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## Partnership Law

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# PARTNERSHIP LAW

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## I. INTRODUCTION

**D**URING the Survey period, courts decided a number of interesting cases that shed new light on Texas partnership and limited liability company law. For example, courts considered the instances in which partners have fiduciary duties and, when they do, the extent of such fiduciary duties. The courts also considered which actions or inactions constitute a breach of such fiduciary duties. Further, the courts dealt with recent changes in the Texas Business Organization Code involving liability of partners in partnerships and members in limited liability companies. Also during the Survey period, courts analyzed the standard necessary to bring a derivative claim on behalf of a partnership against a partner. Generally, the decisions this Survey period emphasized the need to carefully draft court documents and to comply with civil procedure rules when bringing claims. Additionally, the courts' willingness to give great weight to the terms set forth in partnership and LLC agreements underscores the importance of careful negotiation and drafting of

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these types of agreements. This Article is divided into four main Sections that explore recent decisions encompassing the following topics: (II) fiduciary duties, (III) veil piercing, (IV) derivative claims, and (V) limited liability of partners in limited liability partnerships.

## II. FIDUCIARY DUTIES

### A. *BROWN V. KEEL*

The First Court of Appeals rendered an opinion that provides guidance on the scope of fiduciary duties that one partner owes to another.<sup>1</sup> The court focused on the need for a complaining party to demonstrate that a breach proximately caused the claimed damages in order to recover.<sup>2</sup> In 2004, R. Scott Brown and Allan Keel discussed an investment opportunity involving oil and gas funds with GulfWest Energy (GulfWest), a Houston-based oil and gas company.<sup>3</sup> Brown and Keel formed a limited liability company, Volant, and they sent GulfWest an acquisition proposal.<sup>4</sup> Brown and Keel realized that they needed investors, and Keel consequently sought out Oaktree Capital Management (Oaktree), a California private investment fund, to fill this role.<sup>5</sup> Keel sent Oaktree a term sheet that proposed that Oaktree provide the necessary funding to buy out GulfWest completely, thereby converting it from a public to a private company.<sup>6</sup> The term sheet also proposed that Keel and Brown would stay on as management—with Keel as CEO and Brown as CFO—and that Keel and Brown would provide \$300,000 in initial funding, receive five-year employment contracts, and receive a 1% transaction fee, as well as equity options.<sup>7</sup>

Oaktree rejected the proposal, and it decided instead to invest only half of the proposed investment to own a majority stake in GulfWest.<sup>8</sup> Oaktree opted to make the investment itself, rather than to use Keel and Brown's company, Volant, and Oaktree changed the terms Brown and Keel had initially proposed to terms much less favorable to them.<sup>9</sup>

During the negotiations, discord developed between Brown and Oaktree's key negotiator, Skardon Baker.<sup>10</sup> In January 2005, Baker notified Keel that Oaktree no longer had intentions of hiring Brown as CFO and that the company questioned Brown's ability to fill the role.<sup>11</sup> Keel did not disclose this conversation to Brown; instead, on the following day, he

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1. *See* Brown v. Keel, No. 01-10-00936-CV, 2012 WL 760933, at \*8–11 (Tex. App.—Houston [1st Dist.] Mar. 8, 2012, no pet.) (mem. op.).

2. *Id.* at \*9.

3. *Id.* at \*1.

4. *Id.*

5. *Id.*

6. *Id.*

7. *Id.*

8. *Id.*

9. *Id.*

10. *Id.* at \*2.

11. *Id.*

allowed Brown to loan money to GulfWest, whose liquidity problems had become severe enough to interfere with the transaction.<sup>12</sup> Throughout January, Keel failed to notify Brown of Oaktree's intentions, but he did send an email to Oaktree's management that encouraged them to pay Brown what he was due and also shared his confidence in Brown's abilities to act as a competent CFO.<sup>13</sup> Later in January, Oaktree informed Brown that there would not be a place for him as CFO, but it opened discussions about another role for him.<sup>14</sup> Keel, on the other hand, rejected the idea of placing Brown in any other role.<sup>15</sup> In February, Keel notified Brown that there would be no place for him to work within the company.<sup>16</sup>

The deal between Oaktree and GulfWest closed the same month, February 2005, and Brown then brought suit.<sup>17</sup> He alleged that Keel had breached his fiduciary duty of loyalty to Brown by not disclosing his discussions with Oaktree about Brown's position and by discouraging Oaktree from hiring Brown in a capacity other than CFO.<sup>18</sup> At trial, the jury awarded Brown damages of \$1.25 million, based on the value of the stock options as of February 2005, which a successful transaction would have given Brown.<sup>19</sup> In response, Keel moved for a judgment notwithstanding the verdict (JNOV), which the court granted.<sup>20</sup> The court entered a take-nothing judgment in favor of Keel, reasoning that no partnership was created and that there was no proximate causation.<sup>21</sup>

On appeal, the court of appeals overruled the JNOV with respect to the partnership formation issue and held that a partnership was indeed formed between Brown and Keel.<sup>22</sup> In making this determination, the court analyzed the following factors: (1) whether Brown and Keel had rights to share profits of the business; (2) whether Brown and Keel intended to be partners; (3) whether Brown and Keel had rights to participate in the control of the business; (4) whether Brown and Keel agreed to share losses of the business and liabilities arising from the business; and (5) whether Brown and Keel contributed or agreed to contribute money to the business.<sup>23</sup> Although Brown did not have to prove the existence of every one of these factors, the court found that there was enough evidence to prove the existence of each factor.<sup>24</sup>

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12. *Id.*

13. *Id.*

14. *Id.*

15. *Id.*

16. *Id.*

17. *Id.* at \*3.

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.* at \*3-4.

22. *Id.* at \*8.

23. *Id.* at \*4.

24. *Id.* at \*5-8.

On the other hand, the court of appeals upheld the trial court's finding on the causation issue and held that there was no evidence to support a finding that Keel's breach of his fiduciary duty proximately caused Brown's injuries.<sup>25</sup> The court noted that Brown had the burden to present evidence that: (1) "but for" Keel's breach, the transaction would have given Brown stock options; (2) Keel's breach was a significant reason for Brown's failure to receive the stock options; and (3) it was foreseeable that the breach would cause Brown's loss of the stock options.<sup>26</sup>

The court of appeals noted that even though Keel's actions may have precluded Brown from receiving an alternative management position within the company, there was no evidence that he would have received stock options if he had been hired for another position.<sup>27</sup> The court reasoned that Keel's actions did not cause Brown to lose something of value because Brown was seeking damages for a loss of stock options—not a loss of salary for a new position—and Keel produced evidence that Oaktree had devoted all of its available stock options to other members of the team.<sup>28</sup>

Brown argued that Oaktree could have offered him stock options in the form of warrants, even if they decided not to hire him.<sup>29</sup> In response to this argument, the court of appeals held that Keel's conduct had nothing to do with Oaktree's decision not to give Brown these stock options and that there was no evidence that Oaktree ever even considered this option.<sup>30</sup> As a result, even though Keel's actions breached the fiduciary duties that he owed to his partner, Keel was not liable because Brown could not prove that Keel's breach proximately caused his damages.<sup>31</sup>

Justice Sharp presented an interesting dissent on the issue of causation.<sup>32</sup> Justice Sharp reiterated the standard for a JNOV, reminding the court of appeals that it should not overturn the jury's finding of causation "[a]s long as a reasonable jury could infer that Keel's actions were a substantial factor in having brought about Brown's injury."<sup>33</sup> Justice Sharp looked at Brown's injury more broadly by describing Brown's damages as the loss of his whole compensation package, rather than merely as the loss of potential stock options.<sup>34</sup> Justice Sharp pointed out that when Oaktree notified Brown that he would not be offered a position as GulfWest's CFO, Oaktree still expressed interest in allowing Brown to serve in another management capacity, which would have come with a compensation package.<sup>35</sup> Keel, at least to some degree, prevented this

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25. *Id.* at \*11.

26. *Id.* at \*9.

27. *Id.* at \*10.

28. *Id.*

29. *Id.* at \*11.

30. *Id.*

31. *Id.*

32. *Id.* (Sharp, J., concurring and dissenting).

33. *Id.*

34. *Id.*

35. *Id.*

from happening when he told Oaktree that he did not feel that Brown would be a good fit for another position within the company.<sup>36</sup> This alone was enough, in Justice Sharp's opinion, to demonstrate a basis for a reasonable jury to infer that Keel's actions were a substantial factor in bringing about Brown's injury.<sup>37</sup>

This case is particularly thought-provoking because the justices reached very different outcomes based almost solely on how broadly they defined Brown's injury. On the face of the facts, it seems clear that Keel acted in a manner that was an obvious breach of his duty of loyalty to his partner. Although he had knowledge for over a month that the company did not want to place Brown in a CFO position, he failed to notify Brown. To make matters worse, Keel even allowed Brown to loan his personal money to GulfWest in order to keep the transaction alive after he was aware of Oaktree's position. In addition to these breaches of loyalty through omission and inaction, Keel then proactively committed a breach by commission when he recommended that the company not place Brown in any other position. Given the somewhat egregious course of action that Keel took against his partner, it seems as though the court of appeals split hairs to conclude that although Keel breached his fiduciary duties, he did not proximately cause a loss of stock options specifically. As Justice Sharp pointed out, a JNOV requires a very high standard to overturn a jury's verdict, and the facts here provide enough evidence for a reasonable jury to find that Keel's actions precluded Brown from receiving adequate compensation, which include these stock options.

This case highlights the importance of procedure and the careful drafting of all court documents, a recurring theme throughout this Survey period. If Brown simply had pleaded his damages more generally by, for example, arguing that he had lost money, rather than specifically arguing that he had lost stock options, the majority would have likely reached a different conclusion.

#### B. *DANIELS V. EMPTY EYE, INC.*

In another court of appeals case from Houston, this time from the Fourteenth District, the court explored the scope of fiduciary duties owed by partners in a partnership, specifically addressing the fiduciary duties that a limited partner owes to a limited partnership.<sup>38</sup> Although limited partners do not necessarily owe any formal fiduciary duties to the limited partnership,<sup>39</sup> this case illustrates that a limited partner may owe such duties if the court finds the existence of an informal fiduciary relation-

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36. *Id.*

37. *Id.* at \*12.

38. *Daniels v. Empty Eye, Inc.*, 368 S.W.3d 743, 746-47 (Tex. App.—Houston [14th Dist.] 2012, pet. denied).

39. *See id.* at 759 (Frost, J., dissenting); *see also* *AON Props., Inc. v. Riveraine Corp.*, No. 14-96-00229-CV, 1999 WL 12739, at \*23 (Tex. App.—Houston [14th Dist.] Jan. 14, 1999, no pet.) (mem. op.) (finding no authority in Texas that imposes fiduciary duties on a limited partner).

ship, usually by demonstrating that there is a relationship of trust and confidence between the limited partner and the partnership.<sup>40</sup>

The dispute at issue involved a series of personal and professional relationships. In 1997, Jiles Daniels married Judith Daniels.<sup>41</sup> In 2000, the two formed Empty Eye, Inc. (the Corporation).<sup>42</sup> Later that year, Jiles, Judith, and the Corporation formed Empty Eye & Associates, L.P. (the Limited Partnership).<sup>43</sup> The Corporation served as the general partner and 1% owner of the Limited Partnership, and Jiles and Judith served as limited partners and 99% owners.<sup>44</sup> In 2005, the Limited Partnership purchased land to begin a project to build an apartment complex.<sup>45</sup> To finance the project, the Limited Partnership arranged for construction financing from Independence Bank.<sup>46</sup> Under the financing agreement, the bank required Jiles and Judith to each sign a personal guaranty of the Limited Partnership's indebtedness to the bank, but the contract's terms allowed the guaranty to be revoked at any time before the bank distributed any funds.<sup>47</sup>

Sometime in 2006, Jiles and Judith began having marital difficulties, and Jiles filed for divorce in December 2006.<sup>48</sup> Jiles then rescinded his personal guaranty on the loan from Independence Bank.<sup>49</sup> No funds had been advanced for the construction yet, and the bank subsequently rescinded the construction loan.<sup>50</sup> Jiles informed various contractors that he did not authorize any work on the project, and he informed at least one contractor that the bank had rescinded the construction loan.<sup>51</sup>

In January 2008, the Limited Partnership, Judith, and the Corporation brought an action against Jiles for breach of fiduciary duty.<sup>52</sup> They argued that Jiles had put his own interests above that of the Limited Partnership by rescinding his personal guaranty—with knowledge that the actions would ruin the Limited Partnership—in order to protect himself from personal liability.<sup>53</sup> The jury found that there was enough evidence to support this assertion, and it concluded that Jiles's actions breached his fiduciary duties to the Limited Partnership.<sup>54</sup>

Jiles appealed the jury's finding, contending that the evidence was legally insufficient to prove that he owed a fiduciary duty.<sup>55</sup> The court of

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40. See *Daniels*, 368 S.W.3d at 750.

41. *Id.* at 747.

42. *Id.*

43. *Id.*

44. *Id.*

45. *Id.*

46. *Id.*

47. *Id.*

48. *Id.*

49. *Id.*

50. *Id.*

51. *Id.*

52. *Id.*

53. *Id.*

54. *Id.*

55. *Id.* at 748.

appeals explained that “[a] ‘fiduciary’ is a ‘person who occupies a position of peculiar confidence towards another’” and that “[a]n informal fiduciary relationship, also known as a ‘confidential relationship,’ may arise ‘where one person trusts in and relies upon another, whether the relation is a moral, social, domestic[,] or merely personal one.’”<sup>56</sup> The court clarified that in the instance of a business transaction, the special relationship of trust and confidence must exist prior to the commencement of the business transaction.<sup>57</sup>

The jury charge at the trial stated:

A relationship of trust and confidence existed if Plaintiff justifiably placed trust and confidence in Jiles Daniels to act in its best interest. Plaintiff’s subjective trust and feelings alone do not justify transforming arm’s-length dealings into a relationship of trust and confidence.

...

You are instructed that a limited partner does not owe a fiduciary duty to the limited partnership or another limited partner simply because of his status as a limited partner.<sup>58</sup>

The court held that there was sufficient evidence in the record to support the jury’s finding that a relationship of trust and confidence existed between Jiles and the Limited Partnership.<sup>59</sup> As support for its conclusion, the court noted that Jiles owed a fiduciary duty to each other partner of the Limited Partnership: he had a duty to the Corporation because he was a corporate officer, and he had a duty to Judith because they were married.<sup>60</sup> The court pointed to Jiles’s involvement in developing the Limited Partnership’s business plan and the fact that Judith trusted him as a business partner to support its finding that they both placed trust and confidence in Jiles, which gave rise to a confidential relationship and, as a result, an informal fiduciary relationship.<sup>61</sup> The court of appeals also emphasized the fact that Jiles and Judith used the Limited Partnership to manage real estate for rental purposes and to help build their own home.<sup>62</sup> Even though Jiles and Judith were merely limited partners in the partnership, they took on the responsibility for the partnership’s debt when they signed personal guaranties.<sup>63</sup> The court of appeals held that these facts provided legally sufficient evidence to support the finding that the Limited Partnership justifiably had a relationship of trust and confidence with Jiles, and, therefore, that an informal fiduciary relationship existed.<sup>64</sup> As a result, the court upheld the portion of the award for Jiles’s

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56. *Id.* at 749 (quoting *Kinzbach Tool Co. v. Corbett-Wallace Corp.*, 160 S.W.2d 509, 512 (Tex. 1942) and *Crim Truck & Tractor Co. v. Navistar Int’l Transp. Corp.*, 823 S.W.2d 591, 594 (Tex. 1992)) (internal quotation marks omitted).

57. *Id.* at 750.

58. *Id.*

59. *Id.*

60. *Id.*

61. *Id.* at 750–51.

62. *Id.* at 750.

63. *Id.* at 750–57.

64. *Id.* at 751.



breach of fiduciary duty.<sup>65</sup>

In response, Justice Frost contributed a vigorous dissent on the issue, lamenting that “for the first time in the history of Texas jurisprudence, evidence is held legally sufficient to support the imposition of an informal fiduciary duty on a limited partner to place the interests of the limited partnership before his own interests.”<sup>66</sup> Justice Frost pointed out that informal fiduciary duties can arise from relationships involving trust and confidence that would normally not give rise to a formal fiduciary duty but that Texas courts are very reluctant to find such relationships.<sup>67</sup> In fact, courts had previously held that “[n]ot every relationship involving a high degree of trust and confidence rises to the stature of a fiduciary relationship.”<sup>68</sup> Justice Frost took issue with the majority’s argument that the existence of Jiles’s formal fiduciary duties to Judith and the Corporation supported a finding that a relationship of trust and confidence existed, giving rise to an informal fiduciary duty to the Limited Partnership—to whom no formal fiduciary duty was otherwise owed.<sup>69</sup>

Instead, Justice Frost argued, “[a] fiduciary relationship must stand on its own.”<sup>70</sup> Justice Frost criticized the majority for imputing a fiduciary relationship between Jiles and the Limited Partnership merely on a showing that fiduciary relationships existed between Jiles and Judith and between Jiles and the Corporation.<sup>71</sup> Since the record showed no reason to disregard the separate legal status of these entities, the majority, according to Justice Frost, should not have relied on Jiles’s other relationships to determine his relationship with the Limited Partnership.<sup>72</sup> Jiles’s mere status as a limited partner of the Limited Partnership alone does not give rise to a relationship of trust and confidence so as to establish an informal fiduciary duty.<sup>73</sup> Justice Frost argued that because Jiles did not hold an officer position or maintain a marital relationship with the Limited Partnership, the formal fiduciary duties that may have existed between himself and Judith and between himself and the Corporation were not relevant to the determination of Jiles’s relationship to the Limited Partnership.<sup>74</sup>

Justice Frost made convincing arguments, and if nothing else, her dissent demonstrates the importance of this case: it underscores the newfound ease with which Texas courts might be willing to find an informal fiduciary relationship, thereby imposing the fiduciary burdens that accompany such fiduciary relationships between limited partners and limited partnerships. This case also raises the question of whether the mere

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65. *Id.*

66. *Id.* at 755–56 (Frost, J., dissenting).

67. *Id.* at 756.

68. *Id.*

69. *Id.* at 757.

70. *Id.*

71. *Id.*

72. *Id.*

73. *Id.* at 759.

74. *Id.* at 758.

act of signing personal guaranties on partnership loans might expose limited partners to a greater risk of fiduciary duty liability.

### C. *STREBEL v. WIMBERLY*

The First Court of Appeals, in *Strebel v. Wimberly*, addressed the scope of fiduciary duties that members owe to an LLC and that partners owe to a partnership, and the case provides insight on how courts will interpret contracts when the scope of fiduciary duties that a partner or member owes is at issue.<sup>75</sup> In this case, John Wimberly and Douglas Strebel were members of a limited liability company, Black River Capital, LLC (Black River LLC), and each held a 50% membership interest.<sup>76</sup> Strebel solicited business from his friend, John Wilder, who had recently assumed the role of TXU Energy CEO.<sup>77</sup> Because the work stemmed from Strebel's contact with Wilder, Wimberly and Strebel orally agreed to share their profits—60% to Strebel and 40% to Wimberly.<sup>78</sup>

As the business expanded, Wimberly and Strebel decided to negotiate an amended Black River LLC agreement to memorialize their discussion.<sup>79</sup> In December 2005, the members executed the amended Black River LLC agreement.<sup>80</sup> The agreement kept the profit-sharing ratios the same and specified that even though Strebel was managing manager, he would not have the authority to make major decisions—including “changing any Member’s Sharing Ratio, requesting additional Capital Contributions, and making Fundamental Changes in the Company”—without consulting the Board of Managers.<sup>81</sup> Wimberly, Strebel, Wimberly’s wife, and Strebel’s wife were all managers of the LLC, and they comprised the Board of Managers.<sup>82</sup> The agreement also specified that the managers owed fiduciary duties to the company and its members commensurate with the fiduciary duties that directors owe Delaware corporations.<sup>83</sup> It further stated that the members owed fiduciary duties to the company comparable to those duties that Delaware corporations owe their stockholders.<sup>84</sup>

On the same day, Wimberly, Strebel, and two others entered into a limited partnership agreement for Black River Capital Partners, LP (Black River LP).<sup>85</sup> That agreement established Black River LLC as the general partner, with broad power to control Black River LP.<sup>86</sup> The

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75. See *Strebel v. Wimberly*, 371 S.W.3d 267, 276–86 (Tex. App.—Houston [1st Dist.] 2012, pet. filed).

76. *Id.* at 270.

77. *Id.*

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.* at 271.

82. *Id.*

83. *Id.*

84. *Id.*

85. *Id.*

86. *Id.*

Black River LP agreement limited the general partner's "duties (including fiduciary duties)" to those "expressly set forth in th[e] [a]greement."<sup>87</sup> The agreement did not impose any other fiduciary duties on the general partner.<sup>88</sup>

In November 2006, Strebel notified Wimberly that Wimberly's sharing ratio in Black River LP would be reduced significantly.<sup>89</sup> Because Strebel was managing manager of Black River LLC—the general partner of Black River LP—and owned the majority of limited partner voting rights in Black River LP, he held the authority to unilaterally amend the Black River LP agreement to retroactively reduce Wimberly's share as of August 2006.<sup>90</sup> In January 2007, Wimberly complained about Strebel's actions and his failure to consult with the Board of Managers of Black River LLC before amending the Black River LP agreement.<sup>91</sup> In September 2009, the parties presented their case to a jury, and Wimberly accused Strebel of breaching fiduciary duties by retroactively decreasing his distribution percentages and moving funds from profits to bonuses in order to decrease Wimberly's share of distributions.<sup>92</sup> The jury held in Wimberly's favor, but Strebel appealed.<sup>93</sup>

The court of appeals offered a detailed analysis of the scope of Strebel's fiduciary duties. First, the court analyzed the Black River LLC agreement to look for clues about the scope of fiduciary duties that Strebel owed to Wimberly as a fellow member in the LLC.<sup>94</sup> Delaware law governed the LLC agreement, and the court explained that the terms of the agreement were the best source to determine the existence and scope of any fiduciary duties that the manager might owe.<sup>95</sup> Since the agreement stated that "[m]anagers shall have fiduciary duties to the Company and the Members equivalent to the fiduciary duties of directors of Delaware corporations," the court concluded that it should measure Strebel against that standard.<sup>96</sup>

The court explained that the Supreme Court of Delaware has held that directors of Delaware corporations owe duties of good faith, due care, and loyalty to the corporation and its shareholders.<sup>97</sup> Strebel tried to argue that the LLC agreement's language referring to duties owed to members meant duties owed as a whole to *all* members, rather than to one particular member.<sup>98</sup> The court did not find this argument convincing and instead stated its preference to read contracts as a whole, giving terms

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87. *Id.* at 272.

88. *Id.*

89. *Id.*

90. *Id.*

91. *Id.*

92. *Id.* at 274.

93. *Id.* at 274–75.

94. *Id.* at 276–78.

95. *Id.* at 276–77.

96. *Id.* at 277–78.

97. *Id.* at 277.

98. *Id.*

their plain and ordinary meaning.<sup>99</sup> If the court interpreted the contract language in accordance with Strebel's interpretation, the court pointed out, it would essentially render a portion of the contract language meaningless.<sup>100</sup> The court reasoned that because the contract imposed fiduciary duties to the company *and its members*, Strebel's interpretation negated the obvious meaning of the contract.<sup>101</sup>

The court ultimately decided that it should determine the applicable fiduciary duties for Strebel at the Black River LP level, since Strebel's actions to retroactively reduce Wimberly's sharing ratio took place as a decision made by the partnership.<sup>102</sup> As a result, the court analyzed Strebel's fiduciary duties based on the Black River LP agreement.<sup>103</sup> The court held for Strebel on the fiduciary duties issue.<sup>104</sup> It explained that because Strebel's actions were in his capacity as managing manager of the partnership's general partner, the scope of Strebel's fiduciary duties turned on the fiduciary duties that the general partner owed to the partnership.<sup>105</sup> The court analyzed the contractual language of the Black River LP agreement regarding fiduciary duties, and it pointed out that the agreement expressly disclaimed the general partner's fiduciary duties and consequently foreclosed Wimberly's ability to recover on a breach of fiduciary duty claim against Strebel in his capacity as managing manager of the general partner.<sup>106</sup> The decision also addressed Strebel's potential fiduciary duties to Wimberly in his capacity as a fellow limited partner in the Partnership, but the court pointed out that, generally, limited partners do not owe fiduciary duties to other limited partners, except in special instances that did not apply in this case.<sup>107</sup> Therefore, Strebel avoided any potential liability based on his capacity as a limited partner as well.<sup>108</sup>

Although the court's conclusion ended up being relatively straightforward and based mostly on contract interpretation, the opinion holds value because it contains a lively discussion of the fiduciary duties that members and partners generally owe in the absence of contract language to the contrary. Additionally, it examines how courts are likely to construe contract language regarding fiduciary relationships when conflicts arise. The case showcases the court's general willingness to place significant weight on the contract's language because the terms are a reflection of the parties' negotiation. Furthermore, it stresses the importance of negotiating a well-drafted partnership agreement that reflects the parties' intent at the forefront. In this case, if Wimberly had negotiated that any amendments to the partnership agreement—including changing sharing

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99. *Id.*

100. *Id.* at 278.

101. *Id.*

102. *Id.* at 283.

103. *Id.* at 278–82.

104. *Id.* at 281.

105. *Id.* at 283–85.

106. *Id.* at 284–85.

107. *See id.* at 280–81.

108. *Id.* at 281.

ratios—would require his consent, he could have avoided this resulting litigation and, ultimately, defeat.

### III. VEIL PIERCING

#### A. *SHOOK v. WALDEN*

In *Shook v. Walden*, the Third Court of Appeals in Austin examined the recent state of the law regarding veil piercing in the context of limited liability companies.<sup>109</sup> Since the case arose before the enactment of the new LLC provision governing veil piercing in the Texas Business Organizations Code (TBOC), the court of appeals had to determine how to apply veil piercing law in the context of an LLC without statutory guidance.<sup>110</sup> The court interpreted the issue using corporate veil piercing laws in a manner that happens to be consistent with the newly enacted LLC statute governing veil piercing.<sup>111</sup>

In September 2006, Terry and Joy Walden entered into a pair of contracts with S & J Endeavors, LLC (S & J), a homebuilding and real estate development company, that involved a real property sale and a home construction project.<sup>112</sup> The first contract related to the sale of a plot of residential land (the Land Contract), and the second contract involved S & J's commitment to build a residence for the Waldens on the soon-to-be purchased plot of land (the Construction Contract).<sup>113</sup>

S & J had two members, Patrick Jaehne and Stanley Shook.<sup>114</sup> Jaehne controlled most of the day-to-day operations of the company, and he negotiated both the Land Contract and the Construction Contract with the Waldens.<sup>115</sup> Although Shook played some role in the company, he contended that his role was mainly limited to that of a passive investor.<sup>116</sup> He claimed that he had only invested because Jaehne had recently married his daughter, and he wanted to assist Jaehne in obtaining the company to ensure that Jaehne could support her.<sup>117</sup>

Immediately after signing the contracts in September 2006, the Waldens paid \$62,000, and construction on the house began.<sup>118</sup> Shortly thereafter, a host of problems between the Waldens and S & J began. First, the Waldens were displeased with the quality of work in the construction of their home and complained about various defects and changes in the plan.<sup>119</sup> Second, S & J failed to promptly transfer title to

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109. *Shook v. Walden*, 368 S.W.3d 604, 607 (Tex. App.—Austin 2012, pet. denied).

110. *See id.*

111. *See* TEX. BUS. ORGS. CODE ANN. § 101.002 (West 2012).

112. *Shook*, 368 S.W.3d at 607.

113. *Id.*

114. *Id.* at 608.

115. *Id.*

116. *Id.*

117. *Id.*

118. *Id.*

119. *Id.*

the Waldens.<sup>120</sup> The delay occurred because, even though S & J purportedly sold the land to the Waldens, the title was actually wholly owned by Jaehne in his individual capacity.<sup>121</sup> Jaehne had fallen behind on his personal debt obligations on the property, which inhibited his ability to transfer clear title to the Waldens.<sup>122</sup> Jaehne eventually transferred title to the Waldens, but it was more than one year after the contemplated completion date and with a vendor's lien attached.<sup>123</sup> In response, the Waldens filed suit.<sup>124</sup> The jury determined that Shook was personally liable for S & J's contracts based on theories of both alter ego and sham.<sup>125</sup> Shook appealed the jury's finding, alleging that the Waldens also needed to prove that he had engaged in actual fraud and had failed to do so.<sup>126</sup>

In addressing Shook's arguments, the court engaged in an in-depth analysis of the current state of the law on corporate veil piercing in LLC cases. The court explained that in response to the *Castleberry* decision, which greatly increased the scope of personal liability for corporate shareholders and directors, the legislature amended article 2.21 of the Texas Business Corporation Act to limit judicial application of corporate veil piercing principles.<sup>127</sup> One limitation prohibited courts from imposing corporate contractual obligations directly on shareholders

on the basis of actual or constructive fraud, or a sham to perpetrate a fraud" except on proof that the shareholder had "caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit" of the shareholder.<sup>128</sup>

While Texas corporate veil piercing law was evolving, the first LLC statutes were created.<sup>129</sup> In 1991, Texas enacted the first Texas Limited Liability Company Act (LLC Act), which was later recodified as Title III of the TBOC.<sup>130</sup> The court recognized that since S & J was formed before the LLC Act's recodification, it had to analyze the case under the former LLC Act laws.<sup>131</sup> The relevant portion of the LLC Act, article 4.03, stated that "[e]xcept as and to the extent the regulations [of the LLC] specifically provide otherwise, a member or manager is not liable for the debts, obligations[,] or liabilities of a limited liability company including under a judgment decree, or order of a court."<sup>132</sup>

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120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.* at 609.

124. *Id.*

125. *Id.* at 610.

126. *Id.* at 611.

127. *Id.* at 612.

128. *Id.* (quoting Act of May 12, 1989, 71st Leg., R.S., ch. 217, § 1, 1989 Tex. Gen. Laws 974, 974).

129. *Id.* at 613.

130. *Id.*

131. *Id.*

132. *Id.* (quoting TEX. BUS. ORGS. CODE ANN. § 101.114 (West Pamph. 2011)).

Even though Texas veil piercing law was evolving in the corporate sector at the time of the LLC Act's enactment, the LLC Act included no similar provisions.<sup>133</sup> In 2011, the Texas legislature added § 101.002 to address this very issue: it clarified that code sections that regulate veil piercing with respect to corporations also apply to LLCs.<sup>134</sup> Because this case began before the amendment, however, Shook correctly acknowledged that the case should be governed by former law.<sup>135</sup> When the Texas corporation statutes were silent on the issue of veil piercing, Texas courts still imposed veil piercing on corporations.<sup>136</sup> Likewise, the court of appeals recognized that most Texas courts have also treated LLCs in the same manner—uniformly permitting the piercing of LLCs' veils despite statutory silence—using similar standards as developed in corporate statutes.<sup>137</sup>

Shook pointed out on appeal that the jury instructions failed to describe the requirement that he must have used S & J to perpetrate an actual fraud for his “direct personal benefit” under both the alter ego and sham theories.<sup>138</sup> The Waldens, on the other hand, argued that these standards should not apply to LLCs.<sup>139</sup> They argued that the legislature's intentional silence—before 2011—and the inherent differences between corporations and LLCs meant that the same standards should not apply.<sup>140</sup> Instead, they argued that these factors evidenced a legislative intent not to apply the restrictions required for corporate veil piercing in the LLC context.<sup>141</sup>

Acknowledging that the Texas Supreme Court had not yet spoken on the application of veil piercing laws in the LLC context, the court of appeals decided to let the legislative policy judgments and balancing of interests that occurred through legislative amendments post-*Castleberry* guide its application of LLC veil piercing law.<sup>142</sup> The court highlighted the Waldens failure to identify any differences between LLCs and corporations in the context of piercing an entity's veil in a contract claim.<sup>143</sup> The court instead reasoned that the core inquiry was the same in both cases: “when should the policies of shielding investors and entrepreneurs from liability yield to the goal of preventing ‘abuse’ of the entity's separate existence?”<sup>144</sup> As a result, the court held that the Waldens had to prove that Shook used S & J to perpetrate fraud for his direct personal benefit and that he actually perpetrated the fraud.<sup>145</sup> Since the Waldens

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133. *Id.*

134. *Id.* at 613–14.

135. *Id.* at 614.

136. *Id.*

137. *Id.*

138. *Id.* at 615.

139. *Id.*

140. *Id.* at 615–16.

141. *Id.*

142. *Id.* at 617, 620.

143. *Id.* at 621.

144. *Id.*

145. *Id.*

admitted that they did not meet this burden, the court held in favor of Shook on the veil piercing issue and found him to be not personally liable.<sup>146</sup>

Justice Henson dissented, noting that in the absence of legislative direction under the LLC statute, she would have applied *Castleberry* standards.<sup>147</sup> Under *Castleberry*, no actual fraud finding is necessary, and therefore, Justice Henson would have upheld the jury's decision that Shook was liable under either theory.<sup>148</sup>

### B. *IN RE JULIET DEBTORS, LP*

In *In re Juliet Debtors, LP*, a bankruptcy court explored the issue of reverse veil piercing in the limited partnership context.<sup>149</sup> Reverse veil piercing is similar to traditional veil piercing, but it occurs in reverse: creditors can reach a *corporation's* assets for liabilities belonging to an *individual* when the individual has used the corporation as an alter ego.<sup>150</sup> In this bankruptcy case, Chapter 7 trustees of Juliet Homes, LP, Juliet GP, LLC, and Douglas Brown sued a group of defendants, alleging "preferential transfers, fraudulent transfers under both the Bankruptcy Code and the Texas Uniform Fraudulent Transfer Act, unjust enrichment, and legal fees."<sup>151</sup> As part of their claims, the trustees also sought to pierce the corporate veil of entities associated with the Juliet debtors (Juliet Homes, LP, and Juliet GP, LLC).<sup>152</sup>

The court held that the trustees avoided dismissal by meeting their burden to plead the elements of a reverse veil piercing claim.<sup>153</sup> In contrast to its treatment of traditional veil piercing, Texas has not codified the doctrine of reverse veil piercing, the requirements of which are therefore defined by Texas common law.<sup>154</sup> Historically, Texas courts have used reverse veil piercing in order "to bring assets of an affiliated entity into a bankruptcy estate."<sup>155</sup>

Generally, courts have hesitated to use the doctrine in the bankruptcy context.<sup>156</sup> They have held that the doctrine should only apply "when there is such a unity between corporation and individual that the separateness of the corporation has ceased and holding only the individual liable would result in injustice."<sup>157</sup> In general, the court will consider a

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146. *Id.* at 621–22.

147. *Id.* at 628 (Henson, J., concurring and dissenting).

148. *Id.* at 630.

149. *In re Juliet Homes, LP*, No. 07-36424, 2011 WL 6817928, at \*18 (Bankr. S.D. Tex. Dec. 28, 2011).

150. *Id.*

151. *Id.* at \*1.

152. *Id.*

153. *Id.* at \*19–20.

154. *Id.* at \*18.

155. *Id.* at \*19.

156. *See id.*

157. *Id.* (quoting *Bollore S.A. v. Imp. Warehouse, Inc.*, 448 F.3d 317, 325 (5th Cir. 2006)).



variety of factors to determine whether to reverse pierce the corporate veil, including: the relationship between the corporation and individual, respect for corporate formalities, segregation of corporate and individual assets, the amount of control and interest that the individual has over the corporation, and the individual's use of the corporation for personal gain.<sup>158</sup>

In this case, the trustees alleged that the non-debtor Juliet entities were merely alter egos of the debtors and served to perpetrate a fraud on the bankruptcy estate.<sup>159</sup> The trustees' complaint specifically alleged that: (1) the debtors formed the entities as a tool to perpetrate their fraud; (2) the debtors ran the entities for their personal benefit and conducted business through them; (3) the entities lacked separateness from the debtors by commingling funds and failing to keep corporate and personal assets separate; and (4) Brown perpetrated fraud by diverting company revenues to render the debtors insolvent.<sup>160</sup> The court held that these specific facts stated a claim for reverse veil piercing under Texas law, in light of the above-described factors necessary to justify reverse veil piercing.<sup>161</sup> As a result, the court denied the defendants' motion to dismiss for failure to adequately plead reverse veil piercing.<sup>162</sup>

#### IV. DERIVATIVE CLAIMS

In *Wesolek v. Layton*, a federal court in the Southern District of Texas focused on procedure and clarified the standard necessary for plaintiffs to bring a derivative action in Texas on behalf of a partnership when they claim a loss in partnership value.<sup>163</sup> In this case, a large group of plaintiffs purchased units of two Texas limited partnerships—Layton Energy Wharton, LP, and Layton Energy Fund 2, LP (collectively, the Funds)—that later greatly decreased in value.<sup>164</sup> Daniel Layton and J. Clarke Legler operated the Funds through Layton Energy Texas, LLC (Layton Energy).<sup>165</sup> The plaintiffs alleged that both Layton and Legler took money from the Funds to serve as collateral for other projects that Layton and Legler were operating.<sup>166</sup> Layton frequently induced investors to invest by promising they would receive a 300–500% return on their investments within three to five years.<sup>167</sup> Around the summer of 2010, Layton avoided investors' inquiries, allowed leases to expire, failed to pay service providers, failed to comply with state and federal regulations, failed to acquire properties that he had claimed he would acquire, and

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158. *Id.*

159. *Id.*

160. *Id.*

161. *Id.*

162. *Id.* at \*20.

163. *Wesolek v. Layton*, 871 F. Supp. 2d 620, 626–27 (S.D. Tex. 2012).

164. *Id.* at 623, 633.

165. *Id.* at 623.

166. *Id.* at 624.

167. *Id.*

engaged in general self-dealing that caused harm to the Funds.<sup>168</sup> In addition, the plaintiffs alleged that Layton frequently disregarded the separateness of the other businesses involved and the Funds, “treat[ing] them as a single business enterprise.”<sup>169</sup>

Based on these facts, the plaintiffs sued to rescind the sale of their partnership interests and to recover the money that they had invested in the Funds.<sup>170</sup> The plaintiffs filed a class action suit seeking recovery based on multiple theories, including fraud, conspiracy, and conversion, in December 2011.<sup>171</sup> In response, defendants Layton Corporation, Layton Energy, Layton, and Legler filed a motion to dismiss.<sup>172</sup> They argued that the plaintiffs lacked standing to bring their claims because the injuries that they complained of occurred solely to the Funds—not to the plaintiffs individually.<sup>173</sup> In January 2012, the plaintiffs filed an amended class action complaint (ACAC) that purported to bring the claims on behalf of the plaintiffs individually and on behalf of the Funds derivatively.<sup>174</sup>

Defendants Layton and Legler sought dismissal under Federal Rule of Civil Procedure 12(b)(1) based on a lack of subject-matter jurisdiction.<sup>175</sup> Layton and Legler argued that because the claims set forth in the original petition sought relief for harms that the Funds suffered, the plaintiffs had no standing to assert these claims.<sup>176</sup> Further, they argued that because the plaintiffs had no standing in their original petition, the court had never acquired subject-matter jurisdiction.<sup>177</sup> Therefore, the defendants argued, the plaintiffs had no right to file their ACAC.<sup>178</sup> The court sided with the defendants and dismissed the plaintiffs’ claims for a lack of subject-matter jurisdiction; but first it engaged in a thorough analysis of the current state of the law regarding standing with respect to partnerships.<sup>179</sup>

The court explained that the test for standing in Texas requires a real controversy between the parties that the judicial help sought will resolve.<sup>180</sup> The court then clarified that under Texas law, a partnership is a distinct entity: it can sue and be sued separately from its partners.<sup>181</sup> Limited partners can bring actions to recover on behalf of the limited partnership only 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

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168. *Id.* at 624–25.

169. *Id.* at 625.

170. *Id.*

171. *Id.*

172. *Id.* at 626.

173. *Id.* at 626–27.

174. *Id.* at 626.

175. *Id.* at 626–27.

176. *Id.*

177. *Id.*

178. *Id.*

179. *Id.* at 627–29.

180. *Id.* at 627–28.

181. *Id.* at 628.

partners to bring the action is not likely to succeed.”<sup>182</sup> Limited partners may choose to bring a cause either in their individual capacity—a direct claim—or on behalf of the partnership—a derivative claim.<sup>183</sup> The classification of the claim matters because, for the purpose of determining subject-matter jurisdiction, the limited partnership is an indispensable party in a derivative action.<sup>184</sup> On the other hand, the limited partnership is not a required party in a direct action.<sup>185</sup>

The court held that all of the plaintiffs’ claims seeking relief for a loss of investment value must have been brought derivatively on behalf of the Funds.<sup>186</sup> The court reached this determination after the plaintiffs failed to provide any authority holding that a loss of value in the Funds would give them standing to bring the claims directly.<sup>187</sup> Instead, the defendants provided authority demonstrating that Texas law required the plaintiffs to bring claims for loss of value derivatively.<sup>188</sup> Specifically, the court considered precedent stating that a loss of value in a limited partnership directly injured the limited partnership, while any loss to a partner resulting from a decrease in ownership interest was “indirect to and duplicative of” the injury to the limited partnership.<sup>189</sup>

Ultimately, the court reasoned that the Funds were the proper entities to bring suit.<sup>190</sup> Although the plaintiffs attempted to bring a derivative claim in their amended complaint, the court held that the plaintiffs did not comply with § 153.403 of the TBOC, which requires that plaintiffs plead “with particularity” the efforts that they took to request that the general partner act or why they did not make those efforts.<sup>191</sup> Additionally, the plaintiffs failed to comply with Federal Rule 23.1(b), which required them to verify the derivative complaint and disclaim any allusive intent to qualify for jurisdiction when the court otherwise would not have jurisdiction.<sup>192</sup> Although the plaintiffs sought leave to amend their amended complaint to comply with the requirements, the court rejected their request.<sup>193</sup> The court cited the fact that the plaintiffs did not provide any indication of the additional facts that they would allege or explain why they had not alleged them in the first place.<sup>194</sup> In sum, the court dismissed the derivative claim asserted for loss of value in the Funds.<sup>195</sup>

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182. *Id.*

183. *Id.*

184. *Id.* at 629.

185. *Id.*

186. *Id.* at 632.

187. *Id.*

188. *Id.*

189. *Id.* (quoting *Nauslar v. Coors Brewing Co.*, 170 S.W.3d 242, 251 (Tex. App.—Dallas 2005, no pet.)).

190. *Id.* at 633.

191. *Id.* at 633–34.

192. *Id.* at 634 (citing FED. R. CIV. P. 23.1(b)).

193. *Id.*

194. *Id.*

195. *Id.*

Turning to the plaintiffs' claims for common law fraud and violations of the Texas Securities Act arising from misrepresentations that occurred before the plaintiffs purchased their interests in the Funds, the court held that the plaintiffs could bring these claims directly for personal harm suffered individually, as opposed to harms suffered by the Funds.<sup>196</sup> However, the court still ended up dismissing these claims for failure to plead with sufficient particularity rather than for lack of standing.<sup>197</sup>

This case emphasizes a recurring theme of the Survey period: the importance of careful drafting of court documents and careful compliance with civil procedure requirements. In this case, a careful study of Texas law would have revealed that a claim for a loss of value in the Funds should have been brought derivatively and that even after the complaint was amended to add a derivative claim, the complaint must also detail with particularity the actions that were taken to encourage the general partner to bring the derivative action or why these actions were never taken. Here, more specificity in the complaint—as well as a better understanding of derivative actions—could have changed the outcome of the case.

#### V. LIMITED LIABILITY OF PARTNERS IN LIMITED LIABILITY PARTNERSHIPS

In *Rhodes Colleges, Inc. v. Johnson*, a federal court in the Northern District of Texas addressed the recent Texas limited liability partnership statutory amendment from September 2011 that changed the imposition of personal liability on partners of a limited liability partnership.<sup>198</sup> The court applied earlier Texas law because the plaintiff's claim arose before the enactment of the new statute.<sup>199</sup> The plaintiff, Rhodes Colleges, Inc. (d/b/a Everest College) sued Van Wey & Johnson, LLP (VW & J), as well as the lawyers who were partners in the firm in their individual capacities, Julie E. Johnson and Kay L. Van Wey, asserting claims of common law libel per se, statutory libel per se, business disparagement, and tortious interference with contract.<sup>200</sup>

Johnson's legal practice focused heavily on education fraud, and she had multiple clients who engaged her to bring fraud actions against Everest College.<sup>201</sup> In January 2009, she received her first education fraud cases against Everest College.<sup>202</sup> In response, she updated the firm's website content to include statements about Everest College that alluded to education fraud.<sup>203</sup> The website contained such comments as: (1) "When

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196. *Id.* at 636.

197. *Id.*

198. *Rhodes Colls., Inc. v. Johnson*, No. 3:10-CV-0031-D, 2012 WL 627273, at \*7 & n.7 (N.D. Tex. Feb. 27, 2012).

199. *Id.*

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

201. *Id.* at \*1.

202. *Id.*

203. *Id.*

schools promise far more than they can possibly deliver, that's educational fraud. At the [VW & J] law firm in Dallas, our attorneys have represented hundreds of students in confronting educational fraud at Everest College and other for-profit educational institutions," and (2)

When the lawyers at [VW & J] began getting calls from students at Everest College, we began to investigate. Everest College was promising to prepare students for lucrative careers. The truth was far different. The school is not accredited. They are in the education business for one reason—to make a profit.<sup>204</sup>

The website also accused the school of misrepresenting job placement facts and having students spend time and money on programs that would not transfer to other schools.<sup>205</sup> In May 2009, Van Wey and Johnson parted ways, and each formed individual laws firms—Van Wey Law, P.L.L.C (VWL), and the Law Office of Julie Johnson, P.L.L.C. (LOJJ), respectively—and Johnson transferred the website content to her own firm website.<sup>206</sup>

In response to the website content, Everest filed this lawsuit against Johnson, Van Wey, VW & J, LOJJ, and VWL, alleging common-law libel per se, statutory libel per se, business disparagement, and tortious interference with contract.<sup>207</sup> Van Wey and VWL moved for summary judgment to dismiss the claims against them.<sup>208</sup> In a footnote, the court recognized the defendants' argument that Van Wey was not personally liable under the new Texas statute, effective as of September 1, 2011, that eliminates all exceptions to the general rule that partners in limited liability partnerships cannot be personally liable for the partnership's debts.<sup>209</sup> Because the amendment was not expressly retroactive, however, the court held that this statute could not govern because Everest's claims arose before the enactment of the statute.<sup>210</sup>

Instead, the court turned to Texas law in effect at the time of the allegedly defamatory statements to determine whether Van Wey was personally liable for a debt or obligation of the partnership.<sup>211</sup> The court explained that under § 152.801 of the TBOC, a partner is not liable for another partner's negligence unless that partner:

(1) was supervising or directing the other partner or representative when the error, omission, negligence, incompetence, or malfeasance was committed by the other partner or representative; (2) was directly involved in the specific activity in which the error, omission, negligence, incompetence, or malfeasance was committed by the other partner or representative; or (3) had notice or knowledge of

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204. *Id.*

205. *Id.* at \*2.

206. *Id.* at \*1.

207. *Id.* at \*2.

208. *Id.*

209. *Id.* at \*7 n.7.

210. *Id.*

211. *Id.* at \*7.

the error, omission, negligence, incompetence, or malfeasance by the other partner or representative at the time of the occurrence and then failed to take reasonable action to prevent or cure the error, omission, negligence, incompetence, or malfeasance.<sup>212</sup>

Van Wey neither supervised nor directed Johnson when Johnson made the decision to post the statements about Everest College on the VW & J website.<sup>213</sup> Van Wey did not monitor the website, and Van Wey did not know that the Everest content was on the site prior to this lawsuit.<sup>214</sup> Everest provided no evidence that presented a fact issue on any of the liability exceptions listed in § 152.801 of the TBOC, and the court therefore granted summary judgment in Van Wey's favor.<sup>215</sup>

The court also granted summary judgment in VWL's favor because VWL's website never contained the allegedly defamatory content.<sup>216</sup>

## VI. CONCLUSION

On the whole, the cases from this Survey period reflect the recurring theme that compliance with civil procedure is very important to a case's outcome and that lawyers must exercise the utmost care in drafting court documents to reach favorable outcomes. The cases from this Survey period also emphasize the importance of well-negotiated and well-drafted LLC and partnership agreements, especially since courts have demonstrated the unwavering weight they will give to the agreement's terms. Further, the cases from the Survey period express a possible newfound ease with which courts may impose fiduciary duties on limited partners in limited partnerships in the future. The cases also shed light on the current state of the law regarding veil piercing and reverse veil piercing. Given the recent changes to the TBOC that courts discussed briefly during this Survey period, involving personal liability of partners in partnerships and members in LLCs, the next Survey period should contain cases that provide even more in-depth analysis of these provisions.

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212. *Id.*

213. *Id.*

214. *Id.*

215. *Id.* at \*8.

216. *Id.*

