ is a poignant example of the weighty consequences that can follow a failure to indicate a signatory's representative capacity for a joint venture, limited liability company, or partnership. Jay LaFrance, on behalf of EcoFriendly Water Co., LLC (EFW), obtained a \$350,000.00 loan from Thomas Lowery, which was evidenced by a signed two page written contract.³⁸ Pursuant to the agreement, repayment was to occur over 180 months and would include \$148,199.98 in interest, all of which would be accelerated in the event of default.³⁹ LaFrance, on behalf of EFW, paid the first two installments and then defaulted, necessitating Lowery's filing suit against both EFW and LaFrance, as borrowers, for breach of contract.⁴⁰ Lowery, as lender, moved for partial summary judgment, submitting only the written agreement and excerpts from LaFrance's deposition.⁴¹ LaFrance presented a

33. *Id.* at 319.

34. *Id.* at 317 (citing *In re Waterstone Owners Ass'n, Inc.*, No. 03-18-00352-CV, 2018 WL 4016860, at *3 (Tex. App.—Austin Aug. 23, 2018, orig. proceeding) (mem. op.) (quoting *In re Nitla S.A. de C.V.*, 92 S.W.3d 419, 422 (Tex. 2002) (orig. proceeding) (per curiam))).

35. *Id.* at 318.

36. *Id.* at 319.

37. No. 05-18-00763-CV, 2019 WL 1950177 (Tex. App.—Dallas May 2, 2019, no pet.) (mem. op.).

38. *Id.* at *1. While not specifically discussed by the court, citations to deposition testimony in footnotes to the case indicate these proceeds were deposited into LaFrance's personal account, and not the business account of EFW. *Id.* at *1 n.3.

39. *Id.* at *1.

40. *Id.*

41. *Id.*

vigorous defense, making numerous arguments, among which was a lack of personal liability because the loan was made to EFW.⁴² While the seeming dearth of plaintiff's evidence indicated the likelihood of an eventual trial, the lower court granted partial summary judgment.⁴³ Lowery subsequently dropped all of his remaining claims, and judgment was entered shortly thereafter against LaFrance in his personal capacity in the amount of \$492,664.⁴⁴

The ease with which the trial court made its judgment and the Fifth Dallas Court of Appeals thereafter affirmed the judgment was due in large part to the simplicity of the evidence. The instrument creating the indebtedness was straightforwardly named a "Personal Loan Agreement."⁴⁵ In its short two pages, the document stated that while there may be multiple signatories, "each of the undersigned understands that they are each as individuals responsible and jointly and severally liable for paying back the full amount."⁴⁶ The end of the agreement contained LaFrance's handwritten signature on a line labeled "Borrower's Signature."⁴⁷ Despite LaFrance's assertions that the loan was explicitly made to EFW and the terms of the contract were ambiguous as to his personal liability, the appellate court held the terms of the contract to be clear and definite, not susceptible to alternative interpretations.⁴⁸ Citing both statutory authorities and case law, the court relied on the plain language of the agreement, i.e., that LaFrance had explicitly consented to his own personal liability.⁴⁹

While the maxim is generally true that some limited deviation from corporate formalities will not attach liability to an individual, signature blocks combined with contractual terms imparting personal liability are an exception to the rule. Attorneys should take particular care to advise their clients of the potential consequences of hurriedly signing documents on behalf of a joint venture or partnership, especially where the express language of the document contemplates imparting liability onto a signatory in their personal capacity.

42. *Id.* at *3–4.

43. *Id.* at *2.

44. *Id.*

45. *Id.* at *1.

46. *Id.* at *4.

47. *Id.* at *2.

48. *Id.* at *4.

49. *Id.* (first citing TEX. BUS. ORGS. CODE ANN. § 21.225(1) (stating that statutory provisions limiting an individual's liability do not apply where that person "expressly assumes, guarantees, or agrees to be personally liable to the obligee for the obligation"); then citing *Neel v. Tenet HealthSystem Hosps. Dall., Inc.*, 378 S.W.3d 597, 606 (Tex. App.—Dallas 2012, pet. denied) (officer of a professional association signed a lease in his personal capacity, the terms of which stated that all members of the association would be personally liable except for an officer signing on behalf of a corporation)).

IV. FIDUCIARY DUTIES

A. PERPETRATING A FRAUD AND CORPORATE VEIL PIERCING

*Stover v. ADM Milling Co.*⁵⁰ is a cautionary tale of corporate veil piercing for those who use the corporate form for their own personal benefit—even inadvertently. Jace Harkey and Reginald Stover formed Hesed Enterprises L.L.C. (Hesed) for the purpose of acquiring a non-operational mill owned by ADM Milling Co. (ADM).⁵¹ They capitalized Hesed with \$50,000, but failed to open a company bank account or maintain any financial documents on the company’s behalf.⁵² As a result, Stover and Harkey used their own personal funds to retain attorney Robert Holmes to represent Hesed in the transaction.⁵³ Subsequent negotiations resulted in the parties entering into a purchase and sale agreement (the Agreement) dated March 8, 2013, pursuant to which Hesed agreed to buy the mill from ADM for \$1,600,000.⁵⁴ The terms of the Agreement also contained non-competition and confidentiality provisions along with an agreement that both parties would use their best efforts to close the transaction by June 1, 2013.⁵⁵ Stover and Harkey each put up \$25,000 of their personal funds as earnest money for Hesed, again without any formal recordkeeping.⁵⁶ That same month Stover and Harkey visited the mill a second time and were given keys to the property.⁵⁷ They were also provided with the contact information of the railroad company from which Hesed could lease the tracks running through the mill.⁵⁸

Two months later, Holmes shared Hesed’s plans to purchase the mill with his son, Holmes II, who became interested in the transaction as a potential investment opportunity.⁵⁹ A month later, the deal failed to close on time.⁶⁰ Stover told ADM that, among other things, Hesed was having issues with the environmental inspection of the mill and negotiations with the railroad company.⁶¹ When the transaction failed to close on the agreed upon date, Holmes informed his son, Holmes II, that he should take over the purchase of the mill from ADM by making an offer to purchase Hesed from Stover.⁶² The general understanding between the parties in the subsequent discussions was that Stover and Harkey would sell Hesed to Holmes II for \$1,800,000—a \$200,000 increase over the ex-

50. No. 05-17-00778-CV, 2018 WL 6818561 (Tex. App.—Dallas Dec. 28, 2018, pet. filed) (mem. op.).

51. *Id.* at *2.

52. *Id.*

53. *Id.*

54. *Id.*

55. *Id.*

56. *Id.*

57. *Id.*

58. *Id.* Built along a main railroad line, the mill contained private tracks running between its various buildings, and also tributary tracks running from the main railroad line which ADM leased from the Burlington Northern Santa Fe Railroad Company. *Id.*

59. *Id.*

60. *Id.*

61. *Id.*

62. *Id.* at *3.

isting purchase price.⁶³ Hesed never informed ADM of these separate negotiations, and instead attempted to re-negotiate the closing date with ADM under the previous Agreement.⁶⁴ Concurrently with the negotiations to sell their interest in Hesed to Holmes II, the parties, through Holmes, were successful in getting ADM to agree to an extension of the closing date in exchange for yet another \$50,000.⁶⁵ However, negotiations to sell Hesed to Holmes II failed to materialize, the additional \$50,000 was never paid, and the original Agreement with ADM was terminated by Hesed shortly thereafter.⁶⁶

ADM sued Hesed, Holmes, the Holmes Law Firm, and, pursuant to the piercing of the corporate veil attack, Stover and Harkey in their individual capacities for breach of contract and numerous causes of action based in fraud.⁶⁷ At trial, the record revealed that: no environmental inspection of the mill was ever performed; there were no communications with the railroad company; and the \$200,000 increase in the purchase price was to be diverted to Stover and Harkey for their personal benefit—not for Hesed's obligations.⁶⁸

Ordinarily, a failure to maintain strict adherence to corporate formalities is not sufficient in and of itself to disregard the corporate form.⁶⁹ For the court, the lynchpin here was Stover and Harkey's seemingly fraudulent intent to string along ADM while seeking to personally benefit from their undisclosed ancillary transaction with Holmes II.⁷⁰ In the end, this was a costly mistake that resulted in joint and several judgments against not only Hesed and Holmes, but also against Stover and Harkey to the tune of well over a million dollars in actual and punitive damages and attorney's fees.⁷¹ In justifying its decision to pierce the corporate veil on grounds of fraud, the court was careful to distinguish between the tort of fraud and the much less burdensome standard of actual fraud, which involves only "dishonesty of purpose or intent to deceive."⁷²

Practitioners should be vigilant in stressing to their clients the importance of maintaining strict organizational discipline when operating under the umbrella of a limited liability company or other liability-limiting

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.*

67. *Id.* at *4.

68. *Id.* at *2–3, *10.

69. *See* TEX. BUS. ORGS. CODE ANN. § 21.223(a)(3) (stating that a holder of shares will not be held liable to a corporation or its obligees for corporate obligations on the basis of the corporation's failure to observe corporate formalities and enumerating a non-exhaustive list of such formalities); TEX. BUS. ORGS. CODE ANN. § 101.002(a) (applying Section 21.223 *et seq.* to limited liability companies).

70. *ADM Milling Co.*, 2018 WL 6818561, at *10 (citing *Hong v. Havey*, 551 S.W.3d 875, 885–86 (Tex. App.—Houston [14th Dist.] 2018, no pet.) (discussing cases showing that funds obtained through a corporation's fraudulent activity and diverted to individual defendants is sufficient evidence of a direct personal benefit)).

71. *Id.* at *4.

72. *Id.* at *9 (quoting *Latham v. Burgher*, 320 S.W.3d 602, 607 (Tex. App.—Dallas 2010, no pet.).

structure. As seen here, failure to do so can undermine the purpose for setting up such an entity in the first place.

B. CONTRACTUAL MODIFICATION OF STATUTORY FIDUCIARY DUTIES

*Cruz v. Ghani*⁷³ is an example of Texas's commitment to freedom of contract above and beyond a rigid application of statutorily created fiduciary duties. The case centered around the failed business relationship between two friends—Mehrddad Ghani, a businessman, and Dr. Erwin Cruz, a neurologist.⁷⁴ Ghani, Cruz, and several other minor investors formed four entities for the purpose of providing magnetic resonance imaging to patients in north Dallas: (1) North Dallas Medical Imaging, LP (NDMI); (2) NDMI's general partner, MCG Group, Inc. (MCG); (3) later, Plano AMI, LP (Plano AMI); and (4) Plano AMI's general partner, Ghani Medical Investments, Inc. (GMI).⁷⁵ The business arrangement was that Ghani would manage the two businesses, MCG and GMI, while Cruz would refer his patients to NDMI and Plano AMI for scanning, and persuade fellow doctors to do likewise.⁷⁶ Ghani and Cruz both shared in the profits of NDMI and Plano AMI as equal limited partners.⁷⁷

Breakdowns in the working relationship between Ghani and Cruz eventually resulted in the dissolution of NDMI and Cruz being expelled from Plano AMI.⁷⁸ Ghani then formed another medical imaging company, Plano Open MRI, LP (Plano Open) without Cruz.⁷⁹ Cruz responded by bringing suit for numerous claims against Ghani including breach of his fiduciary duties to NDMI, Plano AMI, and himself as a limited partner.⁸⁰ As to NDMI, Cruz claimed that had Ghani provided him with adequate financial disclosures he never would have agreed to dissolve NDMI, and his failure to do so constituted a breach.⁸¹ As to Plano AMI, Cruz claimed that Ghani unfairly pursued the Plano Open business because it was in direct competition with Plano AMI.⁸² The jury resolved both of these issues in Cruz's favor, but the court subsequently granted a motion for judgment notwithstanding the verdict (JNOV) in Ghani's favor, effectively reversing the jury's decision.⁸³ Cruz appealed.⁸⁴

The Fifth Dallas Court of Appeals overturned the lower court's finding of breach of fiduciary duties in relation to NDMI,⁸⁵ but not as to Plano

73. No. 05-17-00566-CV, 2018 WL 6566642 (Tex. App.—Dallas Dec. 13, 2018, pet. denied) (mem. op.).

74. *Id.* at *1.

75. *Id.* at *1–2.

76. *Id.* at *1.

77. *Id.*

78. *Id.* at *3–5.

79. *Id.* at *5.

80. *Id.*

81. *Id.* at *3–4, *7–8.

82. *Id.* at *12–13.

83. *Id.* at *1.

84. *Id.*

85. *Id.* at *11.

AMI.⁸⁶ In the case of NDMI, Ghani claimed not only that he informed Cruz of NDMI's declining profitability, but also that Cruz had uninhibited access to NDMI's financial information.⁸⁷ However, the court reasoned that there was enough evidence that a reasonable jury could find that Ghani failed to provide Cruz with a complete and truthful accounting of NDMI's financial condition.⁸⁸ The court paid particular attention to Ghani's pressure to dissolve NDMI while simultaneously forming Plano Open without Cruz, which would "pursue opportunities in the same industry and in the same geographic area" as NDMI.⁸⁹ The court held that a jury could reasonably conclude Ghani had used his management position to further his own business interest at the expense of NDMI, or at the very least that he had put himself in a position where there was a conflict of interest between his personal interests and his obligations to NDMI.⁹⁰

In stark contrast to the court's holdings regarding NDMI, the Dallas Court of Appeals upheld the lower court's JNOV as to Plano AMI, largely on the basis of that entity's operating agreement.⁹¹ In pertinent part, paragraph 6.1(f) of the Plano AMI operating agreement stated:

(f) *Outside Activities and Conflicts of Interest.* The General Partner or any Affiliate thereof and any director, officer, employee, agent, or representative of the General Partner or any Affiliate thereof shall be entitled to and may have business interests and engage in business activities in addition to those relating to the Partnership, including business interests and activities in direct competition with the Partnership. Neither the Partnership nor any of the Partners shall have any rights by virtue of this Agreement or the partnership relationship created hereby in any business ventures of the General Partner, any Affiliate thereof, or any director, officer, employee, agent, or representative of either the General Partner or any affiliate thereof.⁹²

Turning to the Texas Business Organizations Code, the court outlined the basis upon which the regulatory scheme would implicitly permit a partnership to modify a party's fiduciary duties.⁹³ Despite the duty of loyalty explicitly contemplating a prohibition on competition and the fact that this duty cannot be completely eliminated, the court acknowledged that partners "may identify specific types of activities or categories of activities that do not violate the duty of loyalty if the types of categories are

86. *Id.* at *14.

87. *Id.* at *7.

88. *Id.* at *10.

89. *Id.*

90. *Id.* at *11.

91. *Id.* at *14.

92. *Id.* at *13.

93. *Id.* (quoting TEX. BUS. ORGS. CODE ANN. § 153.152(a) ("General Powers and Liabilities of General Partner" . . . 'Except as provided by this chapter, the other limited partnership provisions, or a partnership agreement . . .')).

not manifestly unreasonable.”⁹⁴ The court relied heavily on its conviction that Texas public policy strongly favors freedom of contract.⁹⁵ In summation, the appellate court concluded that the trial court was correct in granting the JNOV on this issue as the express terms of the Plano AMI operating agreement precluded any complaint Cruz might make as to the directly competitive nature of Plano Open.⁹⁶ Pursuant to the Texas Business Organizations Code, Cruz would have had to claim that such provisions were manifestly unreasonable to have preserved the issue for review.⁹⁷

Here, the court signaled both the importance of managing members maintaining loyalty to their organization (even in the minutiae of providing timely and accurate information to other limited partners) and the ability of members to change the calculus of exactly how that loyalty will be interpreted. Practitioners should be mindful of these lessons when advising clients of the grave responsibility fiduciary duties place on members of an organization, but also of the flexibility to fashion the scope of those duties in a reasonable and intentional manner.

V. COMMUNITY PROPERTY INTERESTS

*Mason v. Mason*⁹⁸ stands for the proposition that while an individual spouse’s membership interest in a limited liability company may be characterized as separate property (depending on when or how it was acquired), the community estate may nonetheless claim reimbursement for benefiting that separate property interest through contributions to the limited liability company itself. Jeff Mason was the sole member and manager of 338 Industries, LLC (338) prior to his marriage to Keri Cotterman Mason—characterizing that interest as his separate property.⁹⁹ The community estate made loans of nearly \$600,000 to 338 during the marriage.¹⁰⁰ Throughout the marriage and after divorce proceedings began, 338 made a total of \$752,324 worth of disbursements.¹⁰¹ The expenditures ranged from traveling and hotel rooms to gambling and adult

94. *Id.* (quoting TEX. BUS. ORGS. CODE ANN. § 152.002(b)(2)).

95. *Id.* at *14; *Phila. Indem. Ins. Co. v. White*, 490 S.W.3d 468, 475 (Tex. 2016) (espousing freedom of contract within the constraints of public policy); *Harrison v. Harrison Interests, Ltd.*, No. 14-15-00348-CV, 2017 WL 830504, at *4 (Tex. App.—Houston [14th Dist.] Feb. 28, 2017, pet. denied) (mem. op.) (“[W]e must balance the principle that fiduciary duties arise as a matter of law with our obligation to honor the contractual terms that parties use to define the scope of their obligations and agreements, including limiting fiduciary duties that might otherwise exist.”); *see also* *Strebel v. Wimberly*, 371 S.W.3d 267, 284 (Tex. App.—Houston [1st Dist.] 2012, pet. denied) (citing *Nat’l Plan Adm’rs, Inc. v. Nat’l Health Ins. Co.*, 235 S.W.3d 695, 703 (Tex. 2007)).

96. *Cruz*, 2018 WL 6566642, at *14.

97. *Id.*; TEX. BUS. ORGS. CODE ANN. § 152.002(b)(2).

98. No. 03-17-00546-CV, 2019 WL 1967166 (Tex. App.—Austin May 3, 2019, no pet.) (mem. op.).

99. *Id.* at *1; TEX. FAM. CODE ANN. § 3.001(1) (stating that a spouse’s separate property consists of property owned or claimed by the spouse before marriage.).

100. *Mason*, 2019 WL 1967166, at *6.

101. *Id.* at *3.

entertainment.¹⁰² Keri was unaware of these charges until formal discovery began. Jeff argued these were legitimate business expenses made with the company credit card and which he dutifully reported to the Internal Revenue Service.¹⁰³ The trial court was not persuaded, and neither was the Third Austin Court of Appeals.¹⁰⁴

Citing the Texas Business Organization Code, the court stated that a limited liability company's property is neither the community property nor the separate property of its members—it belongs exclusively to the business entity.¹⁰⁵ With ample case law to back it up, the court further clarified that all subsequent distributions from a business to a member during a marriage constitutes community property, even when one spouse's interest in that business qualifies as their own separate property.¹⁰⁶ This chain of reasoning resulted in the inevitable characterization of 338's expenditures as personal distributions to Jeff which he "wasted to the detriment of the community."¹⁰⁷

The court's next task was to explain how the squandered funds could be brought back into the community estate for division in the ongoing divorce proceedings. Coming up with a rationale for reimbursement of the community estate from 338's remaining funds proved to be a more circuitous affair. The appellate court justified the lower court's decision, arguing that "the trial court could have reasonably determined that the loaned funds benefitted [338] and, in turn, that Jeff's separate property, i.e. his membership interest in [338], was benefitted indirectly."¹⁰⁸ The court concluded by affirming a contribution cost valuation of such benefit to Jeff's membership interest in 338 at \$283,051.¹⁰⁹

The lesson from *Mason* for practitioners is that reimbursement claims from contentious divorces have the potential to reach into a partnership—even a partnership whose interests are held entirely by one spouse as separate property. Lawyers on either side of a divorce should take care to advise their clients regarding the potential ramifications for, and sources of contribution from, business entity interests characterized as separate property. Texas courts have proven themselves willing to follow the trail of community property wherever it may lead, even to a spouse's membership interest in a separately held business entity.

102. *Id.*

103. *Id.* at *4.

104. *Id.* at *1.

105. *Id.* at *4 (citing TEX. BUS. ORGS. CODE ANN. § 101.106(b) ("A member of a limited liability company or an assignee of a membership interest in a limited liability company does not have an interest in any specific property of the company.")); see also *Mandell v. Mandell*, 310 S.W.3d 531, 539 (Tex. App.—Fort Worth 2010, pet. denied).

106. *Mason*, 2019 WL 1967166, at *4; see also *In re Marriage of Hudson*, No. 06-18-00011-CV, 2018 WL 4656288, at *8 (Tex. App.—Texarkana Sept. 28, 2018, no pet.) (mem. op.); *Lifshutz v. Lifshutz*, 199 S.W.3d 9, 27 (Tex. App.—San Antonio 2006, pet. denied).

107. *Mason*, 2019 WL 1967166, at *4.

108. *Id.* at *6.

109. *Id.* at *7.

VI. RECOVERY OF ATTORNEY'S FEES AND ADVANCEMENT COSTS

A. LIMITATIONS ON RECOVERY OF ATTORNEY'S FEES

In *Top Cat Ready Mix LLC v. Alliance Trucking, L.P.*,¹¹⁰ the Fifth Dallas Court of Appeals reinforced well-established Texas law that a plaintiff may not recover attorney's fees in a case against a limited liability company, limited liability partnership, or limited partnership. The plaintiff in this case, Alliance Trucking, L.P. (Alliance), sued the defendant, Top Cat Ready Mix LLC (Top Cat), as "a domestic, for-profit limited liability corporation authorized to do business in the State of Texas with its principal office in Ennis, Texas."¹¹¹ Because Top Cat did not file a verified denial that it was not a corporation (as Alliance alleged), the court found that Top Cat waived the defense that it was actually a limited liability company and therefore protected against an award of attorney's fees.¹¹²

The dispute between the parties began when Top Cat, a concrete mixing company, contracted with Alliance to purchase materials.¹¹³ Over the course of several months, Alliance sent multiple invoices to Top Cat for its services.¹¹⁴ Although Top Cat made a partial payment on the first of these invoices, the balance remained unpaid.¹¹⁵ Afterward, Alliance sued Top Cat in hopes of recovering the unpaid invoices, interest, and attorney's fees.¹¹⁶ Although Top Cat failed to preserve the defense of its status as a limited liability company as discussed above, the court of appeals ultimately found that Alliance did not conclusively establish it was entitled to recover attorney's fees in the amount granted by the trial court.¹¹⁷ Despite the favorable outcome, this case should serve as a warning for defense counsel to carefully read complaints against their clients including which exact legal name is used. As Texas courts have consistently shown, the outcome of a case may turn on the classification of a business entity and a strict interpretation of the letter of the law, or even a failure to file a verified denial.

B. ADVANCEMENT OF LEGAL COSTS STRICTLY ENFORCED

In *L Series, L.L.C. v. Holt*,¹¹⁸ the Fort Worth Court of Appeals further

110. No. 05-18-00175-CV, 2019 WL 275880 (Tex. App.—Dallas Jan. 22, 2019, no pet.) (mem. op.).

111. *Id.* at *5.

112. *Id.* (citing TEX. R. CIV. P. 93(6), which mandates that a party seeking to raise the defense that the party is not a corporation must file a verified affidavit). In Texas, attorney's fees may be awarded against a corporation under section 38.001 of the Texas Civil Practice and Remedies Code. TEX. CIV. PRAC. & REM. CODE ANN. § 38.001.

113. *Top Cat Ready Mix*, 2019 WL 275880, at *1.

114. *Id.*

115. *Id.*

116. *Id.*

117. *Id.* at *6.

118. 571 S.W.3d 864 (Tex. App.—Fort Worth 2019, pet. denied).

solidified the supremacy of Texas public policy honoring freedom of contract. *Holt* is a case of first impression in which a group of limited liability companies were required to advance the legal fees of a former employee, officer and member, whom the companies were suing. Conrad Holt was a general manager of three separate auto dealerships in the DFW metroplex.¹¹⁹ He was also a member and former president of three limited liability companies holding ownership interests in those same dealerships, and also of a fourth limited liability company that owned the real estate the dealerships leased (collectively, the Companies).¹²⁰ Mr. Holt was terminated from his employment after multiple accusations of fraud were leveled against him and one of his sales representatives.¹²¹

The Companies sued Mr. Holt on numerous grounds relating to fraudulent activity and breach of fiduciary duty.¹²² Mr. Holt responded with a counterclaim for breach of contract.¹²³ The Companies later amended their complaint and added a claim for further breach of fiduciary duties tied to Mr. Holt's position as an officer.¹²⁴ This last claim proved fateful, as it provided Mr. Holt the grounds upon which to invoke the Companies' advancement obligations and demand reimbursement of his legal fees and expenses.¹²⁵ The trial court granted Holt's motion for advancement of his past reasonable attorney's fees and expenses, and for such future costs on an ongoing monthly basis.¹²⁶ The Companies sought immediate relief through an interlocutory appeal and a writ of mandamus.¹²⁷

In determining whether the trial court abused its discretion, the Second Fort Worth Court of Appeals closely scrutinized the exact terms of the agreement.¹²⁸ Using freedom of contract as its lodestar and looking to precedent in Delaware case law as a guide, the court focused its inquiry on the precise bargain the parties had struck.¹²⁹ As in Delaware, Texas courts look to determine the true intent of the parties to a contract by "examining and considering the entire document to harmonize and give effect to all provisions so none are rendered meaningless."¹³⁰ However, Texas courts will also seek to refrain from interpretations which are "unreasonable, inequitable, and oppressive" whenever they are able.¹³¹

Employing these cannons of construction, the court looked first to the Companies' advancement provisions that provided for

119. *Id.* at 867.

120. *Id.*

121. *Id.* at 867-68.

122. *Id.* at 867.

123. *Id.* at 868.

124. *Id.*

125. *Id.*

126. *Id.*

127. *Id.*

128. *Id.* at 873.

129. *Id.* at 875-76.

130. *Id.* at 873 (citing *J.M. Davidson, Inc. v. Webster*, 128 S.W.3d 223, 229 (Tex. 2003)).

131. *Frost Nat'l Bank v. L & F Distribs., Ltd.*, 165 S.W.3d 310, 312 (Tex. 2005).

reasonable expenses incurred by a Person of the type entitled to be indemnified under Section 8.01 who was, is or is threatened to be made a named defendant or respondent in a Proceeding [1] *in advance of the final disposition of the Proceeding* and [2] *without any determination as to the Person's ultimate entitlement to indemnification*.¹³²

The Companies' agreements further defined a person entitled to be indemnified as a "person who was or is made a party [to a] pending or completed action, suit[,], or proceeding . . . , by reason of the fact that he or she . . . is or was serving at the request of the Company and an officer, trustee, employee, agent, or similar functionary of the Company."¹³³

Turning next to matters of public policy, the court cited Delaware case law in grappling with the "admittedly maddening aspect" of advancement claims which typically require companies to pay the legal costs of the very people they are suing for misconduct.¹³⁴ While sympathetic to the Companies' predicament in this regard, the court ultimately reasoned that not enforcing the clear terms of these advancement provisions rendered such prelitigation promises illusory.¹³⁵ The court concluded by echoing the Delaware Chancery Court's admonition that entities would be better served by thoughtfully drafting such provisions in advance.¹³⁶

Boards of directors should carefully review their operating documents and any ancillary agreements before bringing an action against a current or former member. Courts in Texas, as in Delaware, are apt to hold an organization to the exact terms of its agreements, even when those provisions seem patently unfair.

VII. CONCLUSION

This body of cases reflects the need for practitioners and businesspeople to draft formation documents carefully and adhere to their terms. This Article shows that Texas courts tend to value organizational discipline and the plain text of statutes over compelling but not spectacular arguments of fairness, while also affirming the ability of organizations to make modifications to statutory duties in certain circumstances. The Survey period further emphasizes that members would be wise to scrupulously honor corporate formalities to give businesses the best chance to benefit from limited liability. While courts over the Survey period presented examples to guide partnership counsel in the year to come, counsel should monitor developments in Texas partnership law as courts continue to hear cases on principles left unexplored this year.

132. *Holt*, 571 S.W.3d at 873.

133. *Id.*

134. *Id.* at 875; *Reddy v. Elec. Data Sys. Corp.*, No. CIV.A. 19467, 2002 WL 1358761, at *5-6 (Del. Ch. June 18, 2002) (mem. op.).

135. *Id.* at *6.

136. *Holt*, 571 S.W.3d at 875-76; *Barrett v. Am. Country Holdings, Inc.*, 951 A.2d 735, 747 (Del. Ch. 2008).

