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Corporations

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I. INTRODUCTION

LAST year we warned that the corporation was in significant legal jeopardy in Texas.¹ In fact, we suggested that after years of chipping away at the sanctity of the corporate form, the increasing and unpredictable use of the “single-business-enterprise” approach to corporate veil piercing could ultimately lead to the evisceration of the liability shield provided by the corporate form to the shareholders of Texas-based

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1. See Glenn D. West & Benton B. Bodamer, *Corporations*, 59 SMU L. REV. 1143, 1143 (2006) (noting that “[u]nless the Texas Supreme Court acts soon, the corporation, as a distinct legal entity, separate from its shareholders, officers and affiliates, is in serious danger in Texas”).

businesses. While there were some encouraging judicial developments during this Survey period,² we continue to be concerned by the Texas courts'³ inconsistent application of Article 2.21 of the Texas Business Corporation Act ("Article 2.21").⁴ In Part II, we continue our discussion of this trend by highlighting some of the more important decisions by the Texas courts during this Survey period regarding Article 2.21.

Additionally, we have again sought to provide practical drafting suggestions based on the decisions of Texas courts interpreting agreements that are commonly involved in corporate transactions.⁵ Last year we focused our discussion of corporate transaction agreement drafting on the effective use of nonreliance clauses to contractually avoid extra-contractual fraud claims.⁶ In Part III, we continue this discussion and highlight some disturbing developments that may serve to infuse a level of uncertainty about the extent to which nonreliance clauses will continue to provide a shield to the imposition of liability for fraud or other extra-contractual claims.

Finally, in Part IV, we report on an important decision that reaffirms that officers and directors of Texas corporations owe fiduciary duties only to the shareholders of the corporations for whom they serve and not to the creditors of those corporations, even in the so-called "zone of insolvency."

II. THE SANCTITY OF THE CORPORATE FORM IN TEXAS

Texas courts have long purported to uphold the importance of the corporation as an entity separate and distinct from its officers, shareholders, and affiliates.⁷ Indeed, as noted during this Survey period, "[i]t is an ele-

2. Although the Survey period for this Article is January 1, 2006 through December 31, 2006, relevant cases past this point were included as permitted up to the time this Article was submitted for publication.

3. As in previous years, relevant courts, for purposes of this Survey, are limited to Texas state courts, federal district courts in Texas and the United States Court of Appeals for the Fifth Circuit interpreting issues of Texas law, when appropriate. Since this Survey's scope is limited to Texas corporate law issues, neither purely federal corporate issues nor federal or state securities issues are discussed.

4. TEX. BUS. CORP. ACT ANN. art. 2.21 (Vernon 2003). It should be noted that for corporations formed on or after January 1, 2006, for corporations formed prior to January 1, 2006, that self-elect, and as of January 1, 2010, for all corporations, the Texas Business Organizations Code ("TBOC") replaces Article 2.21 as controlling law. This change in no way affects the law substantively, however, as the requirements of the TBOC are identical to those of Article 2.21). See TEX. BUS. ORGS. CODE ANN., tit. 2, §§ 21.223-225 (Vernon 2005).

5. See West & Bodamer, *supra* note 1, at 2.

6. *Id.* at 1156.

7. See West & Bodamer, *supra* note 1, at 1143-48. See also Glenn D. West & Susan Y. Chao, *Corporations*, 56 SMU L. REV. 1395, 1396-97 (2003) (noting that

[d]espite frequent pronouncements by Texas courts that the corporate form is not to be easily avoided or ignored, Texas courts have manifested a reluctance to unequivocally afford corporate officers, directors and shareholders the basic protections of that corporate form: namely, freedom from liability for the obligations of the corporation with whom the corporate officers, directors and shareholders are affiliated—protection that has always been the

mentary principle of corporate law that a corporation and its stockholders are separate entities . . .”⁸ and “[a] bedrock principle of corporate law is that an individual can incorporate a business and thereby normally shield himself from personal liability for the corporation’s contractual obligations.”⁹ Nevertheless, Texas courts frequently impose liability for corporate-level actions and contracts on the shareholders (including parent corporations), officers, or other affiliates of that corporation based on a myriad of theories.¹⁰ In past surveys, we have been particularly focused on the inappropriateness of any of those theories in imposing liability on nonparty affiliates of the named corporate parties to contractual obligations for such contractual obligations, or for any matter relating to or arising from such corporate contractual obligations, in direct contravention of Article 2.21.¹¹ Specifically, pursuant to Article 2.21, the only means by which a shareholder or affiliate of a corporate obligor may be liable for the obligations of that corporate obligor based on “alter ego,” “actual fraud,” “constructive fraud,” “sham to perpetuate a fraud,” or any other “similar theory” is by demonstrating that the shareholder or affiliate of the corporate obligor “caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for [such shareholder’s or affiliate’s] direct personal benefit.”¹² Article 2.21 further provides that the specified means of imposing liability (based on actual fraud for the direct personal benefit of the shareholder or affiliate of the corporate obligor) is “exclusive and preempts any other liability . . . under common law or otherwise.”¹³

During this Survey period, we were encouraged by the clarity of many of the Texas courts’ decisions in properly applying Article 2.21. On the other hand, there remains reason for continued concern based on the failure of other Texas courts to clearly and properly apply Article 2.21. Despite encouraging developments during the Survey period, Texas courts still do not apply Article 2.21 in every situation involving an attempted

most “fundamental” purpose for the formation of the corporate entity and protection that was specifically confirmed and enhanced by the Texas legislature in Article 2.21 of the Texas Business Corporations Act (internal citations omitted).

8. *In re HSM Kennewick, L.P.*, 347 B.R. 569, 571 (Bankr. N.D. Tex. 2006) (citing *In re Murchison*, 54 B.R. 721 (Bankr. N.D. Tex. 1985)).

9. *Willis v. Donnelly*, 199 S.W.3d 262, 271 (Tex. 2006).

10. See West & Bodamer, *supra* note 1, at 1145-46. During this Survey period, there were also several cases that discussed the applicability of veil piercing theories to limited liability companies in Texas. See, e.g., *In re JNS Aviation, LLC*, 350 B.R. 283, 299 (Bankr. N.D. Tex. 2006); *In re Kilroy*, 54 SMU L. REV. 1221, 1227 (2001); Glenn D. West & Sarah B. Stacy, *Corporations*, 58 SMU L. REV. 719, 726 (2005).

11. West & Bodamer, *supra* note 1, at 1148-53; West & Chao, *supra* note 7, at 1407-08; Glenn D. West & Adam D. Nelson, *Corporations*, 57 SMU L. REV. 799, 804-09 (2004); Glenn D. West & Brandy L. Treadway, *Corporations*, 55 SMU L. REV. 803, 815-16 (2002); Glenn D. West, *Corporations*, 54 SMU L. REV. 1221, 1227 (2001); Glenn D. West & Sarah B. Stacy, *Corporations*, 58 SMU L. REV. 719, 726 (2005).

12. TEX. BUS. CORP. ACT ANN. art. 2.21(A)(2) (Vernon 2003); see also *S. Union Co. v. Edinburg*, 129 S.W.3d 74, 87 (Tex. 2003) (reaffirming that Article 2.21 is the “exclusive” means of imposing liability on a parent, shareholder, or affiliate for corporate contractual obligations).

13. TEX. BUS. CORP. ACT ANN. art. 2.21(B) (Vernon 2003).

imposition of liability on any subsidiary, parent, affiliate (including an officer acting solely on behalf of a corporation) or shareholder of a corporation for the corporation's contractual obligations, or "any matter relating to or arising from" that corporation's contractual obligations.¹⁴

A. TEXAS CASES PROPERLY APPLYING ARTICLE 2.21

During this Survey period, the Texas Supreme Court rejected the most recent effort to employ a common-law theory to impose liability on a nonparty affiliate of a corporate obligor for that corporate obligor's contractual obligations.¹⁵ In *Willis v. Donnelly*,¹⁶ the Texas Supreme Court reinforced the precedent established in *Southern Union Co. v. City of Edinburg*¹⁷ and upheld the clear language of Article 2.21.¹⁸

Willis involved a commercial dispute stemming from the formation of a spa business in Houston. Michael Willis and several others established two corporations to operate the business. First, the group created Urban Retreat of Houston, Inc. ("URH"), which was the entity that would operate the initial spa. Second, Willis/Hite Enterprises, Inc. ("WHI") was established to serve as the "umbrella company" into which the initial URH and other subsequent spa companies would be integrated "if the concept worked in multiple locations."¹⁹ Willis was a shareholder, director, and officer of both corporations. After the establishment of the corporate entities, the group contacted Donnelly, who was a successful hair stylist and co-owner of Hairmasters of Houston, Inc. The parties agreed that Donnelly would join the business, and they memorialized this in a letter agreement. In the letter agreement, Donnelly agreed to use his best efforts to transfer his hair-salon business to the spa and also to manage the spa. In consideration for this obligation, URH and WHI promised Donnelly a salary and future stock transfers that were, in part, contingent on the new business reaching certain performance goals. As the business progressed, even though it did poorly overall, the conditions for certain stock transfers to Donnelly were eventually satisfied.²⁰

The litigation in *Willis* commenced when Willis sued Donnelly for failure to pay a separate loan that Willis had made to Donnelly. Donnelly counterclaimed by alleging breach of the letter agreement against the two corporate parties thereto, as well as Willis individually. At trial, the jury found that WHE and URH had indeed breached the letter agreement by failing to transfer stock to Donnelly. In addition, the jury also deter-

14. TEX. BUS. CORP. ACT ANN. art. 2.21(A)(2).

15. *Willis*, 199 S.W.3d at 273; see also West & Bodamer, *supra* note 1, at 1148 (noting that recent Texas cases "demonstrate a clear need and opportunity for the Texas Supreme Court to unambiguously extinguish the inappropriate application of common-law veil-piercing theories to Texas cases covered by Article 2.21" (internal citations omitted)).

16. *Willis*, 199 S.W.3d at 272.

17. See *S. Union Co. v. City of Edinburg*, 129 S.W.3d 74, 87 (Tex. 2003).

18. *Willis*, 199 S.W.3d at 272.

19. *Id.* at 265.

20. *Id.*

mined that Willis was individually liable under the letter agreement because he ratified the agreement. Both parties appealed the decision, and the court of appeals: (1) held that the trial record supported the liability determination for breach of contract; and (2) affirmed the jury's imposition of individual liability against Willis based on the determination that he ratified the letter agreement.²¹

On appeal to the Texas Supreme Court, the supreme court rejected the lower courts' imposition of liability for breach of contract on Willis in his individual capacity, clearly and unequivocally rejecting the ratification theory adopted by the lower courts. The supreme court started its review of the case by noting that "[a]s a matter of law, the corporate shield from liability should operate in these circumstances. . . . [because] [a]voidance of personal liability is not only sanctioned by the law; it is an essential reason that entrepreneurs like Willis choose to incorporate their businesses."²² The supreme court next discussed the evolution of Texas law in the context of shareholder liability, noting the precedent that it created in the seminal case of *Castleberry v. Branscum*²³ and how this precedent was subsequently minimized by the Texas legislature.²⁴ The supreme court then concluded that "[u]nder current law, by statute, a shareholder 'may not be held liable to the corporation or its obligees with respect to . . . a contractual obligation of the corporation. . . on the basis that the holder . . . is or was the alter ego of the corporation or on the basis of actual or constructive fraud, a sham to perpetrate a fraud or other similar theory . . .,'" except pursuant to the express provisions of Article 2.21.²⁵

In applying Article 2.21 to the ratification theory asserted by Donnelly, the supreme court noted that neither of the two exceptions contained in Article 2.21 were applicable. First, the supreme court explained that a shareholder may be held individually liable if it is proven that the "shareholder 'caused the corporation to be used for the purposes of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit of the shareholder.'"²⁶ However, the supreme court ultimately determined that this statutory exception was not available because the jury had rejected Donnelly's fraud claim.²⁷ Second, the supreme court also considered the statutory exception that allows for the imposition of individual liability on a shareholder "where the shareholder 'expressly . . . agrees to be personally liable to the obligee for the obligation.'"²⁸ In this context, the supreme court held that this exception was

21. *Id.* at 269.

22. *Id.* at 271.

23. *Castleberry v. Branscum*, 721 S.W.2d 270, 272 (Tex. 1986).

24. *Willis*, 199 S.W.3d at 271 (noting that "[t]he business community was displeased with the flexible approach to piercing the corporate veil embraced in *Castleberry*, and in response the Legislature in 1989 narrowly prescribed the circumstances under which a shareholder can be held liable for corporate debts.").

25. *Id.* at 272 (quoting TEX. BUS. ORGS. CODE § 21.223(a)).

26. *Id.* at 272 (quoting TEX. BUS. ORGS. CODE § 21.223(a)).

27. *Id.*

28. *Id.* at 272 (quoting TEX. BUS. ORGS. CODE § 21.225(1)).

not available.²⁹ In particular, the supreme court found no evidence that Willis expressly agreed to assume personal liability under the letter agreement. Rather, the supreme court found the factual record replete with clear evidentiary indications that Willis did not intend to be personally bound by the agreement. Willis, in fact, did not sign the agreement, and, while Donnelly asserted during trial that Willis previously agreed to “live up to the letter agreement,” the supreme court found that Donnelly provided no evidentiary substantiation as to whether Willis made such assertions in his individual or corporate capacity.³⁰ According to the supreme court, “[t]o impose liability against Willis under a common law theory of implied ratification because [he] accepted the benefits of the letter agreement would contravene the statutory imperative that, absent actual fraud or an express agreement to assume personal liability, a shareholder may not be held liable for contractual obligations of the corporation.”³¹ As a result, the supreme court held that “characterizing the theory as ‘ratification’ rather than ‘alter ego’ is simply asserting a ‘similar theory’ of derivative liability that is covered by the statute.”³²

Willis provides a prime example of how a court should treat the issue of shareholder liability. For corporate practitioners, it provides a dose of healthy optimism that the Texas Supreme Court has affirmatively set a judicial tone that reaffirms the vitality of the corporate form as a barrier to the imposition of individual liability. In addition, early indications are that Texas appellate courts are responding and following the clear mandate that *Willis* provides.³³

Two of the courts of appeals’ decisions decided during this Survey period are particularly clear examples of Texas courts properly applying the provisions of Article 2.21 to cases in which a party is attempting to impose personal liability on the basis of an alter-ego theory. First, in *Bates v. De Tournillion*,³⁴ the plaintiff filed suit against Bates Kwik Change, Inc. (“BKC”) and its shareholder Charles Bates asserting claims for breach of contract, fraud, breach of fiduciary duty, conversion, and theft, arising out of a lease agreement between the plaintiff, as lessor, and BKC, as lessee. The plaintiff’s petition sought to impose liability against Bates in his individual capacity based on an alter-ego theory. Upon the conclusion of a bench trial, the trial court entered judgment for the plaintiff against both BKC and Charles Bates, individually.

The court of appeals commenced its review of the case by noting that:

29. *Id.*

30. *Id.*

31. *Id.*

32. *Id.* at 273.

33. *See e.g.*, *A.M. Barbar Corp. v. Hellriegel*, No. 09-05-077 CV, 2006 WL 2506417, at *3 (Tex. App.—Beaumont 2006, no pet.); *Goodman Sales Co. v. ASHA Distrib., Inc.*, No. H-05-1260, 2006 WL 2469357, at *3 (S.D. Tex. 2006, no pet.); *Metal Bldg. Components, LP v. Raley*, 2007 WL 74316, at*12 (Tex. App.—Austin 2007, no pet.).

34. *Bates v. de Tournillion*, No. 07-03-0257-CV, 2006 WL 265474 (Tex. App.—Amarillo Feb. 3, 2006, no pet.).

Imposition of liability on a corporate shareholder for the contractual obligation of the corporation on an alter ego or similar theory requires proof that the shareholder (1) caused the corporation to be used for the purpose of perpetrating; and (2) did perpetrate an actual fraud on the contractual obligee primarily for the direct personal benefit of the shareholder.³⁵

The court then concluded that the factual record of the case did not support the trial court's determination. In particular, the court held that, despite the plaintiff's showing that Bates minimally capitalized the corporation, the plaintiff provided no evidence of Bates's use of the corporation to perpetrate a fraud.³⁶ Additionally, the court rejected the plaintiff's contention that Bates's removal of BKC's equipment and inventory from the premises leased from plaintiff under the lease agreement supported the imposition of personal liability. The court found that, "[e]ven inferring an intent to deceive from [Bates's] removal of the equipment and inventory to the storage facility, the evidence fails to meet the requirements of Article 2.21.A(2)."³⁷ In fact, the court found "no evidence [Bates] personally made any use of the items or that his actions were otherwise for his direct personal benefit."³⁸ Because the plaintiff could point to no evidence in the record satisfying the statutory perquisites of Article 2.21.A(2), i.e., BKC being used to perpetuate an actual fraud for the direct personal benefit of Bates, there was not a basis on which the court could properly impose liability on Bates, as the shareholder of BKC, under the lease.³⁹

B. TEXAS CASES FAILING TO PROPERLY APPLY ARTICLE 2.21

In contrast to the previous decisions is *Formosa Plastics Corp., USA v. Kajima International, Inc.*⁴⁰ The *Formosa* case involved, in part, a claim predicated on the single-business-enterprise doctrine—a veil-piercing theory covered in last year's Survey.⁴¹

In *Formosa*, Kajima International, Inc. ("Kajima") and Formosa Plastics Corporation, USA ("Formosa USA") entered into a series of construction contracts.⁴² The contracts at issue were executed after Kajima, an industrial construction company, successfully bid for work on one of Formosa USA's plants. Kajima claimed Formosa USA fraudulently induced it to enter into the contract by withholding specific information relating to the work. As a consequence, Kajima asserted it was misled into making artificially low bids on the contracts. Kajima filed its original

35. *Id.* at *2 (relying on TEX. BUS. CORP. ACT ANN. art. 2.21).

36. *Id.* at *3.

37. *Id.*

38. *Id.*

39. *Id.*

40. *Formosa Plastics Corp., USA v. Kajima Int'l, Inc.*, 216 S.W.3d 436 (Tex. App.—Corpus Christi 2006, pet. filed).

41. See West & Bodamer, *supra* note 1, at 1145-53.

42. *Formosa*, at 444.

action in Texas state court asserting breach of contract and fraud, among other claims, against Formosa USA and its subsidiary Formosa Plastic Corp., Texas ("Formosa Texas"). Because Formosa Texas was not a party to the contracts, Kajima's claims against both defendants were predicated, in part, on the single-business-enterprise theory. Kajima sought to merge Formosa USA and Formosa Texas under the single-business-enterprise theory in order to make Formosa USA liable for the actions and alleged fraud of Formosa Texas. Kajima sought and obtained a partial summary judgment based on the finding that Formosa USA and Formosa Texas were a single-business enterprise as a matter of law prior to the trial before a jury. At trial, the jury determined that Formosa USA had defrauded Kajima.⁴³

One of the many issues on appeal was whether the trial court erred by granting Kajima's motion for partial summary judgment based on the finding that Formosa USA and Formosa Texas, its wholly owned subsidiary, were operated as a single-business enterprise. As a result of this partial summary judgment, "the jury was instructed that it could consider the conduct of Formosa Texas when deciding the liability of Formosa USA."⁴⁴ Kajima claimed that Formosa USA and Formosa Texas were operated as a single-business enterprise because: (1) the companies had common employees during the relevant period of time; (2) the companies shared common offices; and (3) the companies had a centralized or coordinated accounting system with respect to the approval of construction details. Formosa USA countered by arguing that Article 2.21 applied and required that Kajima make a showing of actual fraud.⁴⁵

As to the viability of Kajima's single-business-enterprise claim against the defendants in *Formosa*, the court first addressed the issue of Article 2.21's general applicability to the facts of the case. In particular, the court correctly noted that Article 2.21 not only applies to contractual obligations, but also to "any matter relating to or arising from the obligation." Therefore, the court "assume[d], without deciding," that despite the fact that the case was submitted to the jury on the issue of fraud, the fraud issue was derivative of the parties' contractual relationship because the fraud related to and arose out of that contractual obligation.⁴⁶ As a re-

43. *Id.* at 445.

44. *Id.* at 459.

45. *Id.*

46. This is an important issue that has been frequently overlooked by the courts. A claim of fraud arising out of a contractual relationship is "a matter relating to or arising from" that contractual relationship and therefore within the applicable matters to which Article 2.21 is directly applicable. West & Bodamer, *supra* note 1, at 1150 n.39 and 1158 n.90; West & Nelson, *supra* note 11, at 806 n.40; West & Chao, *supra* note 7, at 1408 n.99. See also *In re Jim Walter Homes, Inc.*, 207 S.W.3d 888, 895 (Tex. App.—Houston [14th Dist.] 2006, no pet.) ("Courts recognize the use of 'any' dispute 'arising out of or relating to' as broad language that expressly includes tort and other claims relating to the contractual relationship."); *Clark v. Power Mktg. Direct, Inc.*, 192 S.W.3d 796, 798-99 (Tex. App.—Houston [1st Dist.] 2006, no pet.) (forum selection clause requiring that "any action, claim or demand arising under or as a result of this Agreement shall be filed in Franklin County,

sult, Article 2.21 was directly applicable to this case.⁴⁷

Notwithstanding a finding that Article 2.21 was generally applicable, the court went on to conclude that Article 2.21 did not protect a subsidiary of a parent obligor from liability under the single-business-enterprise theory. Rather, according to this court, Article 2.21 only protects shareholders of the corporate obligor from exposure to the contractually related obligations of that corporate obligor. Because the corporate obligor (i.e., the entity that was the named party to the contracts) was Formosa USA (the parent company) and not Formosa Texas (the subsidiary), the court held that Article 2.21 did not actually protect Formosa USA from exposure to a claim based on the actions of its subsidiary, Formosa Texas, related to the contractual obligations entered into by Formosa USA.⁴⁸ Moreover, the court also noted, without discussion, that “[b]ecause the evidence of Formosa USA’s own fraud is sufficient to support the jury’s finding that Formosa USA committed fraud, Formosa has not been harmed by the trial court’s ruling on the single-business enterprise.”⁴⁹

Because the trial court had ruled that the jury could consider the actions of Formosa Texas in determining the liability of Formosa USA, it is difficult to know for certain how the court could be so confident that the jury found Formosa USA guilty of its own fraud. Having thus concluded, however, the court then goes to great lengths to show how Formosa Texas and Formosa USA nonetheless should be considered a single-business enterprise as a matter of law. The court reaches this conclusion based on the fact that the companies shared certain employees and common offices, used a centralized accounting system, shared the name “Formosa,” and performed services for each other.⁵⁰ Each of the facts relied upon by the court to conclude that Formosa USA and Formosa Texas were a single-business enterprise as a matter of law, are common facts applicable to most parent-subsidiary relationships. Like last year’s concern with a number of cases that appeared to impose liability under the single-business-enterprise theory without any finding of wrongful conduct, holdings such as these cast doubt on the continued efficacy of the corporate shield in Texas, and hopefully the Texas Supreme Court will find an opportunity to make the single-business-enterprise theory a thing of the past.⁵¹

Another disturbing Texas decision regarding the applicability of Article 2.21 during the Survey period is *In re Morrison*.⁵² *Morrison* involved a determination of whether a debt was dischargeable under the Bankruptcy Code. Western Builders of Amarillo, Inc. (“Western Builders”) had entered into a written subcontract with Morrison Excavation, Inc. (“Morri-

Ohio” held to cover tort claims of fraudulent inducement and was not limited to contractual disputes under the Agreement.).

47. *Formosa*, 216 S.W.3d at 461.

48. *Id.* at 463.

49. *Id.*

50. *Id.*

51. See West & Bodamer, *supra* note 1, at 1145-53.

52. 361 B.R. 107 (Bankr. W.D. Tex 2007).

son Excavation"). David Morrison was the primary shareholder as well as the president of Morrison Builders. As part of the decision to engage Morrison Excavation as a subcontractor, Western Builders required that Morrison Excavation provide a financial statement. David Morrison personally delivered (by fax) a copy of Morrison Excavation's financial statement to Western Builders. The financial statement contained a significant overstatement of Morrison Excavation's accounts receivable. At the time the statement was delivered it is unclear whether Mr. Morrison knew of this error in his company's financial statement, but there was significant evidence that, before the subcontract was actually signed or funded, he knew of the error in the financial statement that had been submitted on behalf of Morrison Excavation.

As a result of cost overruns that Morrison Excavation could not fund, Western Builders ultimately terminated the subcontract with Morrison Excavation and incurred substantial damages by completing the project through other subcontractors. David Morrison thereafter filed personal bankruptcy. Western Builders argued that had they known the true financial situation of Morrison Builders they never would have entered into the subcontract. Western Builders claimed that David Morrison was personally liable for Western Builders losses arising out of the subcontract with Morrison Excavation because "Morrison caused Morrison Excavation to be used for the purpose of perpetuating a fraud and did perpetuate an actual fraud on Western Builders primarily for his own personal benefit."⁵³

Morrison argued that he had acted only on behalf of Morrison Excavation, and not for his own direct personal benefit pursuant to Article 2.21. The court, however, noted that "Morrison was the majority stockholder and president of Morrison Excavation . . . [and] [a]ny benefit to Morrison Excavation was a personal benefit to Morrison . . . [because] he needed the doors to stay open to draw his large salary and maintain his

53. *Id.* at 117. Western Builders also argued and the court held that even if Morrison was not liable under Article 2.21, Texas law allows "individual liability on the part of a corporate agent for misrepresentations made by him." *Id.* at 120. As a result, since Morrison personally participated in the delivery of (or subsequent failure to correct) the misleading financial statements of Morrison Excavation, "he can be personally liable for such action." *Id.* at 121. We have previously suggested that, contrary to this court's opinion, the fraud committed by a corporate agent solely in the furtherance of the business of his corporate principal is within the coverage of Article 2.21. See West & Stasny, *supra* note 11, at 726; West & Nelson, *supra* note 11, at 804-09; West & Chao, *supra* note 7, at 1403-08; West & Treadway, *supra* note 11, at 814-16; West, *supra* note 11, at 1226-37. Article 2.21 covers not only piercing-the-veil theories such as alter ego, but also "actual fraud . . . or other similar theory." Whatever the theory pursuant to which a shareholder or affiliate of the corporation is made to answer for that corporation's contractual obligations or any other matter related to or arising from that contractual obligation (including claims of extra-contractual fraud), Article 2.21 requires a showing that such fraud was for the "direct personal benefit" of the person sought to be charged with such liability. Otherwise, Article 2.21 truly does not protect the owner of a corporation, who also serves as an officer of that corporation, because "[u]nder Texas law, a corporation or other legal entity can conduct business only through natural persons." *In re L&D Interests, Inc.*, 350 B.R. 391, 400 (Bankr. S.D. Tex. 2006).

lifestyle.”⁵⁴

“Direct personal benefit” cannot possibly mean the indirect benefit a shareholder obtains by owning the majority or even all of the stock of a corporation. Similarly, “direct personal benefit” cannot mean the salary that such a shareholder receives as a corporate officer. Such benefits would always be present in any closely held corporation, and Article 2.21 clearly requires proof of an actual fraud being perpetrated through the use of the corporate form with the proceeds derived from that fraud “directly” benefiting the individual shareholder or affiliate of the corporate obligor. The court cited no evidence showing a direct use, by David Morrison personally, of funds derived from the fraudulent procurement of the subcontract by Morrison Excavation from Western Builders.⁵⁵ Other cases that have discussed the meaning of “direct personal benefit” have tended to require a specific use of corporate funds (procured through the fraud) to fund personal (rather than corporate) expenses.⁵⁶ To make a showing of “direct personal benefit” simply by noting that because Morrison “ran the company and made all of the decisions regarding its operation[,] . . . [a]ny benefit to Morrison Excavation was a personal benefit to Morrison[,]” is to make the statute meaningless.

III. DRAFTING CORPORATE AGREEMENTS—AVOIDING FRAUD CLAIMS THROUGH THE EFFECTIVE USE OF NONRELIANCE CLAUSES

As noted in prior surveys, disputes over corporate contractual arrangements are rarely limited to breach of contract claims.⁵⁷ Inevitably, extra-contractual tort claims of fraud and misrepresentation against one of the parties or their officers result from nearly every contractual dispute. This reality persists despite frequent pronouncements by the Texas courts that they have generally resisted the “contortion”⁵⁸ of contract and tort law and have instead adopted the principal that “if a contract spells out the parties’ respective rights regarding a particular matter, the contract, not common-law tort principles, governs any dispute about that matter.”⁵⁹ Stated differently, “[a]lthough a party’s actions may breach duties in tort, contract, or both, Texas law is clear that ‘mere nonfeasance under a contract creates liability only for breach of contract.’”⁶⁰ Nevertheless, as

54. *In re Morrison*, 361 B.R. at 120.

55. Western Builders did claim that Morrison used some advance payments for personal use, but the court did not point to any specific evidence of an actual diversion of Morrison Excavation funds to the personal use of Morrison.

56. See *Bates*, 2006 WL 265474, at *3.

57. West & Bodamer, *supra*, note 1, at 1157; West & Stasny, *supra* note 11, at 721.

58. See Glenn D. West, *Avoiding Extra-Contractual Fraud Claims in Portfolio Company Sales Transactions—Is “Walk-Away” Deal Certainty Achievable for the Seller?*, Weil, Gotshal & Manges LLP Private Equity Alert (March, 2006), available at www.weil.com.

59. *Castle Tex. Prod. L.P. v. Long Trusts*, 134 S.W.3d 267, 274 (Tex. App.—Tyler 2003, pet. denied).

60. *Lookshin v. Union Planters Bank*, No. H-05-3834, 2006 WL 3147330, at *10 (S.D. Tex. Oct. 30, 2006).

noted by the Texas Supreme Court during this Survey period, there has long been a tension between “the need to keep tort law from overwhelming contract law so that private agreements are not subject to readjustment by judges and juries,”⁶¹ and the perceived public policy need to avoid treating a contract that was procured “by fraud [as] simply another contract dispute.”⁶²

While that tension would appear to be easily resolvable, since no one would want to countenance “fraud,” it is in fact a very difficult tension to resolve because fraud encompasses much more than most people believe. For example, “[a] contractual promise made with no intention of performing may give rise to an action for fraudulent inducement.”⁶³ Indeed, “a party may bring a fraudulent inducement claim even if the terms of the promise are later subsumed into a contract.”⁶⁴ Furthermore, “while breach alone is no evidence of fraudulent intent, breach combined with ‘slight circumstantial evidence’ of fraud is enough to support a verdict for fraudulent inducement.”⁶⁵ Thus, if one makes a promise in a written agreement, any subsequent breach is simply a breach of contract, but if one makes a promise that induces someone to enter into a contract in which that promise is memorialized, personal liability for fraud may exist. Fraud can encompass both affirmative statements made and, in certain circumstances, a failure to disclose information that “could not have been uncovered [by the other party] by reasonable investigation and inquiry.”⁶⁶ For sophisticated parties who have carefully crafted their agreements to strictly allocate risk among themselves introducing these uncertain tort concepts into their business dealings may result in exactly the effect that the Texas courts claim they seek to avoid, i.e., allowing “private agreements [to be] subject to readjustment by judges and juries.”⁶⁷

We have noted in the past that properly drafted disclaimer of reliance and merger provisions set forth in agreements between sophisticated parties can greatly reduce the possibility of these extra-contractual claims being sustained.⁶⁸ We even suggested that Texas was a state with a particularly strong record of “holding parties to the express terms of their writ-

61. *Tony Gullo Motors I, L.P. v. Chapa*, 212 S.W.3d 299, 306 (Tex. 2006).

62. *Id.*

63. *Id.* at 304.

64. *Id.* at 305. Interestingly, New York law does not appear to permit a fraudulent inducement claim to be premised on representations that are actually made a part of the written contract. *Wall v. CSX Transp., Inc.*, 471 F.3d 410, 417 (2d Cir. 2006). But the existence of a contract in New York does not foreclose a claim for fraudulent inducement based on a misrepresentation if “the misrepresentation is collateral to the contract it induced.” *Id.* at 416.

65. *Tony Gullo*, 212 S.W.3d at 305.

66. *Cronus Offshore, Inc. v. Kerr McGee Oil & Gas Corp.*, 369 F. Supp.2d 848, 858 (E.D. Tex. 2004).

67. *Tony Gullo*, 212 S.W.3d at 306.

68. West & Bodamer, *supra* note 1, at 1160-66; West & Stasny, *supra* note 11, at 721-26; West & Nelson, *supra* note 11, at 814-19.

ten agreements.”⁶⁹ Unfortunately, during this Survey period there were some disturbing Texas cases that potentially will erode the degree of confidence with which sophisticated parties to a corporate transaction can reliably depend on the written agreement they fashioned for themselves to definitively allocate risk.

A. TEXAS CASES NARROWLY INTERPRETING *Schlumberger*

In last year’s Survey we noted a consistent series of Texas cases that, relying upon the Texas Supreme Court’s decision in *Schlumberger Technology Corp. v. Swanson*,⁷⁰ confirmed that sophisticated parties may contractually disclaim reliance on extra-contractual representations and defeat any claims of fraud, including fraudulent inducement, that may arise in connection with or relate to the subject matter of a written contract.⁷¹ While there continued to be cases during this Survey period that reaffirmed the applicability of *Schlumberger* to any contract involving sophisticated parties, who have chosen to define their agreements exclusively by written contract, the Fourteenth District Court of Appeals in Houston provided an exceedingly narrow interpretation of *Schlumberger* in *Warehouse Associates Corp. Centre II, Inc. v. Celotex*.⁷² *Celotex*, currently on appeal, countered years of a consistently broad analysis of the *Schlumberger* precedent.

Celotex involved the sale of real property under a contract that included the following extensive “as-is” and “waiver-of-reliance” provision:

OTHER THAN THE WARRANTIES OF TITLE CONTAINED IN THE DEED, PURCHASER ACKNOWLEDGES AND AGREES THAT SELLER HAS NOT MADE, DOES NOT MAKE AND SPECIFICALLY DISCLAIMS ANY REPRESENTATIONS, WARRANTIES, PROMISES, COVENANTS, AGREEMENTS OR GUARANTIES OF ANY KIND OR CHARACTER WHATSOEVER, WHETHER EXPRESS OR IMPLIED, ORAL OR WRITTEN, PAST, PRESENT OR FUTURE, OF, AS TO, CONCERNING OR WITH RESPECT TO (A) THE NATURE, QUALITY OR CONDITION OF THE PROPERTY, INCLUDING WITHOUT LIMITATION, THE WATER, SOIL AND GEOLOGY, (B) THE INCOME TO BE DERIVED FROM THE PROPERTY, (C) THE SUITABILITY OF THE PROPERTY FOR ANY AND ALL ACTIVITIES AND USES WHICH PURCHASER MAY CONDUCT THEREON, (D) THE COMPLIANCE OF OR BY THE PROPERTY OR ITS OPERATION WITH ANY LAWS, RULES, ORDINANCES OR REGULATIONS OF ANY APPLICABLE GOVERNMENTAL AUTHORITY OR BODY . . . (E) THE HABITABILITY, MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OF THE PROPERTY, OR (F)

69. West & Bodamer, *supra* note 1, at 1156.

70. *Schlumberger Tech. Corp. v. Swanson*, 959 S.W.2d 171, 181 (Tex. 1997).

71. West & Bodamer, *supra* note 1, at 1156-66.

72. *Warehouse Assocs. Corp. Centre II v. Celotex Corp.*, 192 S.W.3d 225, 234 (Tex. App.—Houston [14th Dist.] 2006, pet. denied).

ANY OTHER MATTER WITH RESPECT TO THE PROPERTY, AND SPECIFICALLY THAT SELLER HAS NOT MADE, AND DOES NOT MAKE AND SPECIFICALLY DISCLAIMS ANY REPRESENTATIONS REGARDING SOLID WASTE, AS DEFINED BY THE U.S. ENVIRONMENTAL PROTECTION AGENCY REGULATIONS AT 40 C.F.R., PART 261, OR THE DISPOSAL OR EXISTENCE, IN OR ON THE PROPERTY, OF ANY HAZARDOUS SUBSTANCE, AS DEFINED BY THE COMPREHENSIVE ENVIRONMENTAL RESPONSE COMPENSATION AND LIABILITY ACT OF 1980, AS AMENDED, AND APPLICABLE STATE LAWS, AND REGULATIONS PROMULGATED THEREUNDER. PURCHASER FURTHER ACKNOWLEDGES AND AGREES THAT HAVING BEEN GIVEN THE OPPORTUNITY TO INSPECT THE PROPERTY, PURCHASER IS RELYING SOLELY ON ITS OWN INVESTIGATION OF THE PROPERTY AND NOT ON ANY INFORMATION PROVIDED OR TO BE PROVIDED BY THE SELLER. PURCHASER FURTHER ACKNOWLEDGES AND AGREES THAT ANY INFORMATION [sic] PROVIDED OR TO BE PROVIDED WITH RESPECT TO THE PROPERTY WAS OBTAINED FROM A VARIETY OF SOURCES AND THAT SELLER HAS NOT MADE ANY INDEPENDENT INVESTIGATION OR VERIFICATION OF SUCH INFORMATION. PURCHASER FURTHER ACKNOWLEDGES AND AGREES THAT THE SALE OF THE PROPERTY AT CLOSING SHALL BE MADE ON AN "AS IS, WHERE IS" CONDITION AND BASIS "WITH ALL FAULTS[.]"⁷³

Celotex Corporation operated an asphalt-shingle manufacturing plant on the property for a number of years prior to entering into the contract for sale of the land at issue in the case. While negotiating the sale, Celotex provided the buyer with a partial environmental report indicating that asbestos had been used in the buildings on the property but omitted information about asbestos contamination in the soil and the use of asbestos in the shingle manufacturing process.

Pursuant to the previously quoted provision, the written contract with the buyer "specifically disclaimed any representations, warranties, promises, covenants[,] and guaranties of any kind" other than the warranties of title contained in the deed.⁷⁴ Additionally, the buyer was expressly entitled to conduct inspections, tests, and investigations "as it deemed necessary to determine the suitability of the property . . . , and [the buyer] agreed that it was relying solely on its own inspection and investigation of the property."⁷⁵ The parties also agreed that "the sale of the property at closing would be on an 'as is, where is' condition and basis 'with all faults.'"⁷⁶ During the agreed upon inspection period in which the buyer

73. *Id.* at 235.

74. *Id.*

75. *Id.* at 227-28.

76. *Id.* at 228.

would have the right to terminate, Celotex discovered asbestos in the soil but did not disclose this finding to the buyer. The buyer conducted an independent environmental assessment of the soil but did not test for asbestos. After the inspection period and closing, the buyer discovered significant asbestos contamination in the soil and brought suit against Celotex alleging fraud and misrepresentation. Presumably based on the extensive “as is” and “nonreliance” clause quoted above, the trial court granted summary judgment in favor of Celotex on all of the buyer’s claims.⁷⁷

On appeal, the *Celotex* court addressed the extent to which *Schlumberger* had overruled prior Texas Supreme Court precedent that had created two exceptions to the enforceability of “as is” and “waiver of reliance” clauses. Specifically, the court noted that in *Prudential Insurance Co. of America v. Jefferson Associates*,⁷⁸ the supreme court excluded the following two situations from its general willingness to enforce specifically negotiated “as is” and “waiver of reliance” clauses entered into by sophisticated parties represented by counsel: “(1) the buyer was induced to enter into the contract containing that language by a fraudulent representation or concealment of information by the seller[;] or (2) the seller engaged in conduct that impaired, obstructed, or interfered with the buyer’s inspection of the property being sold.”⁷⁹ The court referred to these two exceptions as the “fraudulent inducement exception” and the “impairment-of-inspection exception.”⁸⁰ After reviewing *Schlumberger* in detail, the court concluded that both exceptions provided in *Prudential* “still stand, subject to a small exception to the fraudulent inducement exception.” According to the court in *Celotex*, the “small exception” to the “fraudulent inducement exception” created by *Schlumberger* was the limited factual situation confronted by the court in *Schlumberger*, i.e., the resolution of a long-running dispute designed to avoid litigation and to end a business relationship. According to the *Celotex* court, in that situation alone, a claim of fraudulent inducement is rendered ineffective by a nonreliance provision.

The decision in *Celotex* stands in stark contrast to prior consistent readings of *Schlumberger* that afforded broad enforceability to “as-is” and “waiver-of-reliance” provisions in contracts between sophisticated business persons, regardless of the context of the particular agreement in question. Moreover, the most commonly plead fraud based on extra-contractual statements is “fraudulent inducement.” There is little value to a nonreliance provision if a disappointed party can eliminate the effectiveness of a nonreliance clause simply by claiming that the extra-contractual representations or nondisclosures that such party disclaimed reliance upon fraudulently induced such party into entering into the contract.

77. *Id.*

78. 896 S.W.2d 156 (Tex. 1995).

79. *Celotex*, 192 S.W.3d at 230.

80. *Id.* at 231.

The very existence of a nonreliance clause, particularly one as extensive as the one in *Celotex*, should require extra diligence on the part of the buyer. Even in the absence of a nonreliance clause, Texas law states that a plaintiff “cannot recover if he blindly relies upon a misrepresentation the falsity of which would be patent to him if he had utilized his opportunity to make a cursory examination or investigation.”⁸¹ Indeed, “a duty to inquire is created when ‘such information is known as would prompt a person exercising reasonable care to acquire knowledge of the fact in question . . . , [and] [w]hen those inquiries are not made, the person is chargeable with knowledge that would have been acquired through diligent inquiry.’”⁸² While there may be evidence of less than full disclosure by the seller in this case, it is not clear that Warehouse Associates fulfilled its obligations of diligent inquiry. Between sophisticated parties, negotiating at arms length, the only claim of fraudulent inducement that should be available to defeat the effectiveness of a nonreliance provision should be a claim that the seller deliberately prevented the buyer from discovering material information that was “peculiarly” within the knowledge of the seller.⁸³ This does not appear to be such a case. Indeed, the *Celotex* court specifically held that Celotex did not impair Warehouse Associates’s inspection of the property, and a soil test presumably would have revealed the asbestos contamination.⁸⁴

Equally as disturbing as the decision in *Celotex* is the decision of the United States District Court for the Western District of Texas in *Nutrasep, LLC v. TOPC Texas LLC*.⁸⁵ *Nutrasep* involved a dispute over a Technology Licensing Agreement and a Manufacturing Supply Agreement. Nutrasep, LLC (“NTS”) purported to have developed a system for improving the quality of soybean oil. TOPC was an agricultural cooperative that produced soybean oil. NTS sued TOPC for breach of the Technology License Agreement and the Manufacturing Supply Agreement based on TOPC’s failure to make the required payments to NTS under the agreements. TOPC alleged in response that NTS had misrepresented the uniqueness of NTS’s technology and the amount of investment that would be required by TOPC. In a motion for summary judgment, NTS asserted that the “fraud” counterclaims of TOPC should fail as a matter of law because of the merger and nonreliance clauses in the agreements. The clauses in each of the agreements were substantially similar. The clauses in the Technology Licensing Agreement read as follows:

81. *In re Webber*, 350 B.R. 344, 372-73 (Bankr. S.D. Tex. 2006) (citing *Lewis*, 343 F.3d at 546).

82. *Id.* at 373.

83. *See e.g.*, *DynCorp v. GTE Corp.*, 215 F. Supp. 2d 308, 319-23 (S.D.N.Y. 2002); *In re Marketxt Holdings Corp.*, No. 05-01-52, 2006 WL 2864963, at *11-12 (Bankr. S.D.N.Y. Sept. 29, 2006).

84. *Celotex*, 192 S.W.3d at 241.

85. No. A-05-CA-523 LY, 2006 WL 3063432 (W.D. Tex Oct. 27, 2006).

3.3 Licensee, by execution hereof, acknowledges, covenants and agrees that it has not been induced in any way by NTS or its employees to enter into this Agreement, and further warrants and represents that (i) it has conducted sufficient due diligence with respect to all items and issues pertaining to this Article 3 and all other matters pertaining to this Agreement; and (ii) Licensee has adequate knowledge and expertise, or has utilized knowledgeable and expert consultants, to adequately conduct the due diligence, and agrees to accept all risks inherent herein.

* * *

12.1 This Agreement constitutes the entire and only agreement between the parties for Licensed Subject Matter and all other prior negotiations, representations, agreements, and understandings are superseded hereby. No agreements altering or supplementing the terms hereof may be made except by a written document signed by both parties.⁸⁶

Like the court in *Celotex*, the court in *Nutrasep* did not believe that these provisions were necessarily dispositive of the fraud claim or that *Schlumberger* was necessarily applicable. First, the court noted that the *Schlumberger* decision involved an effort to resolve an ongoing dispute arising from the efforts of the parties to terminate a business relationship. In contrast, according to this court, NTS and TOPC “entered into the Agreements in order to create a business relationship, not end an existing one.”⁸⁷ Second, the court found that TOPC was not represented by counsel and the provisions were “standard boiler-plate provisions that do not clearly and unequivocally disclaim reliance on the specific representations that form the basis for [TOPC’s] fraud claims.”⁸⁸ Accordingly, the court denied NTS’s motion for summary judgment on TOPC’s fraud claims, finding that the issue of NTS’s alleged fraud should be decided by a jury.⁸⁹ The court did note, however, that “given the language of the various clauses, a jury may well find [TOPC’s] professions of reliance on [NTS’s] statements lacking in credibility.”⁹⁰

Because there may well have been a question as to whether TOPC was a “sophisticated party,” and because TOPC was not represented by counsel, this decision could have turned more properly upon a finding that the *Schlumberger* criteria had not been satisfied. Unfortunately, the court chose to limit *Schlumberger* to its particular facts in the same manner as *Celotex* despite consistent past precedent to the contrary.

B. TEXAS CASES BROADLY INTERPRETING *SCHLUMBERGER*

In contrast to *Celotex* and *Nutrasep* is *Playboy Enterprises, Inc. v. Edi-*

86. *Id.* at *6.

87. *Id.* at *8.

88. *Id.*

89. *Id.*

90. *Id.*

torial Caballero.⁹¹ *Playboy* involved a dispute between Playboy Enterprises, Inc. ("PEI"), Editorial Caballero, S.A. de C.V. ("EC"), and Grupo Siete International, Inc. ("GSI") regarding a licensing agreement. The licensing agreement specifically allowed EC and GSI to publish and distribute a Spanish-language version of *Playboy* in the United States, but only upon receiving PEI's prior written approval. The License Agreement was for a three-year term beginning January 1, 1997. The first magazine issue was distributed in the United States in October 1997, and the parties subsequently renegotiated payments and entered into a written Renegotiation Payment Plan. But in January 1998, PEI terminated the Licensing Agreement due to EC's non-payment of royalties and other payments owed. EC and GSI subsequently asserted several claims against PEI, including a claim for fraud. Specifically, EC and GSI argued that PEI made several fraudulent oral representations in connection with the execution of the License Agreement. In particular, EC and GSI alleged that PEI committed fraud when it represented that:

- (1) PEI would not enforce or terminate the License Agreement;
- (2) renewal was automatic;
- (3) EC and GSI could import the Spanish-language edition into the United States;
- (4) PEI intended to ramp up circulation after the initial three-year period of the agreement and was not concerned with "cannibalization;"
- (5) it was not going to be a problem to distribute or sell 150,000 copies per month; and
- (6) the parties would be partners.⁹²

PEI denied liability and argued that the license agreement precluded EC and GSI from maintaining an action for fraud based on the oral representations. The court agreed by first noting that the alleged oral representations were "directly contradicted by the express unambiguous terms of the License Agreement," and EC and GSI were not justified in relying upon them as a matter of law.⁹³ In addition, the court found EC's and GSI's reliance on the statements unjustifiable based on the "merger clause," which provided that:

[T]his Agreement represents the entire understanding of the parties. None of the terms of this Agreement can be waived or modified except by an express agreement in writing signed by the parties. There are no representations, promises, warranties, covenants[,] or undertakings other than those contained in this Agreement.⁹⁴

In addressing the merger clause, the court directly relied upon the *Schlumberger* precedent, holding that, "[w]here a contract is negotiated at arms-length by sophisticated businessmen represented by counsel, this type of "merger" clause . . . is enforceable and negates reliance on any alleged oral representations."⁹⁵

91. *Playboy Enters. v. Editorial Caballero, S.A. de C.V.*, 202 S.W.3d 250 (Tex. App.—Corpus Christi 2006, pet. filed Dec. 27, 2006).

92. *Id.* at 257.

93. *Id.*

94. *Id.* at 258.

95. *Id.*

In addition to EC's and GSI's claims for fraud based on alleged oral representations, however, EC and GSI also alleged that PEI had committed fraudulent concealment. Specifically, EC and GSI claimed that PEI had failed to disclose that Hugh Hefner, PEI's chairman emeritus and owner of 70% of PEI's stock, was opposed to a Spanish-language version of Playboy being distributed in the US to the extent it would directly compete with the English-language edition of Playboy. Having found no extra-contractual representations and warranties, as a matter of law, the court went on to find that a claim still existed for fraud by nondisclosure and that a duty to disclose had arisen because:

Without disclosing Hefner's position on these matters, the information relayed to EC and GSI regarding general concerns PEI had about cannibalism and the publication of the Spanish-language edition for distribution in the United States was not the whole truth, was misleading, or conveyed a false impression. Thus, PEI's duty to disclose the material facts arose in at least one, if not all, of the following situations: when one voluntarily discloses information, he has a duty to disclose the whole truth; when one makes a representation, he has a duty to disclose new information when the new information makes the earlier representation misleading or untrue; and when one makes a partial disclosure and conveys a false impression, he has the duty to speak.⁹⁶

Having found that PEI had a duty to disclose Hugh Hefner's position regarding the undesirability of having a Spanish-language edition of Playboy, owned by a competitor and being distributed in the U.S., the court concluded that "EC and GSI can recover for fraud on this basis."⁹⁷

This holding appears to be directly contrary to previous Texas court decisions holding that "alleged nondisclosures are merely the converse of misrepresentations and are subsumed under any contract language disclaiming reliance on affirmative statements."⁹⁸ In a properly crafted nonreliance clause, nonreliance on nondisclosure should be no different than nonreliance on affirmative representations; in each case the party has agreed that it is relying only on that which was specifically stated or disclosed pursuant to the written agreement.

Another more recent federal district court decision, *Fair Isaac Corp. v. Texas Mutual Insurance*,⁹⁹ interprets Texas law and comports with the more traditional broad interpretation of *Schlumberger* in enforcing nonreliance provisions. *Fair Isaac* involved a dispute over a Master Application Servicing Agreement under which Fair Isaac Corp was to provide its "SmartAdvisor" bill-review software to Texas Mutual Insurance Com-

96. *Id.* at 263.

97. *Id.* at 264.

98. *Cronus Offshore, Inc. v. Kerr McGee Oil & Gas Corp.*, 369 F.Supp.2d 848, 859 (E.D. Tex. 2004), *aff'd* 133 Fed. App'x 944 (5th Cir. 2005). *See also Schlumberger Tech. Corp. v. Swanson*, 959 S.W.2d 171, 181 (Tex. 1997) (holding disclaimer of reliance clause precludes claim of fraud by nondisclosure because reliance remains an element of all fraud claims). *See, e.g., West & Bodamer, supra* note 1, at 1156-64.

99. *Fair Isaac Corp. v. Tex. Mut. Ins.*, 2006 WL 2022894, at *3 (S.D. Tex. July 17, 2006).

pany ("Texas Mutual"). After Texas Mutual began using SmartAdvisor, it allegedly "caused a complete collapse of [Texas Mutual's] medical-bill-review function and caused Texas Mutual to overpay bills by millions of dollars."¹⁰⁰ Fair Isaac sued Texas Mutual when Texas Mutual failed to pay the contractually agreed upon consideration. In response, Texas Mutual claimed that Fair Isaac had "fraudulent induced it to enter into the Contract by falsely representing that SmartAdvisor was an existing product in commercial use."¹⁰¹ Fair Isaac denied liability on the counterclaim and moved for summary judgment based on a merger clause in the contract, which provided that "each party represents and warrants to the other party that in entering into this Contract it has not relied upon any representations, promises[,] or assurances from another party not expressly contained in this Contract."¹⁰²

The court started its analysis by assessing the viability of the merger clause as a basis for granting summary judgment. Relying upon the *Schlumberger* precedent, the court noted that the effectiveness of a merger clause was determined by its express language and the circumstances surrounding its inclusion in the contract. Based on the facts present in *Fair Isaac*, the court held that "[t]he clear, unambiguous contract language, agreed upon by sophisticated business entities represented by competent counsel, constitutes a waiver of reliance. . . [and the Plaintiff], therefore, is entitled to summary judgment on [Defendant]'s pre-contract counterclaims [for fraudulent inducement and negligent misrepresentation] because there cannot be justifiable reliance on any representations allegedly made by [Plaintiff]."¹⁰³ In sum, the *Fair Isaac* court rejected the restrictive reading of the *Schlumberger* precedent adopted by the recent *Celotex* decision.¹⁰⁴

In yet another more recent Texas court of appeals case, *Schlumberger* was again considered dispositive of the efficacy of a nonreliance provision contained in a contract for the purchase of a car-wash business. In *Langguth v. JAT Enterprises, Ltd.*,¹⁰⁵ Langguth purchased the McNeil Car Wash and Lube from JAT Enterprises, Ltd. ("JAT"), pursuant to a written contract that provided in section 11 as follows:

11. PROPERTY CONDITION. Other than provided herein, seller hereby disclaims, and purchaser hereby waives, any and all warranties of any nature regarding the property. Seller has not made and

100. *Id.* at *1.

101. *Id.* at *2.

102. *Id.*

103. *Id.* at *4.

104. Texas Mutual also claimed, however, that Fair Isaac had committed fraud and negligent misrepresentation after the contract had been entered into by representing the readiness of the SmartAdvisor system for use (a subject that was not specifically addressed by the contract). As to these post-contract claims, the court did not consider the nonreliance clause applicable. Instead, the court held that because SmartAdvisors' readiness for use was not a subject covered by the contract, post-contractual representations related to that subject could form the basis of a fraud claim. *Id.* at *3-4.

105. No. 03-06-00240-CV, 2007 WL 437186 (Tex. App.—Austin Feb. 6, 2007, no pet. h.).

does not make any representations, warranties or covenants of any kind or character whatsoever, whether express or implied, with respect to: the income, expenses, profit, losses or other aspects of the operation of the property; the square footage of the property; the quality or condition of the property; the suitability or safety of the property for any activities and uses which purchaser may conduct thereon; compliance by seller and/or the property with any laws, rules, ordinances, or regulations of any applicable governmental authority, including subdivision and zoning ordinances and building codes; or the habitability, merchantability, or fitness of the property for a particular purpose. . . . [T]he provisions contained in this paragraph shall survive delivery of the deed. Purchaser shall accept the property "as is", "where is", and with all faults. Purchaser shall make its own independent inspection of all aspects of the property and shall have no recourse whatsoever against seller in the event of discovery of any defects of any kind, latent or patent.¹⁰⁶

Prior to entering into this contract, the real estate broker for JAT provided financial statements respecting the car-wash business to Langguth's broker. Langguth later claimed that he had been induced into entering into the contract based on misrepresentations about the average monthly revenue and income of the car-wash business as apparently disclosed in such financial statements. The trial court granted JAT's motion for summary judgment and Langguth appealed. On appeal, the court held that in accordance with the criteria set forth in *Schulumberger*, including the finding that Langguth was a sophisticated party, "the disclaimer of reliance in section 11 conclusively negates as a matter of law the element of reliance on representations about the income and revenue of the car wash and lube needed to support Langguth's claim of fraudulent inducement."¹⁰⁷

*Welwood v. Cypress Creek Estates, Inc.*¹⁰⁸ is another recent case upholding the efficacy of carefully crafted provisions disclaiming extra-contractual representations or obligations. *Welwood* involved a claim by a homeowner against the developer of a subdivision in Frisco, Texas. The homeowner was the chairman of the homebuilding company that purchased the building lots from the developer. In the lot purchase agreement between the homebuilding company, as purchaser, and the lot developer, as seller, the following "as is" provision was included:

AS A CONDITION PRECEDENT TO SELLER'S UNDERTAKINGS AND AGREEMENTS HEREUNDER, SELLER EXPRESSLY DISCLAIMS AND PURCHASER ACKNOWLEDGES AND ACCEPTS THAT SELLER HAS DISCLAIMED MAKING ANY REPRESENTATIONS, WARRANTIES, OR ASSURANCES WITH RESPECT TO THE SUBDIVISION OR THE LOTS, EXPRESS OR IMPLIED, OR ARISING BY OPERATION

106. *Id.* at *1.

107. *Id.* at *5.

108. 205 S.W.3d 722, 727 (Tex. App.—Dallas 2006, no pet.).

OF LAW, ORAL OR WRITTEN, INCLUDING BUT NOT LIMITED TO, REPRESENTATIONS OR WARRANTIES AS TO ••• PHYSICAL CONDITION, ••• HABITABILITY, MERCHANTABILITY, OR FITNESS FOR A PARTICULAR PURPOSE. PURCHASER AGREES THAT WITH RESPECT TO THE SUBDIVISION AND THE LOTS IT WILL RELY UPON ITS INSPECTION THEREOF OR ITS DETERMINATION NOT TO INSPECT THE SAME, AND UPON CLOSING SHALL ACCEPT THE LOTS IN THEIR "AS IS" CONDITION, WITH ALL FAULTS, AND WITHOUT WARRANTY TO MERCHANTABILITY OR FITNESS FOR ANY SPECIFIC PURPOSE.¹⁰⁹

The lot on which the homeowner's home was constructed by the homebuilder was a lake lot that sloped down from the house to the lake. The homeowner constructed a retaining wall across the back of the lot and installed a pool and landscaping. The slope failed and significant damage was caused to the improvements the homeowner had made. The homeowner alleged that the lot developer had failed to conduct a "slope-stability analysis" as had been recommended by the lot developer's engineers and that failure was "negligence and a breach of an implied warranty of good and workmanlike development services."¹¹⁰ In response, the lot developer moved for summary judgment on the basis that the "as is" clause in the lot development agreement barred these claims. The trial court agreed. On appeal, the court noted that the purpose of an "as is" clause is to ensure that the buyer is agreeing "to make his own assessment of the bargain and accept the risk that he may be wrong."¹¹¹ Relying on the Texas Supreme Court's precedent in *Prudential Insurance Company of America v. Jefferson Associates, Limited*,¹¹² the court noted that a valid "as is" clause "negates the element of causation necessary to recover on claims regarding the physical condition of the property."¹¹³ As with nonreliance and merger clauses, however, the court also noted that the "nature of the transaction and the totality of the circumstances surrounding the agreement must be considered" in determining the effectiveness of an "as is" clause.¹¹⁴ If the "as is" clause is not an important part of the basis of the bargain, "the parties have unequal bargaining positions," or the party seeking to invoke the provision deprived the other party of his right to make an independent determination of the condition of the property, then an "as is" clause will not be determinative. Finding nothing in the circumstances of this case to challenge the effectiveness of the "as is" clause, the court affirmed the trial court's summary judgment.

109. *Id.* at 726.

110. *Id.* at 725.

111. *Id.* at 727.

112. 896 S.W.2d 156, 161 (Tex. 1995).

113. 205 S.W.3d at 728.

114. *Id.*

C. SPECIFIC DRAFTING SUGGESTIONS FROM RECENT TEXAS CASES
REGARDING DISCLAIMER OF RELIANCE
AND MERGER CLAUSES

The importance of carefully crafting your “nonreliance” and “merger” clauses to remove any possible ambiguity concerning the non-applicability of other purported terms or promises outside of the final negotiated written agreement cannot be overemphasized. This was the issue in *Escopeta Oil & Gas Corp. v. Songa Management, Inc.*,¹¹⁵ a case decided by the United States District Court for the Eastern District of Texas during this Survey period. *Escopeta* involved the interpretation of a drilling contract, pursuant to which Songa AS, a Norwegian corporation, agreed to furnish a drilling rig for drilling operations to be conducted in Alaska by Escopeta Oil & Gas Corporation, a Texas corporation (“Escopeta”). The Drilling Contract at issue contained a “merger” clause that read as follows:

Entire Agreement. This Contract constitutes the full understanding of the parties and a complete and exclusive statement of the terms of their agreement, and shall exclusively control and govern all work performed hereunder. All representations, offers, and undertakings of the parties made prior to the effective date hereof, whether oral or in writing, are merged herein, and no other contracts, agreements, or work orders, executed prior to the execution of this Contract, shall in any way modify, amend, alter, or change any of the terms or conditions set out herein.¹¹⁶

Prior to entering into the Drilling Contract, Escopeta’s negotiations were with Songa AS’s affiliate, Songa Management, Inc., a Texas corporation (“Songa Texas”). Following those initial negotiations, a preliminary letter agreement was entered into by Songa AS and Escopeta, which stated that Songa AS or “an affiliate company” would make the rig available for transport by Escopeta during a specified “loading window range” between June 1 and June 30, 2006. The letter agreement further provided for two preliminary payments of \$250,000 each to be made by Escopeta to a Songa AS affiliate company, Songa Drilling PTE. Notably, that same letter agreement specifically stated that it was “subject to negotiation of a mutually agreed, definitive contract.”¹¹⁷ The letter agreement further stated that in the absence of a mutually agreed definitive contract, “the provisions of this letter agreement are void.”¹¹⁸ The definitive agreement entered into by virtue of the Drilling Agreement did not address the two preliminary payments of \$250,000, and “omitted any reference [to] a loading window.”¹¹⁹ Apparently, Songa Texas was not a party to either the preliminary letter agreement or the Drilling Contract.

115. No. 1:06-CV-386, 2007 WL 171721, at *8 (E.D. Tex. Jan. 17, 2007).

116. *Id.* at *1.

117. *Id.*

118. *Id.*

119. *Id.*

The specific issue being addressed by the court in *Escopeta* was whether complete diversity of citizenship existed between the parties to allow the federal court to retain jurisdiction over the case. If Songa Texas was properly joined as a party in the case, there was not complete diversity of citizenship because Escopeta and Songa Texas were both Texas corporations. Songa AS and Songa PTE claimed that Songa Texas had been fraudulently joined as a party to the litigation by Escopeta in order to specifically defeat diversity and thereby deprive the federal court of jurisdiction. According to the court, to establish that Songa Texas had been fraudulently joined, it was necessary for Songa AS and Songa PTE to prove that “there [was] no possibility that plaintiff would be able to establish a cause of action against the non-diverse defendants [i.e., Songa Texas] in state court.”¹²⁰ Thus, the issue before the court was whether there was any basis upon which Escopeta could maintain a viable cause of action against Songa Texas.

Because Songa Texas was not a party to either the Drilling Contract or the letter agreement, Escopeta alleged that Songa Texas had fraudulently induced Escopeta to enter into the Drilling Contract by representing that the rig would be available to be transported to Alaska by Escopeta during the “loading window range” of June 1 through June 30, 2006. Noting that a “third party or agent may be liable for fraudulent inducement even where it is not a party to the underlying contract,”¹²¹ the court identified the six elements of a claim for fraudulent inducement as follows:

- (1) the defendant made a material representation concerning an existing fact;
- (2) the representation was false when it was made;
- (3) the speaker knew the misrepresentation was false, or made it recklessly without knowledge of its truth and as a positive assertion;
- (4) the speaker made the misrepresentation with the intent that it should be acted upon;
- (5) the plaintiff acted with justifiable reliance on the misrepresentation; and
- (6) the plaintiff suffered injury as a result.¹²²

The court quickly concluded that there was “some evidence” to satisfy the first through fourth and the sixth elements of “a claim for fraudulent inducement against [Songa Texas].”¹²³ Nevertheless, the court was still required to address the fifth element, i.e., whether Escopeta was justified in relying upon the alleged representations made outside the Drilling Contract. Songa AS and Songa PTE asserted that the existence of the merger clause in the Drilling Contract specifically “negates the element of justifiable reliance” necessary to sustain a cause of action for fraudulent inducement in Texas.¹²⁴

Because the court’s decision only required that there be some “possibility” that Escopeta could sustain a cause of action against Songa Texas

120. *Id.* at *5.

121. *Id.* at *7.

122. *Id.*

123. *Id.*

124. *Id.* at *8.

based on fraudulent inducement, the court was liberal in its approach to whether the merger clause was effective to defeat any claim of justifiable reliance on the alleged representations purportedly made by Songa Texas prior to the execution of the Drilling Contract. First, the court noted that *Schlumberger* did not endorse all merger clauses in all circumstances and noted that “the contract and the circumstances surrounding its formation determine whether the disclaimer of reliance is binding.”¹²⁵ Second, the court further noted that depending on the specific wording of the clause, the clause may or may not cover extra-contractual tort claims such as fraud in the inducement. Addressing the merger clause in the Drilling Contract, the court could not “conclude as a matter of law that Escopeta had no possibility of recovery against [Songa Texas] on its fraudulent inducement claim.”¹²⁶ According to the court, “the merger clause renders the Drilling Contract controlling as to the terms contained therein, [but] the Drilling Contract’s silence as to the time of performance militates against a conclusive determination that it absolves [Songa Texas] of liability for any purported misrepresentations concerning this significant issue [i.e., the time period during which the rig would be available for transport by Escopeta] made prior to its execution.”¹²⁷ Moreover, the court noted that the letter agreement (which contained a specific reference to the loading window) was not necessarily superseded by the Drilling Contract. Indeed, the letter agreement only said it was “void” if there was no subsequent definitive contract, and the merger clause only over-rode other contracts made to the extent such other contracts “modify, amend, alter, or change” any of the terms of Drilling Contract. Because the drilling contract did not address time of performance, the court believed that it was possible that the purported representations and the letter agreement itself may not have in fact been merged into the Drilling Contract by virtue of the merger clause.

There are several drafting lessons to take away from *Escopeta*. First is the reminder that preliminary letter agreements may be binding. Simply stating that a preliminary letter agreement contemplates a more formal definitive document does not render such a letter non-binding. As we have stated in past surveys, in order to ensure that a preliminary letter agreement is non-binding, the agreement should say so in clear and unambiguous language.¹²⁸ Second, merger clauses should be broad and encompass all aspects of prior dealings and negotiations. If the merger clause is limited to the “subject matter of the agreement” and there were prior dealings not encompassed by the terms of the agreement, a court may well find that the merger clause has not merged those prior agree-

125. *Id.* at *9 (citing *Prudential Ins. Co. v. Jefferson Assocs.*, 896 S.W.2d 156, 179-80 (Tex. 1995)).

126. *Id.*

127. *Id.*

128. West & Stasny, *supra* note 11, at 727-31; West & Chao, *supra* note 7, at 1411-15; West & Nelson, *supra* note 11, at 818-19; West & Treadway, *supra* note 11, at 818-23; West, *supra* note 11, at 1123-38.

ments or representations. Lastly, never rely solely on a merger clause but, instead, always join it to a nonreliance provision that clearly and unequivocally disclaims reliance on anything not specifically contained in the definitive agreement.

IV. FIDUCIARY DUTIES OF TEXAS OFFICERS AND DIRECTORS

In a previous survey we discussed the uncertainty surrounding whether a corporation's officers or directors may owe the corporation's creditors a fiduciary duty when the corporation is within the "zone of insolvency."¹²⁹ As we noted, a basic tenet of Texas corporate law is that directors and officers of a corporation are bound by a strict fiduciary duty to the corporation and its shareholders.¹³⁰ Historically in Texas, this duty generally has not been extended to a corporation's creditors. Rather, under the general rule, directors are regarded as trustees with respect to the shareholders and the corporation, but agents of the corporation with respect to third parties (i.e., creditors).¹³¹ In the 2004 Survey, we discussed *In re Brentwood Lexford Partners, LLC*,¹³² a decision of the United States District Court for the Northern District of Texas that advanced the proposition that, "when a corporation enters the zone of insolvency, the fiduciary duty shifts from the shareholders to the creditors of the corporation."¹³³ However, during this Survey period, the United States District Court for the Southern District of Texas, in *Floyd v. Hefner*,¹³⁴ unambiguously rejected this proposition and reinstated the prior holdings of the Texas courts.

In *Floyd*, the court faced a fact pattern analogous to the facts presented in the *Brentwood* case described in the 2004 Survey. Particularly, the bankruptcy trustee argued that the corporation's officers and directors (1) owed the creditors a fiduciary duty and (2) breached this duty by making a series of decisions which eventually depleted corporate assets and resources that would have been available to the creditors in the aftermath of the corporation's subsequent bankruptcy. First, the trustee argued that the directors and officers chose to expend corporate resources to construct a pipeline for oil transport, although there was not sufficient evidence that the source of oil warranted the pipeline's construction.

129. See West & Nelson, *supra* note 11, at 810-11.

130. *Id.*

131. See *Dollar v. Lockney Supply Co.*, 164 S.W. 1076, 1079 (Tex. App.—Amarillo 1914, no writ).

132. 292 B.R. 255 (Bankr. N.D. Tex. 2003) (citing *In re Hechinger Inv. Co. of Delaware*, 280 B.R. 90, 92 (Bankr. D. Del. 2002)). Subsequent to the *Hechinger* decision, the Delaware Chancery Court clarified that the proper analysis under Delaware law is the "trust found doctrine;" and that doctrine provides the only recognized basis for holding directors liable to creditors. *Prod. Res. Group, L.L.C. v. NCI Group, Inc.*, 863 A.2D 772, 790 (Del. Ch. 2004).

133. 292 B.R. at 272.

134. *Floyd v. Hefner*, No. H.03-5693, 2006 WL 2844245, at *10 (S.D. Tex. Sept. 29, 2006).

Second, the trustee argued that the officers and directors perpetuated a violation of their fiduciary duty when they decided to dig a “Deep Well” on the same site where previous explorations indicated a viable source of oil would likely not be found. Third, the trustee argued that the officers and directors erred when they voted to enter into a \$45 million Secured Facility to finance these projects. Coincidentally, the creditors for these notes were entities in which some directors individually held significant interests. In sum, the trustee argued that the directors owed a fiduciary duty to the creditors of the corporation once it entered the “zone of insolvency” and premised this claim on several authorities. Relying on Fifth Circuit case law, the trustee argued that “officers and directors that are aware that the corporation is insolvent, or within the ‘zone of insolvency’ . . . have expanded fiduciary duties [which extend to] the creditors of the corporation.”¹³⁵

Despite the foregoing claims, the court in *Floyd* rejected the expansion of corporate fiduciary duties as urged by the trustee. In doing so, the court in *Floyd* first made the critical determination that a federal court sitting in diversity jurisdiction over a bankruptcy proceeding must apply state law, either in statutory form or as rendered in an opinion of the highest court.¹³⁶ The court then noted that a federal court should not “adopt innovative theories of law, but must apply that law as it currently exists.”¹³⁷ Looking at the law as it currently existed, as opposed to the suggestions that had been made in various cases and by various legal scholars, the court concluded that the holding of *Conway v. Bonner*¹³⁸ conclusively resolved the question of whether fiduciary duties were owed under Texas law by corporate officers and directors to creditors, rather than shareholders, when a corporation becomes insolvent or nears insolvency. According to the court, *Conway* unequivocally held that merely because a corporation becomes insolvent does not require the directors to act as fiduciaries for the corporation’s creditors. Rather, unless and until a corporation is actually the subject of an insolvency proceeding, the directors’ fiduciary duties are owed solely to the shareholders and not to the creditors.¹³⁹ Indeed, according to the *Floyd* court, the only recognized doctrine, in either Texas or Delaware, that imposes fiduciary duties on a corporation’s officers and directors in favor of a corporation’s creditors is the “trust-fund doctrine.” Under the Texas trust-fund doctrine, “directors of a corporation owe the corporation’s creditors fiduciary duties only after it is both insolvent and has ceased doing business.”¹⁴⁰

135. *Carrieri v. Jobs.com*, 393 F.3d 508, 533 n.24 (5th Cir. 2004).

136. *See Floyd*, 2006 WL 2844245, at *9 (relying on *Butner v. United States*, 440 U.S. 48, 55 (1979)).

137. *See Gallindo v. Precision American Corp.*, 754 F.2d 1212, 1217 (5th Cir. 1985).

138. 100 F.2d 786, 787 (5th Cir. 1939).

139. *Id.* at 787.

140. *Floyd*, 2006 WL 2844245 at *15.

V. CONCLUSION

While some of the cases decided during this Survey period provide some cause for continued concern with respect to the preservation of the corporate form and the efficacy of anti-reliance clauses, other notable decisions provide a healthy dose of optimism for the corporate practitioner in Texas. In particular, the *Willis* court's rejection of the implied ratification doctrine, as yet another basis on which individual shareholders may be held liable for corporate obligations, certainly upholds the sanctity of the corporate form in Texas. In doing so, the Texas Supreme Court forcefully reinforced the long-established convention of Texas corporation law that provides that one of the fundamental purposes of incorporation is the insulation of individual shareholders from liabilities attributable to the corporation's activities, particularly those based in contract or related thereto. Additionally, despite the fact that the *Celotex* decision provided a sharp deviation from longstanding precedent concerning the enforceability of anti-reliance clauses, subsequent cases decided during this Survey period rejected this approach and support the inference that the *Celotex* holding may represent an anomaly. We trust the Texas Supreme Court will address this question shortly. Hopefully, the use of an explicit and expansive anti-reliance clause in a contractual agreement between sophisticated parties will continue to provide a viable liability management mechanism. But we again continue to remind practitioners to remain vigilant in the precise language utilized in these clauses. Finally, we are encouraged by the clarity the *Floyd* decision provided in the area of the so-called "shifting" of fiduciary duties in the "zone of insolvency."