Business Issues in the Context of Divorce

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by

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I. INTRODUCTION In today's world, divorcing spouses sometimes have more than just the legal relationship between spouses. Spouses can also have fiduciary duties that arise from relationships such as officer-to-corporation, partner-to-partner, manager-to-member, trustee-to-beneficiary, agent-to-principal, lawyer-to-client, doctor-to-patient, accountant-to-client, etc. In these situations, divorce proceedings can involve claims of breach of fiduciary duty, the duties varying depending on the fiduciary relationship involved. This Article discusses the fiduciary duties that arise in various legal relationships, with an awareness that one or more of these relationships may exist between spouses. The Article then shifts focus to how spouses and courts can divide legal entities holding or controlling the spouses' wealth.

II. FORMAL AND INFORMAL FIDUCIARY RELATIONSHIPS; NON-FIDUCIARY RELATIONSHIPS. Transactions can be divided into three categories: formal fiduciary, informal fiduciary, and arm's-length. The duties vary with the type of transaction. Formal and informal fiduciaries have duties that depend on the type of fiduciary relationship. Most arm's-length transactions are without special duties, but criminal laws and general tort duties apply.

A. FORMAL FIDUCIARY RELATIONSHIP There are different articulations of who is a formal fiduciary under Texas law. The Texas Supreme Court has listed attorney-client, principal-agent, partners, and joint venturers, as relationships that give rise to a formal fiduciary relationship as a matter of law. *Insurance Co. of N. Am. v. Morris*, 981 S.W.2d 667, 674 (Tex. 1998); *Texas Bank & Trust Co. v. Moore*, 595 S.W.2d 502, 507 (Tex. 1980). Texas Penal Code § 32.43, Commercial Bribery, lists as fiduciaries (A) an agent or employee, (B) a trustee, guardian, administrator, executor, conservator, receiver, or similar fiduciary, (C) a lawyer, physician, accountant, appraiser, or other professional advisor, or (D) an officer, director, partner, manager, or other participant in the direction of the affairs of a corporation or association. Texas Penal Code § 32.45(a)(1), Misapplication of Fiduciary Property, lists as fiduciaries a trustee, guardian, administrator, executors, executor, conservator, and receiver. In the Code of Ethics and Minimum Standards for Guardianship Services,[1] promulgated by the Texas Supreme Court on June 24, 2016, the term "fiduciary" is defined as "[a]n individual, agency, or organization that has agreed to undertake for another a special obligation of trust and confidence, having the duty to act primarily for another's benefit and subject to the standard of care imposed by law or contract." Some of the primary formal fiduciary relationships are set out below.

1. Agent → Principal. "Under the common law of most jurisdictions, including Texas, agency is also a special relationship that gives rise to a fiduciary duty." *Johnson v. Brewer & Pritchard, P.C.*, 73 S.W.3d 193, 200 (Tex. 2002). See Section IV below.

2. Trustee → Beneficiary. The trustee-beneficiary relationship is the epitome of a fiduciary relationships. The duties of a trustee are impacted by statutory standards and prohibitions, as well as common law principles, and the terms of the trust agreement. See Section IV below.

3. Attorney → Client. The attorney-client relationship is on both of the Texas Penal Code's listings of formal fiduciary relationships. *See* Section II.A. above. In *Archer v. Griffith*, 390 S.W.2d 735, 739 (Tex. 1964), the Supreme Court said: "the relation between an attorney and his client is highly fiduciary in nature, and their dealings with each other are subject to the same scrutiny, intendments and imputations as a transaction between an ordinary trustee and his cestui que trust." See Section IV.D below.

4. Administrator/Executor → Devisees. "Even though the Texas Trust Act is not applicable, the executor of an estate is held to the same fiduciary standards in his administration of the estate as a trustee." *Humane Society of Austin and Travis County v. Austin National Bank*, 531 S.W.2d 574, 577 (Tex. 1975). See Section IV.E below.

5. Guardian → Ward. On June 24, 2016, the Texas Supreme Court adopted a Code of Ethics and Minimum Standards for Guardianship Services.[2] Section 2 provides: "2. *Fiduciary Relationship.* A guardian is a fiduciary of a ward under the guardian's care and must exhibit the highest degree of loyalty and fidelity in the guardian's relations with the ward." See Section IV.F below.

6. Corporate Directors/Officers/Managers → Company, Owners, Creditors. "Corporate officers and directors are fiduciaries, and the consequences of their acts a such are determinable under the facts in each case." *Int'l Bankers Life Inc. co. v. Holloway*, 368 S.W.2d 567, 576 (Tex. 1963). This articulation of duties points to almost no specific standards. The Texas Supreme Court decisions and Texas business statutes are a patchwork, and a coherent statement of the duties of corporate directors and officers under Texas law exists mainly in a robust body of comprehensive Texas continuing legal education articles that sometimes fall back on Delaware law and Delaware court decisions to fill gaps in the Texas patchwork. See Section IV.G.2 below.

7. General Partnerships. In *Bohatch v. Butler & Binion*, 977 S.W.2d 543, 545 (Tex. 1998) , the Court wrote: "We have long recognized as a matter of common law that '[t]he relationship between ... partners ... is fiduciary in character, and imposes upon all the participants the obligation of loyalty to the joint concern and of the utmost good faith, fairness, and honesty in their dealings with each other with respect to matters pertaining to the enterprise.'" See Section IV.G.5 below.

8. Limited Partnerships. In *Crenshaw v. Swenson*, 611 S.W.2d 886, 890 (Tex. App.--Austin 1980, writ ref'd n.r.e), the court said that the general partner of a limited partnership has the same fiduciary duties as a trustee owes to the trust beneficiaries. Ordinarily a limited partner's lack of decision-making authority curtails its fiduciary duties to the partnership and other partners. Professor Elizabeth S. Miller, *Fiduciary Duties, Exculpation, and Indemnification in Texas Business Organizations*, 13th ANNUAL ADVANCED BUSINESS LAW ch. 7, p. 1 (2020) ("Miller 2020"). p. 39. However, if a limited partner exercises control over the operation of the business, a fiduciary-like duty arises. *CBIF Limited Partnership v. TGI Friday's Inc.*, No. 05-15-00157-CV, *19 (Tex. App.--Dallas Dec. 5, 2016, pet. denied) (memo. op.); *Strebel v. Wimberly*, 371 S.W.3d 267, 281 (Tex. App.--Houston [1st Dist.] 2012, pet. denied); *Daniels v. Empty Eye, Inc.*, 368 S.W.3d 743, 750-51 (Tex. App.--Houston [14th Dist.] 2012, pet. denied). The duty of loyalty may apply to limited partners. See Texas Business Organizations Code ("TBOC") § 152.205. See Section IV.G.6 below.

9. Joint Venturers. Joint venturers owe each other the fiduciary duties of partners. *CBIF Ltd. v. TGI Friday's, Inc.* No. 05-15-00157-CV (Tex. App.–Dallas Dec. 5, 2016, pet. denied) (memo. op.) See Section IV.G.7 below.

10. Limited Liability Companies. The TBOC does not attribute formal fiduciary obligations to managers and members of LLCs. The case law has turned mostly on the existence of informal fiduciary relationships. See Section IV. G.8. below.

11. Executive Rights Over Mineral Interests. Under Texas law, the holder of the executive right over the mineral interests of other royalty owners owes a duty of utmost good faith to the other owners. *Manges v. Guerra*, 673 S.W.2d 180, 183-84 (Tex. 1984). The duty is a fiduciary duty. *Id.* However, unlike the agent in a principal-agent relationship, or the trustee of an express trust, the holder of executive rights does not have to put the other royalty owners' interests before his own. Instead, this fiduciary duty requires the holder of the executive right to acquire for the non-executive every benefit that he exacts for himself in leasing the property. *Id.* See Section IV.H below.

12. Spouses. Texas has long recognized that the marital relationship entails fiduciary obligations between spouses. See Section IV.N below.

13. Parent → Child. "[P]arents generally stand in the role of fiduciaries toward their minor children." *S.V. v. R.V.*, 933 S.W.2d 1, 8 (Tex. 1996). Neither the Texas Family Code nor other statutes spell out the fiduciary obligations of parent to child. The standards of principal and agent would readily apply, but the common law duties of an express trustee might be a source of authority. *Id.* See Section IV.O below.

B. INFORMAL FIDUCIARY RELATIONSHIPS. In *Crim Truck & Tractor Co. v. Navistar Intern. Transportation Corp.*, 823 SW 2d 591, 594 (Tex. 1992), the Supreme Court wrote:

> We have also recognized that certain informal relationships may give rise to a fiduciary duty. *See, e.g., MacDonald v. Follett*, 142 Tex. 616, 180 S.W.2d 334 (1944). Such informal fiduciary relationships have also been termed "confidential relationships" and may arise "where one person trusts in and relies upon another, whether the relation is a moral, social, domestic or merely personal one". *Fitz-Gerald v. Hull*, 150 Tex. 39, 237 S.W.2d 256, 261 (1951). Because not every relationship involving a high degree of trust and confidence rises to the stature of a formal fiduciary relationship, the law recognizes the existence of confidential relationships in those cases "in which influence has been acquired and abused, in which confidence has been reposed and betrayed". *Texas Bank & Trust Co. v. Moore*, 595 S.W.2d 502, 507 (Tex. 1980). The existence of a confidential relationship is usually a question of fact. *See MacDonald*, 142 Tex. at 623, 180 S.W.2d at 339; *Schiller v. Lick*, 150 Tex. 363, 240 S.W.2d 997, 1000 (1951). Although we

> recognize that the existence of a confidential relationship is ordinarily a question of fact, when the issue is one of no evidence, it becomes a question of law. *See Thigpen v. Locke*, 363 S.W.2d 247, 253 (Tex. 1962).

> In *Mills v. Gray*, 147 Tex. 33, 210 S.W.2d 985 (Tex. 1948), and *Fitz-Gerald v. Hull*, 150 Tex. 39, 237 S.W.2d 256 (Tex. 1951), the Supreme Court recognized that confidential relationships may arise not only from the technical fiduciary relationships such as attorney-client, trustee-cestui que trust, partner and partner, etc. – which as a matter of law are relationships of trust and confidence–but may arise informally from "moral, social, domestic or purely personal" relationships. 54 Am. Jur. 173, § 225, "Trusts". The existence of the fiduciary relationship is to be determined from the actualities of the relationship between the persons involved.

In *Texas Bank and Trust Co. v. Moore*, 595 S.W.2d 502, 508 (Tex. 1980), the Court said: "In resolving the problem of the existence or not of a fiduciary relationship this Court has severely scrutinized transactions between parties where trust and confidence is reposed by one, and personal profit is gained by another.... The problem is one of equity and the circumstances out of which a fiduciary relationship will be said to arise are not subject to hard and fast lines." (Citations omitted.)

As for the criminal law perspective, in *Showery v. State*, 678 S.W.2d 103, 107 (Tex. App.--El Paso 1984, pet. ref'd), the court wrote:

> While the legal profession's frequent handling of fiduciary matters leads to an initial impression that the term is solely within the province of our own profession, we must not overlook the fact that we have no monopoly on the English language. "Fiduciary" and "fiduciary relation" have a common meaning to be found in lay dictionaries. See: Webster's Third New International Dictionary (1971 ed.). Such lay definitions are consistent with [Penal Code Section 32.45] subsection (a)(1)(B) and subject to common understanding. The consistent elements, applicable to the statute and this case, are holding or dealing with the property of another with a duty of trust toward the beneficiary.

There are a number of criminal cases describing what constitutes an informal "fiduciary capacity" for purposes of criminal law. A list is given in *Berry v. State*, 424 S.W.3d, 579, 585 n. 7 (Tex. Crim. App. 2013): "*Fuelberg v. State*, 410 S.W.3d 498, 502 (Tex. App.--Austin 2013) (defendant was general manager of non-profit utility cooperative who funneled cooperative's funds to his brother and a friend); *Anderson v. State*, 322 S.W.3d 401, 406-07 (Tex. App.--Houston [14th Dist.] 2010, pet. ref'd) (defendant was investment manager who received funds for sole purpose of investing funds in limited partnership but instead spent funds on personal legal fees and a car); *Head v. State*, 299 S.W.3d 414, 433 (Tex. App.--Houston [14th Dist.] 2009, pet. ref'd) (defendant was financial adviser and protector of elderly woman's two trusts who took personal and business loans from complainant's funds without her knowledge); *Tyler v. State*, 137 S.W.3d 261, 264-66 (Tex. App.--Houston [1st Dist.] 2004, no pet.) (defendant was acting in 'fiduciary capacity' when she agreed to help manage elderly relative's financial assets and then withdrew funds from complainant's bank account without authorization); *Huett v. State*, 970 S.W.2d 119, 124-25 (Tex. App.--Dallas 1998, no pet.) (defendant used investors' money on personal expenditures unrelated to oil-lease business including house and car payments, clothing, and grocery expenses); *Starnes v. State*, 929 S.W.2d 135, 137-38 (Tex. App.--Fort Worth 1996, pet. ref'd) (defendant was hired by volunteer fire department to run charity bingo games and misappropriated money from organization); *Dwyer v. State*, 836 S.W.2d 700, 702 (Tex. App.--El Paso 1992, pet. ref'd) (defendant was accountant who received customers' payments for purpose of forwarding them to utility company but instead applied them to his own personal and business expenses); *Showery v. State*, 678 S.W.2d 103, 106 (Tex. App.--El Paso 1984, pet. ref'd) (defendant was physician who received insurance-company overpayments on patient's behalf and then failed to forward payments to patient).

1. Moral, Social, Domestic, or Merely Personal Relationships. What constitutes a "moral" relationship was not explained in the *Crim Truck* case. Perhaps a spiritual advisor has a "moral" relationship with his/her parishioner. A "social" relationship presumably means a long-standing non-business relationship. As to "domestic," the fiduciary duty between spouses is discussed in Section IV.N below. Other family relationships can support a finding of an informal fiduciary duty or confidential relationship. *See Texas Bank & Trust Co. v. Moore*, 595 S.W.2d 502 (Tex. 1980) (saying that aunt and nephew, standing alone, did not establish a fiduciary relationship). "A family relationship, while it is considered as a factor, does not by itself establish a fiduciary relationship." *Kirkpatrick v. Cusick*, No. 13-13-00149-CV, * 4 (Tex. App.--Corpus Christi Dec. 19, 2013, pet. denied) (memo. op.).

2. The Relationship Must Pre-Exist the Transaction. "[W]hile a fiduciary or confidential relationship may arise from the circumstances of a particular case, to impose such a relationship in a business transaction, the relationship must exist prior to, and apart from, the agreement made the basis of the suit." in *Schlumberger Technology Corp. v. Swanson*, 959 S.W.2d 171, 177 (Tex. 1997).

C. ARM'S-LENGTH TRANSACTIONS.

1. No Fiduciary Duty. In *Berry v. State*, 424 S.W.3d 579 (Tex. Crim. App. 2014), the Texas Court of Criminal Appeals wrote:

> [W]e observe that the civil courts of Texas have generally held that everyday arms-length business transactions, including contracts to sell goods and services, do not give rise to a fiduciary relationship between the parties. *See Crim Truck & Tractor Co. v. Navistar Int'l Transp. Corp.*, 823 S.W.2d 591, 594 (Tex. 1992), superseded by statute on other grounds ("The fact that one businessman trusts another, and relies upon his promise to perform a contract, does not rise to a confidential relationship."). That is because in everyday business dealings, it is assumed that the parties interact for their mutual benefit, and, therefore, a party is not expected to act solely for the benefit of the other party to the contract. *See Schlumberger Tech. Corp. v. Swanson*, 959 S.W.2d 171, 177 (Tex. 1997) (declining to impose fiduciary relationship in contractual situation because "all contracting parties presumably contract for their mutual benefit"). To impose a fiduciary relationship in ordinary business dealings would run contrary to the principle that a fiduciary is obligated to act for the primary benefit of the other party.

While in an arm's length transaction each party is permitted to pursue his own interests without regard to the interests of the other party, there are limits on allowable behavior. In an arm's length transaction a party cannot intentionally misrepresent a material fact in order to procure an agreement. See Section IV.I.2 below. Nor can a party make a promise to perform while secretly harboring the intention to not perform. See Section IV.J.2 below. If a party negligently misrepresents facts relied upon by the other party s/he can be held liable for the tort of negligent misrepresentation. See Section IV.I.3 below.

The Supreme Court wrote: "In an arm's-length transaction the defrauded party must exercise ordinary care for the protection of his own interests and is charged with knowledge of all facts which would have been discovered by a reasonably prudent person similarly situated. And a failure to exercise reasonable diligence is not excused by mere confidence in the honesty and integrity of the other party." *Courseview, Inc. v. Phillips Petroleum Co.*, 312 S.W.2d 197, 205 (Tex. 1957) (involving notice of when the statute of limitations began to run).

Business transactions are normally viewed as being arm's length; however, when a business transaction occurs in the context of a formal or informal fiduciary relationship, fiduciary duties arise. In *Thigpen v. Locke*, 363 S.W.2d 247, 253 (Tex. 1962), the Supreme Court wrote:

> [I]n this case there is not such evidence of justifiable trust and confidence as will create a fiduciary relationship. We may assume that respondents did trust Mr. Thigpen; they have testified so time and time again, but mere subjective trust alone is not enough to transform arms-length dealing into a fiduciary relationship so as to avoid the statute of frauds. Businessmen generally do trust one another, and their dealings are frequently characterized by cordiality of the kind testified to here. If we should permit respondents to set aside their conveyances on such slender evidence, the security of contracts and conveyances in this state would be seriously jeopardized.

In *Thigpen v. Locke,* Chief Justice Calvert, joined by Justice Ruel Walker and Justice Zollie Steakley (three great Justices of the Texas Supreme Court),[3] wrote in dissent about the standard for when a fiduciary duty arises in a business transaction, saying:

> One of the best statements of a rule of measurement which I have found is in *Collins v. Nelson*, 193 Wash. 334, 75 P.2d 570, 574, as follows:
>
>> To establish a fiduciary relationship upon the violation of which fraud is sought to be based, there must be something more than mere friendly relations or confidence in another's honesty and integrity. There must be something in the particular circumstances which approximates a business agency, a professional relationship, or a family tie, something which itself impels or induces the trusting party to relax the care and vigilance which he otherwise should, and ordinarily would, exercise.

Id. 254-55 (Calvert, C.J., dissenting).

III. DEFINING FIDUCIARY DUTIES. Justice Benjamin Cardozo described the fiduciary duty of co-venturers in *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545 (1928), as requiring "something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor most sensitive, is then the standard of behavior." This description is famous, partly due to Cardozo's enduring stature as a renowned jurist and important legal author[4] and partly due to the piquancy of his comment. The Texas Supreme Court similarly said in *Johnson v. Peckham*, 132 Tex. 148, 120 S.W.2d 786, 788 (1938): "When persons enter into fiduciary relations each consents, as a matter of law, to have his conduct towards the other measured by the standards of the finer loyalties exacted by courts of equity. That is a sound rule and should not be whittled down by exceptions." In the decades since Cardozo wrote, the stringency of his description of a fiduciary duty has devolved into a variety of standards that fall below his ideal. In the corporate context, and even in formal fiduciary relationships like trustees of an express trust and partners in a partnership, legislatures and courts have articulated a variety of duties and exceptions.

A. TEXAS PATTERN JURY CHARGE. The State Bar of Texas PATTERN JURY CHARGES (BUSINESS, CONSUMER, INSURANCE & EMPLOYMENT 2020) PJC 104.2 describes the duties of a fiduciary under the common law. The liability question asks: (1) was the transaction fair and equitable to the beneficiary?;(2) did the fiduciary make reasonable use of the confidence placed in him?; (3) did the fiduciary act in the utmost good faith and exercise the most scrupulous honesty toward the beneficiary?; (4) did the fiduciary place the beneficiary's interest before his own and not use the advantage of his position to gain any benefit for himself at the expense of the beneficiary?; <u>and</u> (5) did the fiduciary fully disclose all important information to the beneficiary concerning the transaction? The questions are submitted in one broad form question, and the fiduciary has the burden of proof to secure a "yes" answer.

Where the fiduciary duties are specified by statute or agreement, PCJ 104.4 asks whether the fiduciary complied with "all of the following duties," and says to list duties alleged to have been breached and the standard of care using language from the applicable statute or agreement, or both, and common law duties.

B. DUTY OF LOYALTY. The duty of loyalty is specified for agents, corporate directors and officers, partners, and trustees of express trusts. For an agent, "[u]nless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency." *Johnson v. Brewer & Pritchard, PC*, 73 S.W.3d 193, 200 (Tex. 2002). For a partner, the duty of loyalty includes: accounting to and holding for the partnership property, profit, or benefit derived by the partner, refraining from dealing with the partnership on behalf of a person who has an interest adverse to the partnership; and refraining from competing or dealing with the partnership in a manner adverse to the partnership. TBOC § 152.205.

C. DUTY OF CARE. If Texas law applies, the duty of care is specified by statute for trustees of express trusts, corporate directors and officers, and partners.

1. Ordinary Care. The "reasonably prudent person" standard is another way of describing the standard of care for ordinary negligence. *See Missouri-Kansas-Texas Railroad Co. v. McFerrin*, 291 SW 2d 931, 936 (Tex. 1956) ("we apply the objective common-law test of the reasonably prudent man" in a motor vehicle accident case); *Snow v. Bond*, 438 S.W.2d 549, 550-51 (Tex 1969) (asking "what a reasonable and prudent doctor would have done under the same or similar circumstances" in a medical malpractice case). For trustees, the duty of care is "the use of the skill and prudence which an ordinary capable and careful person will use in the conduct of his own affairs." *InterFirst Bank Dallas, NA v. Risser*, 739 SW 2d 882, 888 (Tex. App.–Texarkana 1987, writ dism'd by agr.). The duty of care of directors and officers of a corporation is the amount of care an ordinarily careful and prudent person would use in similar circumstances. *Gearhart Indus., Inc. v. Smith Intern., Inc.*, 741 F.2d 707, 720 (5th Cir. 1984). A partner's duty of care is to act with the care an ordinarily prudent person would exercise in similar circumstances. TBOC § 152.206.

2. Prudent Investor Standard of Care. Texas Property Code § 117.003 provides that a trustee investing and managing trust assets must comply with the Prudent Investor Rule. Section 117.004(a) sets out the Rule: "A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution." In *Goughnour v. Patterson*, No. 12-17-00234-CV, (Tex. App.--Tyler March 5, 2019, pet. denied) (memo. op.), the court surprisingly held that a claim that a trustee violated the statutory standard of care (the Prudent Investor Rule) equates to a claim for breach of fiduciary duty, and thus the four year limitations period applies to this claim.

3. The Business Judgment Rule. "The business judgment rule in Texas generally protects corporate officers and directors, who owe fiduciary duties to the corporation, from liability for acts that are within the honest exercise of their business judgment and discretion." *Sneed v. Webre*, 465 S.W.3d 169, 173 (Tex. 2015). In *Gearhart Industries, Inc. v. Smith International*, 741 F.2d 707, 723 n. 9 (5th Cir. 1984), the court said "[t]he business judgment rule is a defense to the duty of care. As such, the Texas business judgment rule precludes judicial interference with the business judgment of directors absent a showing of fraud or an ultra vires act. If such a showing is not made, then the good or bad faith of the directors is irrelevant." [Comment: under this standard, ordinary negligence or even gross negligence is not enough to impose liability.] The Supreme Court of Delaware, in *Corwin v. KKR Financial Holdings LLC.* 125 A.3d 304, 313-14 (Del. 2015), said:

> [T]he core rationale of the business judgment rule ... is that judges are poorly positioned to evaluate the wisdom of business decisions and there is little utility to having them second-guess the determination of impartial decision-makers with more information (in the case of directors) or an actual economic stake in the outcome (in the case of informed, disinterested stockholders). In circumstances, therefore, where the stockholders have had the voluntary choice to accept or reject a transaction, the business judgment rule standard of review is the presumptively correct one and best facilitates wealth creation through the corporate form.

In *In re Estate of Poe*, 591 S.W.3d 607, 641 (Tex. App.--El Paso 2019, pet. pending), the court held that the burden to overcome the Business Judgment Rule was on the plaintiff and not the defendant.

D. DUTY OF GOOD FAITH. Under Texas law, a trustee of an express trust has a duty of good faith. "The trustee shall administer the trust in good faith according to its terms and this subtitle [i.e., Texas

Trust Code, subtitle B].” Tex. Prop. Code § 113.051. A trustee must exercise a discretionary power in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.” Tex. Prop. Code § 113.029(a). If a trustee with full discretion to distribute the principal of a trust may distribute principal to the trustee of a second trust, but that discretion must be exercised “in good faith, in accordance with the terms and purposes of the trust, and in the interests of the beneficiaries.” Tex. Prop. Code § 112.072(e).

Under Texas law, a partner is required to discharge his duties to the partnership and other partners in good faith and in a manner that the partner reasonably believes to be in the best interest of the partnership. TBOC § 152.204(b). [Comment: This reasonable belief standard is a mixed subjective and objective standard.] This is not described as a duty, but rather as general standard of conduct or obligation. Additionally, TBOC § 152.204(c) says that “[a] partner does not violate a duty or obligation under this chapter or under the partnership agreement merely because the partner’s conduct furthers the partner’s own interest.” And to make things even clearer, TBOC § 1252.204(d) says that “[a] partner, in the partner’s capacity as partner, is not a trustee and is not held to the standards of a trustee.”

In *Lee v. Lee*, 47 S.W.2d 767, 794-95 (Tex. App.--Houston [14th Dist.] 2001, pet. denied), the court found that different meanings had been applied to the term “good faith” in connection with a transaction under the U.C.C., official immunity, or a whistleblower action. A fiduciary acts in good faith when he or she: (1) subjectively believes his or her defense is viable, and (2) acts reasonably in light of existing law. *Id*.

In the case of *Market Street Associates LP v. Frey*, 941 F.2d 588, 595 (7th Cir. 1991), the court described the duty of good faith and fair dealing in contracts as being “halfway between a fiduciary duty (the duty of utmost good faith) and the duty merely to refrain from active fraud.” The court continued: “The office of the doctrine of good faith is to forbid the kinds of opportunistic behavior that a mutually dependent, cooperative relationship might enable in the absence of rule.” *Id*. at 595. The duty of good faith appears in TBOC § 7.001 (corporate fiduciary duties), and Tex. Prop. Code § 13.051 (general duty of trustees to administer trust in good faith). A clause in a trust document, saying that a person who brings a court action against the trustee forfeits his interest in the trust, is not enforceable if the person proves just cause for bringing the suit and that the action was brought and maintained in good faith. Tex. Prop. Code § 112.038.

E. DUTY TO DISCLOSE. “As a general rule, a failure to disclose information does not constitute fraud unless there is a duty to disclose.” *Bradford v. Vento*, 48 S.W.2d 749, 755 (Tex. 2000). “Generally, no duty of disclosure arises without evidence of a confidential or fiduciary relationship.” *Ins. Co. of N. Am. v. Morris*, 981 S.W.2d 667, 674 (Tex. 1998). However, a duty to disclose has been recognized: (i) in a formal or informal fiduciary relationship; (ii) when a partial disclosure leads to a duty to fully disclose; (iii) when new information causes an earlier disclosure to become misleading or untrue; (iv) when a partial disclosure conveys a false impression; (v) in connection with estoppel by silence; and (vi) when a person “by force of circumstances is under a duty to another to speak.” *A. R. Clark Investment Co. v. Green*, 375 S.W.2d 425, 435 (Tex. 1964) (involving estoppel by silence). “[W]here there is a duty to speak, silence may be as misleading as a positive misrepresentation of existing facts.... There is an analogy to the rule considered by us in considerable depth, and with approval, in *Champlin Oil & Refining Co. v. Chastain*, 403 S.W.2d 376 (Tex. 1965), that an estoppel may arise as effectually from silence, where there is a duty to speak, as from words spoken." *Smith v. National Resort Communities, Inc.*, 585 S.W.2d 655, 658 (Tex. 1979). The duty of disclosure in business transactions is examined in Deborah A. DeMott, *Do You Have The Right to Remain Silent: Duties of Disclosure in Business Transactions*, 19 DELAWARE J. OF BUS. LAW 65 (1994).

In *Huie v. DeShazo*, 922 S.W.2d 920, 923 (Tex. 1996), the Court said: "[t]rustees and executors owe beneficiaries "a fiduciary duty of full disclosure of all material facts known to them that might affect [the beneficiaries'] rights.'"

F. PROHIBITION AGAINST SELF-DEALING. The Federal Deposit Insurance Corporation's (FDIC) Trust Examination Manual defines self-dealing in these terms: "Self-dealing always involves a conflict of interest, but not all conflicts of interest involve self-dealing. Self-dealing occurs when a fiduciary is a party to a transaction with itself or its affiliates." FDIC Trust Examination Manual[5] § 8.B. The Manual quotes the U.S. Supreme Court in *Michoud v. Girod*, 45 U.S. 503, 555 (1846):

> The general rule stands upon our great moral obligation to refrain from placing ourselves in relations which ordinarily excite a conflict between self-interest and integrity.... It therefore prohibits a party from purchasing on his own account that which his duty or trust requires him to sell on account of another, and from purchasing on account of another that which he sells on his own account. In effect, he is not allowed to unite the two opposite characters of buyer and seller, because his interests, when he is the seller or buyer on his own account, are directly conflicting with those of the person on whose account he buys or sells.

Self-dealing by a fiduciary is frowned upon in all areas of fiduciary law. Fiduciaries are entitled to receive reasonable compensation for their services, and perhaps even compensation for risks undertaken, but they are not allowed to take advantage of their fiduciary position to profit at the expense or to the detriment of the beneficiary. When a fiduciary benefits from a transaction with the beneficiary, there is a presumption of fraud and the fiduciary must prove that the transaction was fair to the beneficiary. *See Archer v. Griffith*, 390 S.W.2d 735 (Tex. 1965); *accord*, *Stephens County Museum, Inc. v. Swenson*, 517 S.W.2d 257, 739 (Tex. 1974) ("Under such conditions, equity indulges the presumption of unfairness and invalidity, and requires proof at the hand of the party claiming validity and benefits of the transaction that it is fair and reasonable"). In the trust context, "[s]elf-dealing means the trustee used the advantage of its position to gain any benefit for the trustee, other than reasonable compensation, or any benefit for any third person, firm, corporation, or entity, at the expense of the trust and its beneficiaries." *Grizzle v. Texas Commerce Bank, NA*, 38 SW 3d 265, 281 (Tex. App.–Dallas 2001), *rev' in part on other grounds*, 96 S.W.3d 240 (Tex. 2002); *InterFirst Bank Dallas, N.A. v. Risser*, 739 S.W.2d 882, 888 (Tex. App.--Texarkana 1987, no writ) (containing an in depth discussion of self-dealing). The Texas Trust Code § 114.001 provides that "[t]he trustee is accountable to a beneficiary for the trust property and for any profit made by the trustee through or arising out of the administration of the trust, even though the profit does not result from a breach of trust...." (The statute goes on to say that this standard does not apply to compensation under the trust agreement or an agreement signed by all beneficiaries.)

IV. DUTIES ARISING FROM DIFFERENT RELATIONSHIPS.

A. GENERALIZED DUTIES. In all relationships, there is a duty not to commit a criminal offense, and not to intentionally harm, and not to be reckless or grossly-negligent, and not to be negligent. Texas does not recognize a general legal duty to avoid negligently inflicting mental anguish without physical injury. *Boyles v. Kerr*, 855 S.W.2d 593, 597 (Tex. 1993).

B. AGENT-PRINCIPAL. An agent is duty-bound, unless otherwise agreed, to "act solely for the benefit of the principal in all matters connected with his agency." In *Johnson v. Brewer & Pritchard, P.C.*, 73 S.W.3d 193, 200 (Tex. 2002), the Court quoted the RESTATEMENT (SECOND) OF AGENCY cmt a (1958): "Among the agent's fiduciary duties to the principal is the duty to account for profits arising out of the employment, the duty not to act as, or on account of, an adverse party without the principal's consent, the duty not to compete with the principal on his own account or for another in matters relating to the subject matter of the agency, and the duty to deal fairly with the principal in all transactions between them." The Court indicated that an agent has a duty not to divert an opportunity from the principal in a way that the agent or an entity controlled by the agent profits or benefits in some way. *Id*. at 200. In *Vogt v. Warnock*, 107 S.W.3d 778, 782 (Tex. App.--El Paso 2003, pet. denied), the court held that a power of attorney automatically creates an agency relationship along with its fiduciary duties, even if the power of attorney is not exercised. *Accord*, *Jordan v. Lyles*, 455 S.W.3d 785, 792 (Tex. App.--Tyler 2015, no pet.);

C. TRUSTEE OF EXPRESS TRUSTS. The duties of a trustee of an express trust are governed by statute, common law, and the trust instrument.

1. Statutory Duties, Prohibitions, and Protections. The Texas Property Code states duties and prohibitions of trustees of an express trust.

<u>Good Faith, Statutory Rules, Common Law</u>

Under Texas Property Code § 113.051, General Duty, "[t]he trustee shall administer the trust in good faith according to its terms and this subtitle [B]. In the absence of any contrary terms in the trust instrument or contrary provisions of this subtitle, in administering the trust the trustee shall perform all of the duties imposed on trustees by the common law." Under Section 113.052, unless "expressly authorized or directed by the instrument or transaction establishing the trust" a trustee cannot make a loan to herself or an affiliate; a director, officer, or employee of the trustee or an affiliate; a relative of the trustee; or the trustee's employer, employee, partner, or other business associate. However, under Section 113.052(b)(2), a corporate trustee may make a deposit with itself as allowed under Section 113.057. Under Section 113.053, a trustee cannot buy or sell to itself trust property except in specified instances. Under Section 113.054, a trustee cannot buy or sell trust property to another trust of the trustee except for U.S. government-backed securities transacted at current market price. Section 113.055 prohibits the trustee from buying for the trust securities of the trustee or an affiliate or corporation of which the trustee is a director, owner or manager, except in specified instances.

<u>Statutory Duty of Care in Investing and Managing Assets</u>

Under Section 117.003(a), a "trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule set forth in this chapter [117]." However, under Section 117.003 the Prudent Investor Rule can be expanded, restricted, eliminated, or otherwise altered by the provisions of the trust agreement. The prudent investor standard of care is set out in Section 117.004: "A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution." How "reasonable care" differs from "ordinary care" is not stated. Section 117.010 says that compliance with the Prudent Investor Rule is determined in light of the facts and circumstances existing at the time of the trustee's decision or action. Under Section 117.004(d), a trustee must make a reasonable effort to verify facts relevant to the investment and management of trust assets. Under Section 117.004(f), if a trustee has special skills or expertise, she must use those special skills and expertise. [Comment: it is unclear if the standard of care for a trustee who has special skills or expertise is elevated from the care of an ordinary person to the care of someone with those special skills or expertise.]

Statutory Duty to Diversify

Under Section 117.005, Diversification, the trustee has a duty to diversify unless "special circumstances" warrant the decision not to diversify.

Statutory Duty of Loyalty

Under Section 117.007, Loyalty, "[a] trustee shall invest and manage the trust assets solely in the interest of the beneficiaries." In *Slay v. Burnett Trust*, 187 S.W.2d 377, 388 (1945), the Court said: "the duty of loyalty on the part of the trustee [] prohibit[s] him from using the advantage of his position to gain any benefit for himself at the expense of his cestui que trust and from placing himself in any position where his self interest will or may conflict with his obligations as trustee. "

Statutory Duty of Impartiality

Under Section 117.008, Impartiality, "[i]f a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries."

Exculpation

A trustee cannot be held liable for "a mistake of fact made before the trustee has actual knowledge or receives written notice of the happening of any event that determines or affects the distribution of the income or principal of the trust...." The statute lists as examples marriage, divorce, attainment of a certain age, performance of education requirements, or death. Tex. Prop. Code §114.004. A beneficiary can release a trustee of any duty, responsibility restriction, or liability in a writing delivered to the trustee. Tex. Prop. Code § 114.005.

Third Persons Acting With Trustee

A person, other than a beneficiary, who "without knowledge that a trustee is exceeding or improperly exercising the trustee's powers, in good faith assists a trustee or in good faith and for value deals with a trustee is protected from liability as if the trustee had or properly exercised the power exercised by the trustee." Tex. Prop. Code § 114.008. Under Tex. Prop. Code § 114.086(g), "[i]f a person has actual knowledge that the trustee is acting outside the scope of the trust, and the actual knowledge was acquired by the person before the person entered into the transaction with the trustee or made a binding commitment to enter into the transaction, the transaction is not enforceable against the trust." [This provision appears in a Section dealing with certifications of trust by a trustee.]

2. Common Law Duties of a Trustee. The case law speaks to the duties of the trustee of an express trust. However, common law duties apply only to the extent that they do not conflict with Texas Property Code Chapters 111-117, or the trust instrument. Tex. Prop. Code § 113.051. In *Varity Corp. v. Howe*, 516 U.S. 489, 497 (1996), the Court wrote that "[i]n his management of the trust, the trustee is required to manifest the care, skill, prudence, and diligence of an ordinarily prudent man engaged in similar business affairs and with objectives similar to those of the trust in question." According to Bogert, the principal obligation of the trustee is to "make[] an investigation as to the safety of [an] investment and the probable income to be derived therefrom," and then to make a reasonable investment decision based on that investigation. RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. b, at 530. In addition, "a reasonably prudent trustee always would have considered diversifying his investments." George Gleason Bogert et al., THE LAW OF TRUSTS & TRUSTEES § 612, at 22 (3d ed. 2000). The trustee also has an ongoing duty to monitor investments in the trust portfolio, and "if a particular asset in the trust portfolio [becomes] improper as a trust investment," the trustee is required to "act promptly to sell or convert the asset to avoid or minimize the risk of loss and personal liability." *Id*. § 612, at 19. In *Huie v. DeShazo*, 922 S.W.2d 920, 923 (Tex. 1996), the Court said: "[t]rustees and executors owe beneficiaries 'a fiduciary duty of full disclosure of all material facts known to them that might affect [the beneficiaries'] rights.'" The Court continued: "The trustee's duty of full disclosure extends to all material facts affecting the beneficiaries' rights." *Id.* at 923.

Trustee's Discretion

"Generally, when a trustee is given discretion with respect to the exercise of a power, a court may not interfere except to prevent an abuse of discretion. See RESTATEMENT (SECOND) OF TRUSTS § 187." In *Corpus Christi Bank & Trust v. Roberts*, 597 S.W.2d 752 (Tex. 1980), the Court said that a trustee's exercise of "discretion is subject to review only for an abuse by the Trustee of his discretion." "A court cannot substitute its discretion for that of a trustee, and can interfere with the exercise of discretionary powers only in cases of fraud, misconduct, or clear abuse of discretion." *Di Portanova v. Monroe*, 229 S.W.3d 324, 330 (Tex. App.--Houston [1st Dist.] 2006, pet. denied); *accord*, *In re XTO Energy Inc.*, 471 S.W.3d 126, 132 (Tex. App.--Dallas 2015, no pet.). In *DeRouen v. Bryan*, No. 03-11-00421-CV (Tex. App.--Austin Oct. 12, 2012, no pet.) (memo. op.), the court held that a trustee could not be held liable for mailing distributions to the beneficiary's home address where they were taken by his wife without his permission, and then failing to sue the wife for the return of the money. Both the Trust Code and the trust instrument gave the trustee the discretion to commence litigation in the trustee's discretion. The court said: "[a]bsent bad faith or an abuse of discretion, [the trustee] cannot be held liable for his refusing to do so."

<u>No Duty to Violate Law</u>

A trustee has no duty to violate the law to serve her beneficiaries. RESTATEMENT (SECOND) OF TRUSTS § 166, cmt. a. The court in *In re McKesson HBOC, Inc. ERISA Litigation*, No. C00-2003RMW, 2002 WL 31431588, *6 (N.D. Cal. Sept. 30, 2002) said: "Fiduciaries are not obligated to violate the securities laws in order to satisfy their fiduciary duties."

3. Terms of the Trust Document. "[I]f the trust instrument expressly limits the powers of the trustee or if it provides that the trustee has greater powers than those conferred by the Trust Code, then the language of the trust instrument will control. But if the terms of the trust instrument do not limit or conflict with a power given to trustee, the default rules supplied by the Trust Code apply." *Myrick v. Moody Nat'l Bank*, 336 S.W.3d 795, 801 (Tex. App.--Houston [1st Dist.] 2011, no pet.). "A power given to a trustee by [the Trust Code] does not apply to a trust to the extent that the instrument creating the trust, a subsequent court order, or another provision of [the Code] conflicts with or limits the power." *Id.* § 113.001.

4. Time Limitations on Claims. In *Courseview, Inc. v. Phillips Petroleum Co.*, 312 S.W.2d 197, 205 (Tex. 1957), the Court wrote: "[L]imitation does not begin to run in favor of a trustee and against the cestui until the latter has notice of a repudiation of the trust, and there is no duty to investigate at least until the cestui has knowledge of facts sufficient to excite inquiry."

D. ATTORNEYS. The relationship of attorney-client is a fiduciary one. *Archer v. Griffith*, 390 S.W.2d 735, 739 (Tex. 1964). Duties ethically owed by the lawyer to the client are detailed in the Texas Disciplinary Rules of Professional Conduct ("TDRPC"). The breach of these duties does not give rise to a claim for damages. However, the duties may influence expert testimony on the standard of care or the fiduciary duty in a civil damages or disgorgement lawsuit. In some circumstances a lawyer owes a duty to third parties, and always to the legal system.

1. Duties Under the Code of Ethics.

a. Zealous Representation. The Preamble to the TDRPC, Paras. 2 and 3 say that, in all professional functions, the lawyer should zealously pursue the client's interests within the bounds of the law.

b. Duties to Client. A lawyer's duties to the client are covered in TDRPC Sections I and II. These include the duty of competent and diligent representation (Rule 1.01), a duty to keep the client reasonably informed (Rule 1.03), a prohibition against illegal or unconscionable fees (Rule 1.04), a duty of confidentiality (Rule 1.05), a duty to avoid conflicts of interest (Rule 1.06, 1.07, 1.09 & 1.13), a prohibition of certain transactions with the client (Rule 1.08), a prohibition against successive government and private employment (Rule 1.10), a duty to safekeep the client's property (Rule 1.14), and a duty to exercise independent professional judgment (Rule 2.01).[6]

c. Confidentiality. TDRPC Rule 1.05 requires the lawyer to protect the client's "confidential information," which includes both "privileged information" and "unprivileged client information." However, a lawyer "may" reveal confidential information when the lawyer has reason to believe it is necessary in order to comply with a court order, a Rule of Professional Conduct, or other law. TDRPC Rule 1.05(c)(4). The lawyer "may" reveal confidential information when the lawyer has reason to believe it is necessary to do so in order to prevent the client from committing a crime or fraud. TDRPC Rule 1.05(c)(7). Or to the extent revelation "reasonably appears necessary to rectify the consequences of a client's criminal behavior or fraudulent act in the commission of which the lawyer's services have been used." TDRPC Rule 1.05(c)(8). Texas Rule of Evidence 503 makes confidential attorney-client communications privileged. The privilege belongs to the client, not the lawyer. Tex. R. Evid. 503(b)(1). The privilege does not apply when the lawyer's services were sought or obtained to aid anyone in committing a crime or fraud. Tex. R. Evid. 503(d)(1).

d. Limits on Ethical Duties to Clients. The Preamble to the Texas Disciplinary Rules of Professional Conduct, ¶ 1, says that a lawyer is not only a representative of a client, but also an officer of the legal system. In all professional functions, the lawyer must operate within the bounds of the law. Preamble, ¶ 2. The lawyer's conduct "should" conform to the requirements of the law, in practicing law and in the lawyer's business and personal affairs. Preamble, ¶ 3. Under Rule 1.02(c), a lawyer should not "assist or counsel a client to engage in conduct that the lawyer knows is criminal or fraudulent." A lawyer with confidential information must promptly make reasonable efforts under the circumstances try to dissuade the client from committing a criminal or fraudulent act that is likely to result in substantial injury to the financial interests or property of another. Rule 1.02(d). Where the lawyer has confidential information that the client has committed a crime or fraud using the lawyer's services, the lawyer must make reasonable efforts under the circumstances to persuade the client to take corrective action. Rule 1.02(e). A lawyer "may" reveal confidential client information when the lawyer reasonably believes it is necessary to do so in order to comply with a court order, the Texas Disciplinary Rules of Professional Conduct, or other law, Rule1.05(c)(4), or when the lawyer "has reason to believe it is necessary to do so" to prevent the client from committing a crime or fraud. Rule 1.05(c)(7). [Comment: having "reason to believe" is different from "reasonably believing."] When a lawyer has confidential information "clearly establishing that a client is likely to commit a criminal or fraudulent act that is likely to result in death or substantial bodily harm to a person," the lawyer "shall" reveal the information to the extent revelation "reasonably appears necessary" to prevent the act. Rule 1.05(e). If a lawyer has offered into evidence material evidence that is false, the lawyer must make a "good faith effort" to persuade the client to withdraw or correct the evidence, failing which the lawyer must take "reasonable remedial measures," including disclosure of the true facts. Rule 3.03(b).

2. Duties To The Client. "The existence of an attorney-client relationship gives rise to corresponding duties on the attorney's part to use the utmost good faith in dealings with the client, to maintain the confidences of the client, and to use reasonable care in rendering professional services to the client." *Byrd v. Woodruff*, 891 S.W.2d 689, 700 (Tex. App.--Dallas 1994, writ dism'd by agr.). However, a claim of legal malpractice is a claim of negligence, not a claim for breach of fiduciary duty. *Cosgrove v. Grimes*, 774S.W.2d 662, 664 (Tex. 1989); *Campbell v. Doherty*, 899 S.W.2d 395, 397 (Tex. App.--Houston [14th Dist.] 1995, writ denied).

<u>Fiduciary Standard v. Negligence</u>

"The focus of breach of fiduciary duty is whether an attorney obtained an improper benefit from representing a client, while the focus of a legal malpractice claim is whether an attorney adequately represented a client." *Kimleco Petroleum, Inc. v. Morrison & Shelton, P.C.*, No. 2-02-278-CV (Tex. App.--Fort Worth Dec. 12, 2002, pet. denied) (mem. op.); *Goffney v. Rabson*, 56 S.W.3d 186, 193 (Tex. App.--Houston [14th Dist.] 2001, pet. denied) (giving examples of when a breach of fiduciary duty occurred); *Greathouse v. McConnell*, 982 S.W.2d 165, 172 (Tex. App.--Houston [1st Dist.] 1998, pet. denied). As to a claim of negligence, a lawyer in Texas is held to the standard of care that would have been exercised by a reasonably prudent attorney, based on information s/he had at the time of the act. *Cosgrove v. Grimes*, 774 S.W.2d 662, 665 (Tex. 1989). The courts have also recognized a claim under the Texas Deceptive Trade Practices Act. *Latham v. Castillo*, 972 S.W.2d 66 (Tex. 1998) (client can assert claim under the DTPA provisions regarding unconscionable action or course of action). However, a claimant cannot "fracture" a case against a lawyer. "Nothing is to be gained by fracturing a cause of action arising out of bad legal advice or improper representation into claims for negligence, breach of contract, fraud or some other name. If a lawyer's error or mistake is actionable, it should give rise to a cause of action for legal malpractice with one set of issues ...." *Ersek v. Davis & Davis, P.C.*, 69 S.W.3d 268, 274-75 (Tex. App.--Austin 2002, pet. denied).

<u>Recovery</u>

A suit for legal malpractice is to recover damages proximately caused by the attorney's negligence. In *Douglas v. Delp*, 987 S.W.2d 879, 885 (Tex. 1999), the Court ruled that "when a plaintiff's mental anguish is a consequence of economic losses caused by an attorney's negligence, the plaintiff may not recover damages for that mental anguish." Gross negligence will support exemplary damages. See Section II.B.2.c above.

A claim based on breach of an attorney's duty of loyalty warrants disgorgement of fees already paid rather than compensatory damages, and proof of damages is unnecessary. *Burrow v. Arce*, 997 S.W.2d 229, 239 n. 37 (Tex. 1999).

3. No Duty of Care to Non-Clients. In *Barcelo v. Elliott*, 923 S.W.2d 575, 577 (Tex. 1996), the Court held that "an attorney retained by a testator or settlor to draft a will or trust owes no professional duty of care to persons named as beneficiaries under the will or trust." The Court based its decision on the requirement of privity as a limitation on the lawyer's duties. *Id.* at 577. In *Cantey Hanger, LLP v. Byrd*, 467 S.W.3d 477, 481 (Tex. 2015), the Court said: "Texas common law is well settled that an attorney does not owe a professional duty of care to third parties who are damaged by the attorney's negligent representation of a client." TDRPC Rule 4.01 prohibits a lawyer, in representing a client, from making a "false statement of material fact or law" to a third person, or to "fail to disclose a material fact" to a third person "when disclosure is necessary to avoid making the lawyer a party to a criminal act or knowingly assisting a fraudulent act perpetrated by a client." A violation of these standards does not create liability for damages. TDRPC Preamble, ¶ 15 ("These rules do not undertake to define standards of civil liability of lawyers for professional conduct").

4. Attorney Immunity. As a general rule, attorneys are immune from civil liability to non-clients for actions taken in connection with representing a client in litigation. *See Cantey Hanger, LLP v. Byrd*, 467 S.W.3d 477, 481-82 (Tex. 2015). Immunity does not apply to actions that are not the kinds of conduct that a lawyer engages in while discharging her duties to a client. *See Id.* at 482. Thus, an attorney who personally steals property or knowingly tells lies on a client's behalf may be liable for conversion or fraud. *Chu v. Hong*, 249 S.W.3d 441, 446 (Tex. 2008).

5. Tortious Acts. "[A] lawyer's protection from liability arising out of his representation of a client is not without limits. ... For example, a cause of action could exist against an attorney who knowingly commits a fraudulent act outside the scope of his legal representation of the client.... If a lawyer participates in independently fraudulent activities, his action is 'foreign to the duties of an attorney.' ... A lawyer thus cannot shield his own willful and premeditated fraudulent actions from liability simply on the ground that he is an agent of his client." *Alpert v. Crain, Caton & James, P.C.*, 178 S.W.3d 398, 406 (Tex. App.--Houston [1st Dist.] 2005, pet. denied) (Bland, J.) (citations omitted). In *Chu v. Hong*, 249 S.W.3d 441 (Tex. 2007), the Court held that an attorney could not be held liable for conspiracy or aiding and abetting a fiduciary breach when the claimed wrong was fraud on the community estate, which is not considered to be a tort.

6. Duties Under Contract Law. An attorney-client employment agreement is a contract and the scope of the undertaking is governed by the agreement. While the attorney-client relationship may have a contractual foundation, a claim for bad lawyering is considered to be a negligence claim and not a breach of contract claim or breach of warranty claim. *See Van Polen v. Wisch*, 23 S.W.3d 510, 515 (Tex. App.--Houston [1st Dist.] 2000, pet. denied) (claim for breach of contract, which was based on attorney's failure to appear at hearing, was in the nature of a tort); *Black v. Wills*, 758 S.W.2d 809, 814 (Tex. App.--Dallas 1988, no writ) (claim for breach of contract, which was based on attorney's failure to appear at trial, was in the nature of a tort); *Citizens State Bank v. Shapiro*, 575 S.W.2d 375, 386-87 (Tex. Civ. App.--Tyler 1978, writ re'd n.r.e.) (complaints of attorney's failure to perform obligations under contract was a tort claim). "Legal malpractice claims sound in tort." *Belt v. Oppenheimer Blend Harrison & Tate*, 192 S.W.3d 780, 783 (Tex. 2006).

7. Spouse as Client. In *Bohn v. Bohn*, 455 S.W.2d 401, 408 (Tex. Civ. App.–Houston [1st Dist.] 1970, writ dism'd), a husband, who was a lawyer, prepared transfer documents for the wife to make a gift to him of shares of stock, and discussed them with her. Although the appellate court's decision did not hinge on the husband's status as a lawyer, the court held that the burden was on the husband to establish the fairness of the transaction. So, apart from the husband's burden to prove gift by clear and convincing evidence of delivery, acceptance, and donative intent, the husband also had the burden of a fiduciary to prove fairness of the transaction. In Izzo *v. Izzo*, No. 03-09-00395-CV (Tex. App.–Austin May 14, 2010, pet. denied) (memo. op.), the husband's law associate prepared a post-marital agreement for the husband and wife. The trial court found that before marriage the husband had become the wife's attorney and had assumed control of and invested her assets. The trial court found that the husband had a fiduciary duty arising from his position as wife's attorney, investment advisor, and custodian of her wealth, and the court of appeals affirmed. The appellate court said: "Significantly, the fiduciary duty John owed to Sharon in acting as her attorney and investment advisor is independent from the general fiduciary duty that he owed to Sharon as her spouse...." The court continued: "The fiduciary obligation imposes a duty to exercise good faith and candor, to disclose all relevant information, and to refrain from using the relationship to benefit the fiduciary's personal interest, except with full knowledge and consent of the principal." The appellate court found that the multiple fiduciary relationships triggered a presumption of undue influence. A lawyer who performs legal services for her spouse, especially where the lawyer benefits to the detriment of the spouse, will likely face a presumption of constructive fraud, and have the burden to prove fairness of the transaction, along with other adverse presumptions like undue influence. The most likely way to avoid this is to have an independent attorney draft the documents and advise the non-lawyer spouse privately about the transaction.

E. ADMINISTRATOR AND INDEPENDENT EXECUTOR OF AN ESTATE. Texas Property Code § 161.001 defines "fiduciary" for purposes of Chapter 161 to mean "an executor, administrator, or trustee of an express trust." Texas Estates Code § 351.001 ("TEC") provides that "[t]he rights, powers, and duties of executors and administrators are governed by common law principles to the extent that those principles do not conflict with the statutes of this state." These common law duties include the duty of loyalty and the duty of care, as applied to the tasks of administering an estate or fulfilling the terms of a will.

In Texas, when a person dies without a will, the heirs can have the probate court open an administration of the decedent's estate. A temporary administrator is sometimes appointed pending appointment of a permanent administrator. In *Frost Nat'l Bank of San Antonio v. Kayton*, 526 S.W. 2d 654 (Tex. Civ. App--San Antonio 1975, writ ref'd n.r.e.), the court said "[t]he general rule is that a temporary administrator, having qualified, is charged with the duty of reasonable care to preserve the estate." The case involved the failure to insure against hurricane loss, not a claim of self-dealing or other act or omission that might have been a breach the duty of loyalty. The court went on to say that "[t]here is testimony that the duties of trustees and administrators with respect to preserving assets are basically similar. "*Id*. at 661. The court in *Lawyers Surety Corp. v. Snell*, 617 S.W. 2d 750 (Tex. Civ. App.--Houston [14th Dist.] 1981, no writ), applied a "prudent man" negligence standard to a temporary administrator in a situation with no issue of self-dealing.

"Under Texas law, an executor owes a fiduciary duty to the beneficiaries of the decedent's estate. An executor has several legal obligations in that capacity, including locating and notifying beneficiaries under the will; notifying creditors of the estate; determining and paying the estate's debts; filing tax returns and paying taxes owed by the estate; identifying, valuing, accounting for, and protecting estate assets; asserting estate claims and defending the estate against claims; and distributing remaining estate assets to the beneficiaries on an equitable basis consistent with the will's provisions." Tex. Ethics Op. No. 678 (Sep. 2018). In *Huie v. DeShazo*, 922 S.W.2d 920, 923 (Tex. 1996), the Court said: "[t]rustees and executors owe beneficiaries 'a fiduciary duty of full disclosure of all material facts known to them that might affect [the beneficiaries'] rights.'"

The duties of a personal representative of a decedent's estate have been described as duty of loyalty, a duty to keep and render accounts, a duty to furnish information, a duty to exercise reasonable care and skill, a duty to take and retain control of estate property, a duty to preserve estate property, a duty to enforce claims, a duty to defend, a duty not to co-mingle estate funds, a duty with respect to bank deposits, a duty with respect to investments, a duty to deal impartially with beneficiaries, and a duty with respect to co-fiduciaries. Mary C. Burdette, *Handbook for the Fiduciary Advising and Counseling Executors and Trustees*, State Bar of Texas MALPRACTICE AVOIDANCE FOR ESTATE PLANNERS 50-52 (2010). In *Montgomery v. Kennedy*, 669 S.W.2d 309, 313 (Tex. 1984), the Court said: "As trustees of a trust and executors of an estate with Virginia Lou as a beneficiary, Jack Jr. and his mother owed Virginia Lou a fiduciary duty of full disclosure of all material facts known to them that might affect Virginia Lou's rights."

Texas Estates Code § 351.101, Duty of Care, provides: "An executor or administrator of an estate shall take care of estate property as a prudent person would take of that person's own property, and if any buildings belong to the estate, the executor or administrator shall keep those buildings in good repair, except for extraordinary casualties, unless directed by a court order not to do so." TEC § 351.151 provides that an executor must use "ordinary diligence" to collect claims and debts due the estate. If a personal representative "wilfully neglects" to use "ordinary diligence," he and his sureties are liable for the amount of the claims lost by neglect. TEC § 351.151. A personal representative who operates a business pursuant to court order has the normal fiduciary duties of a personal representative. TEC § 351.204

Texas Estates Code§ 404.001(b) provides that, any time after the expiration of 5 months from the issuance of letter testamentary, any person interested in the estate can demand an accounting, to be in writing, subscribed and sworn to. If an accounting is not produced within 60 days, the interested person can apply to the Probate Court, which may compel compliance. Under TEC § 404.0035(b), the court may remove an independent executor if the independent executor: (i) fails to make an accounting which is required by law to be made; or (2) is guilty of gross misconduct or gross mismanagement in the performance of the independent executor's duties.

F. GUARDIAN-WARD. On June 24, 2016, the Texas Supreme Court promulgated a Code of Ethics and Minimum Standards for Guardianship Services, recognizing that a court-appointed guardian owes a fiduciary duty to the ward.[7] Section 3 and Section 7 of the Code describe a Duty of Confidentiality. Section 5 describes a duty of Competence: "5. A guardian of the person must make reasonable and informed decisions about the ward's residence, care, treatment, and services. A guardian of the estate must take care of and manage the estate as a prudent person would manage the person's own property unless relevant law imposes a higher standard of care. In either case, a guardian must exercise reasonable diligence to remain informed about options available to the ward to promote independence and self-reliance. A guardian must refrain from making decisions outside of the scope of authority granted to the guardian by law or court." Section 7 provides: "7. *Avoidance of Conflicts of Interest and Self-Dealing.* A guardian must avoid conflicts of interest and refrain from personally engaging in transactions with the ward and other forms of self-dealing, except in a manner authorized by law." Section 15(a) prohibits even the appearance of a conflict of interest or impropriety when dealing with the needs of the ward. "Impropriety or conflict of interest arises where the guardian has some personal or agency interest that can be perceived as self-serving or adverse to the position or best interest of the ward." *Id.* "A conflict of interest may also arise where the guardian has dual or multiple relationships with a ward which conflict with each other or has a conflict between the best interests of two or more wards." *Id.* If the guardian becomes aware of a conflict of interest, s/he must immediately disclose that to the court. *Id.* Section 15(b). A guardian of the estate must maintain and manage the ward's estate as a prudent person would manage the person's own property consistent with a fiduciary's duties and responsibilities set forth in the Texas Estates Code." Section 16(a). "The guardian must manage the estate only for the benefit of the ward." Section 16(c). The guardian cannot commingle the estate's assets. Section 16 (e) & (f). "The guardian must employ prudent accounting procedures when managing the estate." Section 16(h). The standards prohibit conflicts of interest unless expressly authorized or directed by the instrument or transaction establishing the trust; commingling in the same terms as for guardians of the person. A guardian cannot profit from a transaction made on behalf of the ward or compete with the ward's estate without permission of the court. Section 19(h).

In *Coble Wall Trust Co. v. Palmer*, 848 S.W.2d 696, 707 (Tex. App.--San Antonio 1991), *rev'd and remanded on other grounds*, 851 S.W.2d 178 (Tex. 1992), the court of appeals said: "[t]he administrator held the estate funds in trust for the beneficiaries, and in dealing with the funds, was required to act in good faith, without regard to personal interests and opportunities for gain resulting form the fiduciary relationship."

G. BUSINESS ENTITIES. Texas law surrounding business entities has developed special fiduciary duties that are described using standards borrowed from other areas of law.

1. What Law Applies? Under TBOC §§ 1.101 & 1.102, the law that governs the formation and internal affairs of an entity is the law of the state where the business was organized. However, Sections 1.101 and 1.102 apply only when the formation occurs when the certificate of formation or similar instrument is filed. TBOC §§ 1.101 & 1.102. Where the entity is not formed by a filing instrument (i.e., a partnership or joint venture), the law governing formation and internal affairs is the law of the entity's jurisdiction of formation. TBOC § 1.103. TBOC § 1.105 defines internal affairs as including the "rights, powers, and duties of its governing authority, governing persons, officers, owners, and members" and "matters relating to its membership or ownership interests." This so-called "internal affairs doctrine" is held to apply to duties owed by corporate directors, officers, managers, to the corporation (but not usually its owners). In any business entity relationship, a central question is which state's law to apply when an entity is organized in one state but conducts business in another state. As to other claims, Texas courts apply the law of the state with the most significant relationship to the case. See RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 6(2) (1971). *Gutierrez v. Collins*, 583 S.W.2d 312 (Tex. 1979) (as to torts); *Duncan v. Cessna Aircraft Co.*, 665 S.W.2d 414, 421 (Tex. 1984) (as to all types of claims). In *Longview Energy Co. v. The Huff Energy Fund, LP*, 533 S.W.3d. 866 (Tex. 2017), in a breach of fiduciary duty suit by a corporation against two directors, the Court applied the law of Delaware to substantive issues and the law of Texas to procedural issues. *Id.* at 872. The Court applied the law of Delaware to the remedy of constructive trust. *Id.* at 873. Texas recognizes choice-of-law clauses in agreements. *DeSantis v. Wackenhut Corp.*, 793 SW 2d 670, 678-84 (Tex. 1990) (recognizing the validity of choice-of-law clauses at stated in RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187, but applying the public-policy exception to covenants not to compete). Courts apply the law of the forum to procedural matters. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 122 (1971).

2. For-Profit Corporations. "Corporate officers and directors are fiduciaries, and the consequences of their acts as such are determinable under the facts in each case." *Int'l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 576 (Tex. 1963). Corporate directors, officers, and managers owe these fiduciary duties to the corporation, sometimes its shareholders, and only rarely to its creditors. Directors, officers, and managers of publicly-traded companies also have a duty of disclosure to the public, and a duty not to profit from "insider information."

a. Directors. TBOC § 22.221(a) says that a corporate director must "discharge the director's duties, including duties as a committee member, in good faith [a subjective standard], with ordinary care [an objective standard], and in a manner the director reasonably [objective] believes [subjective] to be in the best interest of the corporation. Section 22.221(b) says that "[f]or a director to be liable for actions or inactions, the complainant must show that the director (i) did not act in good faith, <u>and</u> (ii) did not use ordinary care, <u>and</u> (iii) did not act in a manner that the director reasonably believed to be in the best interest of the corporation." (Underline added.) [Comment: Because the proposition is conjunctive, to be liable for damages the director must breach all three duties at the same time.] "Good faith" is not defined in the TBOC. Good faith is a subjective standard. "Ordinary care" is an objective standard, the familiar tort standard of ordinary prudence under similar circumstances. "Reasonable belief" of best interest is a mixed standard: "belief" is a subjective assessment of what was in the mind of the director, but the reasonableness of this belief is an objective standard of ordinary care. Section 22.223 says that "[a] director of a corporation is not considered to have the duties of a trustee of a trust with respect to the corporation or with respect to property held or administered by the corporation, including property subject to restrictions imposed by the donor or transferor of the property." [Comment: The trustee of an express trust is required to put the beneficiary's interest before his own. How this differs from the "duty of loyalty" owed by corporate directors is a complicated question.] Under Section 22.224 the board of directors can delegate investment authority, and if it does so "[t]he board of directors is not liable for an action taken or not taken by an advisor under this section if the board acted in good faith [subjective] and with ordinary care [objective] in selecting the advisor." [Comment: the board must meet both the subjective and objective standards for the exception to apply.] Section 22.225(a) flatly prohibits a corporation from making a loan to a director. Under Section 22.225(b), any director who votes for such a loan, or any officer who participates in making the loan, is liable to the corporation for the amount of the loan. In *Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014), the Court said that directors must make decision about declaring dividends "in compliance with the formal fiduciary duties that they, as officers or directors, owe to the corporation, and thus to the shareholders collectively." In *Klinek v. LuxeYard, Inc.*, 596 S.W.3d 437, 453 (Tex. App.--Houston [14th Dist.] 2020, pet. denied), the court said that "[d]irectors owe fiduciary obligations to both the corporation and its shareholders, and those obligations include the fiduciary duties of care, good faith, and loyalty." [The fiduciary duty of directors to the shareholders is a complicated question.]

b. Officers. The TBOC does not directly describe an officer's duties to the corporation. However, TBOC § 22.235, Officer Liability, limits the liability of officers for acts or omissions that are otherwise actionable (presumably this means intentional, grossly negligent, or negligent wrongs). Under Section 22.235, an officer is not liable to the corporation or other person unless his/her conduct (i) was not exercised in good faith [subjective], <u>**and**</u> (ii) was not exercised with ordinary care [objective], <u>**and**</u> (iii) was not exercised in a manner the officer reasonably [objective] believes [subjective] to be in the best interest of the corporation. [Comment: Because the negative proposition is stated conjunctively, an officer is exonerated if any one or more of the three conditions are not met.] We can infer from this statute that officers have a duty of good faith and ordinary care, and must reasonably believe that their actions are in the best interest of the corporation, but they are liable only when an act or omission breaches all three duties. Thus, bad faith alone will not support liability, nor will negligence alone. A belief that an action or inaction is in the corporation's best interest will negate liability as long as that belief is reasonable. [Comment: this third prong is a mixture of objective (i.e., reasonableness) and subjective (i.e., belief) standards.]

c. Contracts with Directors and Officers. "Contracts between a corporation and its officers and directors are not void but are voidable for unfairness and fraud with the burden upon the fiduciary of proving fairness." *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 576 (Tex. 1963). TBOC § 22.230 governs contracts between directors, officers, members of a corporation or its affiliates. Such contracts are valid if (i) the material facts about the relationship or interest and the contract or transaction are disclosed to or known by the board of directors, or a committee or members, and a majority of *disinterested* directors, committee members, or members vote to approve the contract in the exercise of good faith and ordinary care, **or** the contract or transaction is fair to the corporation when it was authorized. [Note that "fairness" is a fiduciary standard.] "[I]nterestedness or disinterestedness does not turn on any technical form of legal status; it is a substantial fact question." *Allen v. Wilkerson*, 396 S.W.2d 493, 501 (Tex. Civ. App.-- Austin 1965, writ ref'd n.r.e.). "An officer or director is considered 'interested' if he or she (1) makes a personal profit from a transaction by dealing with the corporation or usurps a corporate opportunity, (2) buys or sells assets of a corporation, (3) transacts business in his or her officer's or director's capacity with a second corporation of which he or she is also an officer or director or is significantly financially associated, or (4) transacts corporate business in his or her officer's or director's capacity with a family member." *Loy v. Harter*, 128 S.W.3d 397, 407-08 (Tex. App.--Texarkana 2004, pet. denied).

d. Duties to Owners. The fiduciary duties of corporate directors, officers, and managers are owed to the corporation. The directors owe no formal fiduciary duty to the shareholders of the corporation. However, informal fiduciary relationships can exist between specific directors, officers, and managers, and specific shareholders that will give rise to fiduciary duties between those individuals.

e. Duty of Obedience. Baylor Law School Professor Elizabeth S. Miller writes that corporate directors owe a "duty of obedience" which she says forbids ultra vires acts. Miller, *Fiduciary Duties, Exculpation, and Indemnification in Texas Business Organizations*, State Bar of Texas 13th ANNUAL ADVANCED REAL ESTATE STRATEGIES COURTS, ch. 4, p. 1 (2019) ("Miller 2019"). *Accord*, *Gearhart Industries, Inc. v. Smith International*, 741 F.2d 707, 719 (5th Cir. 1984) ("[t]he duty of obedience requires a director to avoid committing ultra vires acts, i.e., acts beyond the scope of the powers of a corporation as defined by its charter or the laws of the state of incorporation").

f. Duty of Care. Corporate directors and others owe a duty of care to the corporation. But in some instances a generalized duty of care is owed to third parties.

<u>Owed to the Company.</u> In *Hoggett v. Brown*, 971 S.W.2d 472, 488 (Tex. App.–Houston [14th Dist.] 1997, pet. denied), the court said: "[a] director's fiduciary duty runs only to the corporation, not to individual shareholders or even to a majority of the shareholders." *Accord*, *Somers v. Crane*, 295 S.W.3d 5, 11 (Tex. App.-Houston [1st Dist.] 2009, pet. denied) (citing cases that so hold). However, "officers or directors may owe a fiduciary duty to individual shareholders if a contract or confidential relationship exists between them in addition to the corporate relationship." *Opperman v. Opperman*,

No. 07-12-00033-CV (Tex. App.–Amarillo Dec. 9, 2013, no pet.) (memo. op.).

Owed to Third Parties. " As a general rule, the actions of a corporate agent on behalf of the corporation are deemed the corporation's acts." *Holloway v. Skinner*, 898 S.W.2d 793, 795 (Tex. 1995). "[A]n officer or director may not be held liable in damages for inducing the corporation to violate a contractual obligation, provided that the officer or director acts in good faith and believes that what he does is for the best interest of the corporation." *Maxey v. Citizen's Nat'l Bank*, 507 S.W.2d 722, 726 (Tex. 1974). "A corporate officer or agent can be liable to others, including other company employees, for his or her own negligence. However, individual liability arises only when the officer or agent owes an independent duty of reasonable care to the injured party apart from the employer's duty." *Leitch v. Hornsby*, 935 S.W.2d 114, 117 (Tex. 1996).

g. Duty of Loyalty. "The duty of loyalty dictates that a corporate officer or director must act in good faith and must not allow the individual's personal interest to prevail over the interest of the corporation." *Loy v. Harter*, 128 S.W.3d 397, 408 (Tex. App.--Texarkana 2004, pet. denied); Miller (2020) at p. 5. However, TBOC § 22.223 says that a director does not have the duties of the trustee of a trust. In *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 577 (Tex. 1963), the Court said this about corporate opportunities: "A corporate fiduciary is under obligation not to usurp corporate opportunities for personal gain, and equity will hold him accountable to the corporation for his profits if he does so. Transactions in which a corporate fiduciary derives personal profit, either in dealing with the corporation or its property, or in matters of corporate interest, are subject to the closest examination and the form of the transaction will give way to the substance of what actually has been brought about." [Comment: question whether the remedy for diversion of a corporate opportunity is disgorgement or damages, or both.] "When a corporate officer or director diverts assets of the corporation to his own use, he breaches a fiduciary duty of loyalty to the corporation. In such a case, a court in equity may find the officer or director holds the usurped property as a constructive trustee for the corporation." *Sw. Livestock & Trucking Co. v. Dooley*, 884 S.W.2d 805, 809 (Tex. App.--San Antonio 1994, writ denied).

h. Reliance on Others. TBOC § 3.105 says that "[i]n discharging a duty or exercising a power, an officer of a domestic entity may, in good faith and ordinary care, rely on information, opinions, reports, or statements, including financial statements and other financial data, concerning the entity or another person and prepared or presented by: (1) another officer or an employee of the entity; (2) legal counsel; (3) a certified public accountant; (4) an investment banker; or (5) a person who the officer reasonably believes possesses professional expertise in the matter."

i. Duties to Creditors. The Texas Uniform Fraudulent Transfers Act ("TUFTA") permits creditors of a business to have a court nullify transfers by the debtor that are made with the "actual intent" to hinder, delay, or defraud any creditor of the debtor, or collection of a creditor's claims, or which occur when the company is insolvent or is made insolvent by the transfer. Tex. Bus. & Comm. Code § 24.005. Bankruptcy law gives similar power to the trustee in bankruptcy. 11 U.S.C. § 548. See Section XII.J below. Under these statutes, the remedy is against the transferee, except when the transferee took in good faith and for a reasonably equivalent value. Tex. Bus. & Com. Code § 24.009(a); 11 U.S.C. § 435(c) (third party protected only to the extent of value given).

When do a business's directors and officers have a duty to creditors of the company that can subject them to personal liability? In *Conway v. Bonner*, 100 F.2d 786, 787 (5th Cir. 1939), the court said that officers and directors of a Texas corporation owe fiduciary duties only to their corporation and not its creditors "so long as it continues to be a going concern, conducting its business in the ordinary way, without some positive act of insolvency." The court cited five Texas Court of Civil Appeals cases in support. *Conway v. Bonner* did not address a corporation that is insolvent. In *Carrieri v. Jobs.com*, 393 F.3d 508, 534 n. 24 (5th Cir. 2004), the court said in dicta: "[o]fficers and directors that are aware that the corporation is insolvent, or within the 'zone of insolvency' ... have expanded fiduciary duties to include the creditors of the corporation." Several bankruptcy judges and a Federal District Judge applying Texas law have declined to apply *Carrieri*. In *Fagan v. La Gloria Oil & Gas. Co.*, 494 S.W.2d 624, 628 (Tex. Civ. App.--Houston [14th Dist.] 1973, no writ), the court said: "It is a basic rule of law that officers and directors of a corporation owe to it duties of care and loyalty. They stand in a fiduciary relationship to the corporation. Such duties, however, are owed to the corporation and not to creditors of the corporation." However, the court went on to describe the "trust fund doctrine":

> when a corporation (1) becomes insolvent and (2) ceases doing business, then the assets of the corporation become a trust fund for the benefit, primarily, of its creditors. The officers and directors hold the corporate assets in trust for the corporate creditors. They are placed in a fiduciary relation to and owe a fiduciary duty to the creditors. That duty obliges them to administer the corporate assets for the benefit of the creditors and to ratably distribute them. The breach of that duty gives rise to a cause of action against the officers and directors which can be prosecuted directly by the creditors.

Id. at 628. TBOC § 21.303 provides that a "a corporation may not make a distribution ... if the corporation would be insolvent after the distribution," except pursuant to winding up and termination pursuant to TBOC ch. 11. TBOC § 22.226(a) provides:

> In addition to any other liability imposed by law on the directors of a corporation, the directors who vote for or assent to a distribution of assets other than in payment of the corporation's debts, when the corporation is insolvent or when distribution would render the corporation insolvent, or during the liquidation of the corporation, without the payment and discharge of or making adequate provisions for any known debt, obligation, or liability of the corporation, are jointly and severally liable to the corporation for the value of the assets distributed, to the extent that the debt, obligation, or liability is not paid and discharged.

Section 22.226(b) provides that a director is not liable under Section 22.226(a) if (i) s/he relied in good faith and with ordinary care on an investment advisor's opinion, or (ii) in good faith [subjective] and with ordinary care [objective] considered the assets of the corporation to be at least equal to their book value; or (iii) relied in good faith [subjective] and with ordinary care [objective] on financial statements of, or other information concerning, a guarantor of corporate debt. Section 22.226(b) provides that a director is not liable under Section 22.226(a) "if, in the exercise of ordinary care [objective], the director acted in good faith [subjective] and in reliance on the written opinion of an attorney for the corporation." Under Section 22.229, a director held liable under Section 22.226 is entitled to contribution from persons who accepted or received the improper distribution.

Thus, under the older Texas case law if the corporation is insolvent and has ceased to do business, the directors owe a fiduciary duty directly to creditors. Creditors can sue directors directly for breach of this fiduciary duty. Under Section 22.226 the fiduciary duty is owed to the corporation, so the creditors must bring a derivative action to recover any money.

A choice-of-law issue can arise where the corporation was organized under the law of one state but is sued by creditors in another state. Are the claims of creditors against the directors and officers governed by (i) the law of the state of organization, or (ii) the law of the forum state, or (iii) the law of the state with the most significant relationship? In the *Longview Energy* case mentioned in **Section VIII.G.1** above, the Texas Supreme Court applied the Delaware law of constructive trusts to a lawsuit by a corporation against its directors. The Internal Affairs Doctrine may not (should not?) apply to creditors' claims against the corporation, allowing the court to apply forum law or the law of the state with the most significant relationship or, if a loan document contains a choice-of-law clause, the law of the chosen state.

j. Duties to Third Parties. In *Holloway v. Skinner*, 898 S.W.2d 793, 795 (Tex. 1995) (involving claim of tortious interference with contract), the Court said: "[c]orporations, by their very nature, cannot function without human agents. As a general rule, the actions of a corporate agent on behalf of the corporation are deemed the corporation's acts...." However, cases say that a corporate officer or agent can be liable to others, including other company employees, for his or her own negligence. However, individual liability arises only when the officer or agent owes an independent duty of reasonable care to the injured party apart from the employer's duty." *Leitch v. Hornsby*, 935 S.W.2d 114, 117 (Tex. 1996). A corporate agent who knowingly participates in a tortious or fraudulent act may be held individually liable to third persons even though he performed the act as an agent of the corporation. *Northwest Cattle Feeders, LLC v. O'Connell*, No. 02-17-00361-CV (Tex. App.--Fort Worth, June 14, 2018, pet. denied) (memo. op.); *Nwokedi v. Unlimited Restoration Specialists, Inc.*, 428 S.W.3d 191, 201 (Tex. App.--Houston [1st Dist.] 2014, pet. denied).

3. Nonprofit Corporations. Nonprofit corporations have no owners, but directors, officers, and managers nonetheless owe fiduciary duties to the corporation. Texas Property Code § 114.003(c) ("A person, other than a beneficiary, who holds a power to direct with respect to a charitable trust is presumptively a fiduciary required to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries").

4. Closely-Held Corporations. A closely-held corporation is defined for purposes of derivative actions as a corporation with fewer than 35 shareholders with no shares traded on a national securities exchange. TBOC § 21.563. In *Cardiac Perfusion Servs., Inc. v. Hughes*, 436 S.W.3d 790, 791 n. 1 (Tex. 2014), the Court wrote: "this Court has never recognized a formal fiduciary duty between a majority and minority shareholder in a closely held corporation." Some Texas courts of appeals have held that no formal fiduciary relationship exists between majority and minority shareholders of closely-held corporations. *Vejara v. Levoir Int'l L.L.C.*, No. 04-11-00595-CV, *3 (Tex. App.--San Antonio Oct. 31, 2012, pet. denied) (memo. op.); *Allen v. Devon Energy Holdings, L.L.C.*, 367 S.W.3d 355, 391 (Tex. App.--Houston [1st dist.] 2012, pet. dism'd by agreement) (opinion not withdrawn). However, informal fiduciary relationships can arise between shareholders. *Flanary v. Mills*, 150 S.W.3d 785, 794

(Tex. App.--Austin 2004, pet. denied). In *Herring Bancorp, Inc. v. Mikkelsen*, 529 S.W.3d 216, 227 (Tex. App.--Amarillo 2017, pet. denied), the court said: "Even in the context of disproportionate ownership interests, the vast majority of intermediate appellate courts of this State have declined to recognize a broad formal fiduciary relationship between majority and minority shareholders that applies as a matter of law to every transaction between them."

5. General Partnerships. The common law duties owed by a partner to other partners have been articulated in cases stretching over many decades. "The relationship between ... partners ... is fiduciary in character, and imposes upon all the participants the obligation of loyalty to the joint concern and of the utmost good faith, fairness, and honesty in their dealings with each other with respect to matters pertaining to the enterprise." *Fitz-Gerald v. Hull*, 237 S.W.2d 256, 264 (Tex. 1951).

However, the Legislature has laid a statutory framework over the common law fiduciary duties of partners. Texas Business Organizations Code § 152.204(a) describes the duties that a partner owes to the partnership and other partners as the duty of loyalty and the duty of care. Section 152.204(b) says that a partner must discharge his duties to the partnership and other partners in good faith and in a manner that the partner believes to be in the best interest of the partnership. [Comment: The belief need not be objectively reasonable.] Under Section 152.204(c), a partner does not violate a duty "because the partner's conduct furthers the partner's own interest." Section 152.204(d) says that "[a] partner, in the partner's capacity as a partner, is not a trustee and is not held to the standards of a trustee."
<u>Duty of Loyalty</u>

Under TBOC § 152.205, a partner's duty of loyalty includes (i) accounting to the partnership and holding for the partnership any property, profit, or benefit derived by the partner in the conduct of partnership business or from use of partnership property, (ii) refraining from dealing with the partnership on behalf of a person who has an interest adverse to the partnership; and (iii) refraining from competing or dealing with the partnership in a manner adverse to the partnership. [Comment: TBOC § 152.002(b)(2) prohibits partnership agreements from eliminating the duty of loyalty, except for permitting certain types or categories of activities if the permissions are not "manifestly unreasonable."]

<u>Duty of Care</u>

TBOC § 152.206(a) defines the partner's duty of care as that degree of care that an ordinarily prudent person would exercise in similar circumstances (i.e., an objective negligence standard). Section 152.206(b) says that an error in judgment does not alone breach the duty of care. [Comment: the culpability must be negligence or higher.] Section 152.206(c) says that a partner is presumed to satisfy the duty of care if the partner acts on an informed basis and in good faith and in a manner the partner reasonably believes to be in the best interest of the partnership. [Comment: meeting this Section 152.206(c) standard puts the burden of proof on the complaining party, where it already was by virtue of ordinary civil litigation rules, but without the reversal of the burden of proof characteristic of fiduciary litigation]

Under Section 152.002(b)(3), partners cannot eliminate the duty of care but they can agree on the standards by which the performance of the duty of care is to be measured, if the standards are not "manifestly unreasonable." Given that the nature of a duty is normally a judge question and not a jury question, we might expect that the "manifestly unreasonable" determination is for the court to decide, not the jury.

Obligation of Good Faith

Under TBOC § 152.204(b), a partner must exercise her rights and powers in conducting partnership business in good faith. The statute calls this an "obligation," not a "duty," in contrast to the two specified duties of loyalty and care. Section 152.002(b)(4). Good faith is nonetheless an obligation encompassing all actions of a partner in conducting partnership business, and it is thus tantamount to an all-encompassing legal duty. Section 152.002(b)(4) provides that the partners cannot eliminate the obligation of good faith, but they can determine the standards by which the performance of this obligation is measured if the standards are not "manifestly unreasonable."

Breach of Partnership Agreement or Statutory Duty

Under TBOC § 152.210, a partner is liable to the partnership and other partners for a breach of the partnership agreement or a breach of duty under Chapter 152 that harms the partnership or other partners. [Comment: this is a statutory basis for partnership law liability that exists independently of contract law, tort law, and common law fiduciary standards.]

Expulsion of a Partner

The fiduciary duty between partners does not extend to the decision to expel a partner. *Bohatch v. Butler & Binion*, 977 S.W.2d at 545 ("partners have no obligation to remain partners").

6. Limited Partnerships. The general partner of a limited partnership owes partnership fiduciary duties to the limited partners. TBOC§ 153.152 (a)(2). *Hughes v. St. David's Support Corp.*, 944 S.W.2d 423 (Tex. App.--Austin 1997, writ denied); *McLendon v. McLendon*, 862 S.W.2d 662 (Tex. App.--Dallas 1993, writ denied). Limited partners do not have fiduciary duties by virtue of being limited partners. *Strebel v. Wimberly*, 371 S.W.3d 267 (Tex. App.--Houston [1st Dist.] 2012, pet. denied); *AON Props. Inc. v. Riveraine Corp.*, No. 14-96-00229-CV, *23 (Tex. App.--Houston [14th Dist.] Jan. 14, 1999, no pet.) (unpublished); *Crawford v. Ancira*, No. 04-96-00078-CV (Tex. App.--San Antonio April 30, 1997, no writ) (unpublished).

TBOC § 153.004 provides that a limited partnership agreement cannot eliminate the partners' right to inspect the books and records.

7. Joint Ventures. In *CBIF Ltd. v. TGI Friday's, Inc.* No. 05-15-00157-CV (Tex. App.--Dallas Dec. 5, 2016, pet. denied) (memo. op.), the parties had a written joint venture agreement. The court applied partnership standards saying that "[t]he relationship between partners is fiduciary in character, and imposes on all the participants the obligation of loyalty to the joint concern and of the utmost good faith, fairness, and honesty in their dealings with each other with respect to matters pertaining to the enterprise." *Id*. at *16. [Comment: the standard of "utmost good faith, fairness and honesty" must be tempered by the description of the duty of loyalty between partners expressed in TBOC § 152.205.]

A joint venture is proved by four elements: (1) a community of interest; (2) an agreement to share profits; (3) an agreement to share losses; and (4) a mutual right of control or management of the enterprise. *Ayco Dev. Corp. v. G.E.T. Serv. Co.*, 616 S.W.2d 184, 186 (Tex. 1981); *Coastal Plains Development Corp. v. Micrea, Inc.*, 572 S.W.2d 285, 287 (Tex. 1978). All elements are essential. *Brazosport Bank of Tex. v. Oak Park Townhomes*, 889 S.W.2d 676, 683 (Tex. App.--Houston [14th Dist.] 1994, writ denied). Thus, persons involved in a business undertaking later found to be a joint venture might learn after the fact that they owed fiduciary duties that they did not specifically agree upon or realize at the time of the events in question.

In *Coplin v. State*, 585 S.W.2d 734 (Tex. Crim. App. 1979), the Court wrote:

> A joint venture, while it is similar to a partnership, differs in that it is limited to a single transaction rather than an ongoing business. 33 Tex.Jur.2d 289, Joint Adventures, Section 3 (1962). However, just as with a partnership,
>
> > "[t]he parties bear a fiduciary relation one to another, and are bound to the same degree of good faith as that which is required in case of a partnership." 33 Tex. Jur.2d 294, Joint Adventures, Section 6.
>
> In its discussion of the fiduciary duty owed by partners to each other, Texas Jurisprudence observes that the existence of a fiduciary relationship "is especially true in favor of a partner who is ignorant of the details of the business as against one who has been entrusted and charged therewith as an expert, and whose advice and good faith have been relied on." 44 Tex. Jur. 2d 376, Partnership, Section 50 (1963).

8. Limited Liability Companies. The TBOC does not state fiduciary duties inside an LLC. In *Bazan v. Munoz*, 444 S.W.3d 110 (Tex. App.--San Antonio 2014, no pet.), the court held that no formal fiduciary duty was owed by majority owners to minority owners of an LLC. However the jury found an informal fiduciary relationship on the facts. In *Guevara v. Lackner*, 447 S.W.3d 566 (Tex. App.--Corpus Christi--Edinburg 2014, no pet.), the court wrote that one member's status as co-member of an LLC did not give rise to a fiduciary relationship, but that an informal fiduciary relationship could have arisen from the fact that the defendants were named in the company agreement as managers, and that they had extensive knowledge of operations while the plaintiff did not. In *Macias v. Gomez*, No. 13-14-00017-CV (Tex. App.--Corpus Christi--Edinburg Dec. 29, 2015, no pet.) (memo. op.), the court held that members of an LLC did not have a formal fiduciary relationship with each other. However, *Allen v. Devon Energy Holdings, L.L.C.*, 367S.W.3d 355, 395-98 (Tex. App.–Houston [1st Dist'] 2012, pet. granted, judgm't vacated w.r.m.), held that while a fiduciary relationship did not exist as a matter of law, on the facts of the case a majority owner and sole manager of an LLC owed a "formal" fiduciary duty to a minority member with regard to the redemption of the minority member's ownership interest because of the majority owner/member's degree of control over the LLC. [Comment: the appellate court called the fiduciary duty a "formal" one, when it really met the criteria of an "informal" fiduciary duty.] In *Siddiquiv. Fancy Bites, LLC*, 504 S.W.3d 349 (Tex. App.--Houston [14th Dist.]2016, pet. denied), the court refused to allow an informal fiduciary relationship between members of an LLC unless the relationship existed before the LLC was created.

In *Vejara v. Levoir Int'l L.L.C.*, No. 04-11-00595-CV, *3 (Tex. App.--San Antonio Oct. 31, 2012, pet. denied) (memo. op.), a minority owner of an LLC was found to have had an informal fiduciary duty to the majority owner because the minority owner exercised created the company, signed the leases, held keys to vehicles, and had exclusive access to stored inventory. In *Angel v. Tauch* (*In re Chiron Equities, LLC*), 552 B.R. 674 (Bankr. S.D. Tex. 2016), the court found that a manager/minority member owed the LLC, but not the other member, fiduciary duties.

9. Majority Owners. The majority owners of a corporation owe no formal fiduciary duties to minority shareholders. In *Willis v. Donnelly*, 199 SW 3d 262, 277 (Tex. 2006), the Supreme Court said: "The only conceivable basis for a fiduciary relationship in this case would be a duty owed by a majority shareholder to a minority shareholder. Assuming without deciding that such a relationship can give rise to a general fiduciary duty, we decline to recognize the existence of such a duty on this record." However, in *Vejara v. Levoir Int'l L.L.C.*, No. 04-11-00595-CV, *3 (Tex. App.--San Antonio Oct. 31, 2012, pet. denied), the court found that the majority shareholder of a closely-held corporation had an informal fiduciary duty to the minority shareholders due to his "operating control" and "intimate knowledge" of the company's daily affairs. *Id.* at 5.

H. HOLDER OF EXECUTIVE RIGHTS. In Texas, the holder of executive rights over the mineral interests of other royalty owners owes a fiduciary duty of utmost good faith to the other owners. *Manges v. Guerra*, 673 S.W.2d 180, 183-84 (Tex. 1984). However, unlike an agent or the trustee of an express trust, the holder of executive rights is not required to put the other royalty owners' interests ahead of his own. Instead, this fiduciary duty requires the holder of the executive rights to acquire for the non-executive every benefit that he exacts for himself in leasing the property. *Id.* You could say that this is a duty of equality, not primacy. In *KCM Fin. LLC v. Bradshaw*, 457 S.W.3d 70, 81-82 (Tex. 2015), the Court said: "In evaluating whether an executive has breached a duty owed to a non-executive, evidence of self-dealing can be pivotal.... Self-dealing has most commonly been observed in situations where the executive employs a legal contrivance to benefit himself, a close familial relation, or both."

I. BUSINESS TRANSACTIONS. Business transactions can occur in the context of different types of relationships. General criminal law and tort duties apply to all business transactions. If a formal or fiduciary relationship exists, fiduciary duties arise.

1. Arm's Length Transactions. In an arm's length transaction, the parties do not owe special duties to one another. However, in merchant transactions under the Uniform Commercial Code, a duty of good faith is owed on every contract. Tex. Bus. & Comm. Code § 1.304. Under Texas law, certain business relationships are "special relationships" that give rise to a duty of good faith. See Section IV.J.6.

2. Intentional Misrepresentation. In every business transaction there is a duty not to make material misrepresentations of fact. Intentional misrepresentation can give rise to a claim of fraud, fraudulent inducement (Section IV.J.2), breach of warranty, or estoppel.

3. Negligent Misrepresentation. In *Federal Land Bank Ass'n of Tyler v. Sloane*, 825 S.W.2d 439, 442 (Tex. 1991), the Texas Supreme Court adopted Restatement (Second) of Torts § 552, recognizing liability for negligent misrepresentation in a transaction in which the defendant has a pecuniary interest, provided the plaintiff's reliance is justifiable.

4. Formal Fiduciary Relationships. A formal fiduciary, who transacts business on behalf of a beneficiary, owes the duty to put the interests of the beneficiary first. (The holder of executive rights over the mineral interests of other royalty owners owes the duty of equal benefit. See Section IV.H above). A fiduciary who transacts directly with the beneficiary faces a presumption of fraud and has the burden to prove that the transaction was "fair" to the beneficiary. *Archer v. Griffith*, 390 S.W.2d 735, 740 (Tex. 1964) (involving an attorney and client).

5. Informal Fiduciary Relationships. A business relationship standing alone does not establish a fiduciary relationship. See Section VI.B. "A fiduciary or confidential relationship may arise from circumstances of the particular case, but it must exist prior to, and apart from, the agreement made the basis of the suit." *Transport Ins. Co. v. Faircloth*, 898 S.W.2d 269, 280 (Tex. 1995). "The fact that people have had prior dealings with each other and that one party subjectively trusts the other does not establish a confidential relationship." *Consolidated Gas & Equip. Co. v. Thompson*, 405 S.W.2d 333, 336 (Tex. 1966). In *Thompson*, the Court wrote:

> Our holdings above cited are to the effect that for a constructive trust to arise there must be a fiduciary relationship before, and apart from, the agreement made the basis of the suit. Such is our holding here. As stated, the fact that one businessman trusts another, and relies upon his promise to carry out a contract, does not create a constructive trust.

Id. at 336.

J. CONTRACTUAL RELATIONSHIPS. Contract law governs the duties of parties arising out of a contract. The rights and duties of contracting parties are determined by the terms of the agreement. But implied contractual duties arise in some contractual relationships. Transactions between merchants grew out of the law of sales, which developed prior to the law of contracts but today can be considered a tort-like variant of the law of contracts. See Orsinger, *170 Years of Texas Contract Law*, State Bar of Texas HISTORY OF TEXAS SUPREME COURT JURISPRUDENCE (2012) ch. 9, p. 74. And some contracts give rise to rights and duties under warranty law, which is distinct from contract law. Tort law protects victims of fraudulent or deceptive behavior in negotiating a contract. Tort law also protects existing or prospective contractual relationships from unprivileged interference. Torts committed while performing contractual duties are compensable as torts.

1. The Terms of the Contract. "Generally, a court looks only to the written agreement to determine the obligations of contracting parties." *Universal Health Servs., Inc. v. Renaissance Women's Grp., P.A.*, 121 S.W.3d 742, 747 (Tex. 2003). [W]hen parties reduce their agreements to writing, the written instrument is presumed to embody their entire contract...." *Danciger Oil & Ref. Co. of Tex. v. Powell*, 154 S.W.2d 632, 635 (Tex. 1941).

2. Fraud in the Inducement. In *Mitchell v. Zimmerman*, 4 Tex. 75, (Tex. 1849), the Court held that a buyer who is a victim of fraud in the inducement of a contract can set the contract aside, or alternatively have the purchase price adjusted to reflect the real value of what was received. In *Gann v. Shaw & Son*, 3 Tex. 310, 311 (1884), the Court said that "every misrepresentation in regard to anything which is a material inducement to sale, which is made to deceive, and which actually does deceive the vendee, is fraud and vitiates the contract." In *Blythe v. Speake*, 23 Tex. 429, 436 (Tex. 1859), the Court wrote that a party defrauded in a contract has a choice of remedies: "'[h]e may stand to the bargain and recover damages for the fraud, or he may rescind the contract, and return the thing bought, and receive back what he paid.'" However, Texas law also provides that "tort damages are recoverable for a fraudulent inducement claim irrespective of whether the fraudulent representations are later subsumed in a contract or whether the plaintiff only suffers an economic loss related to the subject matter of the contract." *Formosa Plastics Corp. USA v. Presidio Eng's & Contractors, Inc.*, 960 S.W.2d 41, 48 (Tex. 1998). "The mere failure to perform a contract is not evidence of fraud." *Id.* at 48.

"Fraudulent inducement ... is a particular species of fraud that arises only in the context of a contract and requires the existence of a contract as part of its proof." *Haase v. Glazner*, 62 S.W.3d 795, 798 (Tex. 2001). Thus, to prove fraudulent inducement, the complaining party must show all the elements of fraud, plus that he entered into the contract as a result of the fraud.

In *Crim Truck & Tractor Co. v. Navistar Int'l Transp. Corp.*, 823 S.W.2d 591, 597 (Tex. 1992), the Court wrote: "As a general rule, the failure to perform the terms of a contract is a breach of contract, not a tort. However, when one party enters into a contract with no intention of performing, that misrepresentation may give rise to an action in fraud." In *Spoljaric v. Percival Tours, Inc.*, 708 S.W.2d 432, 434 (Tex. 1986), the Supreme Court held that a fraud claim in tort could be maintained for the breach of an oral agreement to pay a bonus because a "promise to do an act in the future is actionable fraud when made with the intention, design and purpose of deceiving, and with no intention of performing the act." Thus, making a promise that you intend to keep, together with an exchange of consideration, creates a contract. Making a promise that you do not intend to keep, in order to induce a contract, is a fraud and allows the other party to rescind the contract or to sue for tort damages, including exemplary damages. However, when the damages sought for fraudulent inducement of a contract are the loss of benefit of the bargain, the claim lies in contract. *See Nagle v. Nagle*, 633 S.W.2d 796, 801 (Tex. 1982).

<u>Disclaimer of Reliance</u>

In *Dallas Farm Machinery Co. v. Reaves*, 307 S.W.2d 233, 239 (Tex. 1957) (Calvert, J.), the Court wrote: "'The same public policy that in general sanctions the avoidance of a promise obtained by deceit strikes down all attempts to circumvent that policy by means of contractual devices.'" However, in *Schlumberger Technology Corp. v. Swanson*, 959 S.W.2d 171 (Tex. 1997) (a money damage suit), in a holding somewhat limited to that case, the Court held that, "a release that clearly expresses the parties' intent to waive fraudulent inducement claims, or one that disclaims reliance on representations about specific matters in dispute, can preclude a claim of fraudulent inducement." *Id.* at 181. The Court emphasized, however, "that a disclaimer of reliance or merger clause will not always bar a fraudulent inducement claim.... We conclude only that on this record, the disclaimer of reliance conclusively negates as a matter of law the element of reliance ...." *Id.* at 181. In *Italian Cowboy Partners, Ltd. v. Prudential Ins. Co.*, 341 S.W.3d 323, 328 (Tex. 2011) (a suit for rescission and damages), the Court explained its prior holding, saying that in *Schlumberger* it "held that when sophisticated parties represented by counsel disclaim reliance on representations about a specific matter in dispute, such a disclaimer may be binding, conclusively negating the element of reliance in a suit for fraudulent inducement." The Court *Italian Cowboy* held that a standard merger clause does not waive the right to claim fraudulent inducement. *Id*. at 334.The Supreme Court upheld a disclaimer of reliance clause in *I.B.M. v. Lufkin Industries, LLC*, 573 S.W.3d 224, 225 (Tex. 2018), saying that "[u]nder Texas law, a party may be liable in tort for fraudulently inducing another party to enter into a contract. But the party may avoid liability if the other party contractually disclaimed any reliance on the first party's fraudulent representations. Whether a party is liable in any particular case depends on the contract's language and the totality of the surrounding circumstances." Thus, over a period of 60 years the Supreme Court has gone from categorically rejecting contractual devices to avoid a claim of fraudulent inducement to accepting one contractual device to avoid a claim of fraudulent inducement, but it depends on the contractual language and the totality of the surrounding circumstances.

The Supreme Court has not indicated whether a claim of fraud in the inducement was successfully avoided by non-reliance clause is a question of law for the court or a question of fact for a jury, nor has the Court set out a checklist of elements to make that determination. [Comment: reliance is an element of the tort of fraud and a claim of fraudulent inducement, the difference being that fraudulent inducement required the proof of a fraud <u>plus</u> the proof of a contract.]

3. Breach of Contract. A party suing for breach of contract must show that "(1) a valid contract exists; (2) the plaintiff performed or tendered performance as contractually required; (3) the defendant breached the contract by failing to perform or tender performance as contractually required; and (4) the plaintiff sustained damages due to the breach. A party seeking the equitable remedy of specific performance in lieu of money damages may, in some circumstances, be excused from pleading and proving the second element, but must additionally plead and prove that, at all relevant times, it was ready, willing, and able to perform under the contract." *Pathfinder Oil & Gas, Inc. v. Great W. Drilling, Ltd.*, 574 S.W.3d 882, 890 (Tex. 2019) (citations omitted).

4. The Injury Can Determine Contract or Tort. "Generally, breach of a duty created by contract gives rise to a contract claim, whereas breach of a duty imposed by operation of law gives rise to a tort claim." *Nghiem v. Sajib*, 567 S.W.3d 718, 724 (Tex. 2019). Where the actions of a party could be either a breach of contact or a tort, the "economic loss rule" says that "[w]hen the injury is only the economic loss to the subject of a contract itself, the action sounds in contract." *Medical City Dallas, Ltd. v. Carlisle Corporation*, 251 S.W.3d 55, 601 (Tex. 2008). In *Sharyland Water Supply Corp. v. City of Alton*, 354 S.W.3d 407, 419 (Tex. 2011), the Court said that the economic loss rule did not apply to strangers to the contract.

Courts also articulate an "independent injury rule," saying that when a defendant's conduct would give rise to liability independent of the contract, it sounds in tort, but where the conduct gives rise to liability only because it breaches the contract then it sounds in contract. *Southwestern Bell Tel. Co. v. DeLanney*, 809 SW 2d 493, 494 (Tex. 1991).

5. Even Willful Breach of Promise is not a Tort in Texas. In Texas, intentionally breaching a contract, even for selfish reasons, does not give rise to a tort claim. In *Crim Truck & Tractor Co. v. Navistar Intern. Transp. Corp.*, 823 S.W.2d 591, 595 (Tex. 1992), the Court wrote: "[A] party to a contract is free to pursue its own interests, even if it results in a breach of that contract, without incurring tort liability." In *Amoco Production Co. v. Alexander*, 622 S.W.2d 563, 571 (Tex. 1981), the Court said: "Even if the breach is malicious, intentional or capricious, exemplary damages may not be recovered unless a distinct tort is alleged and proved."

6. Implied Contractual Duty of Good Faith and Fair Dealing. The RESTATEMENT (SECOND) OF THE LAW OF CONTRACTS § 205 (1979) says that "every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement." Initially, the Texas Supreme Court flatly rejected the idea of a duty of good faith and fair dealing implied by law into a contract. *English v. Fischer*, 660 S.W.2d 521, 522 (Tex. 1983) ("This concept is contrary to our well-reasoned and long-established adversary system which has served us ably in Texas for almost 150 years. Our system permits parties who have a dispute over a contract to present their case to an impartial tribunal for a determination of the agreement as made by the parties and embodied in the contract itself."). In *Crim Truck & Tractor Co. v. Navistar Int'l Transp. Corp.*, 823 S.W.2d 591, 595 n. 5 (Tex. 1992), the Court "specifically rejected the implication of a general duty of good faith and fair dealing in all contracts." Later, however, the Texas Supreme Court allowed an implied duty of good faith and fair dealing to arise in "special relationships," and the breach of that duty is a tort. Examples of special relationships are: the holder of executive rights over another's mineral interest, *Manges v. Guerra*, 673 S.W.2d 180 (Tex. 1984); insurers, *Arnold v. National County Mut. Fire Ins. Co.*, 725 S.W.2d 165 (Tex. 1987) (duty of good faith and fair dealing arises from the "special relationship" between insurer and insured); *Aranda v. Insurance Co. of North America*, 748 S.W.2d 210, 215 (Tex. 1988) (duty of good faith and fair dealing imposed on workers' compensation insurers, later overruled in 2012);[8] *Universe Life Ins. Co. v. Giles*, 950 S.W.2d 48 (Tex. 1997) ("an insurer will be liable if the insurer knew or should have known that it was reasonably clear that the claim was covered"). The Supreme Court restricted the implied duty of good faith and fair dealing to parties in contractual privity with the claimant in *Natividad v. Alexsis, Inc.*, 875 S.W.2d 695, 697-98 (Tex. 1994) ("The duty of good faith and fair dealing emanates from the special relationship between the parties and not from the terms of the contract, therefore its breach gives rise to tort damages and not simply to contractual liability"). The Supreme Court rejected an implied duty of good faith and fair dealing between employers and employees in *City of Midland v. O'Bryant*, 18 S.W.3d 209, 216 (Tex. 2000), and between a secured creditor and a co-guarantor, in *FDIC v. Coleman*, 795 S.W.2d 706, 708-09 (Tex. 1990). Texas Courts of Appeals have rejected an implied duty of good faith and fair dealing for: a developer, in *Affiliated Capital Corp. v. Southwest, Inc.*, 862 S.W.2d 30, 34 (Tex. App.--Houston [1st Dist.] 1993, writ denied); a franchisor, in *Barrand, Inc. v. Whataburger, Inc.*, 214 S.W.3d 122, 139 (Tex. App.--Corpus Christi--Edinburg 2006, writ denied); a lender, in *UMLIC VP LLC v. T&M Sales*, 176 S.W.3d 595, 612 (Tex. App.--Corpus Christi--Edinburg 2005, writ denied); and between an insurance company and a broker, in *Casteel v. Crown Life Ins. Co.*, 3 S.W.3d 582, 590 (Tex. App.--Austin 1997), *rev'd in part on other grounds and aff'd in part*, 22 S.W.3d 378 (Tex. 2000). Good faith and fair dealing is succinctly and admirably covered by T. Ray Guy, in *Good Faith Revisited: Extra-Contractual Duties in Texas*.[9] Guy concludes: "The duty of good faith and fair dealing remains an outlier in Texas common law, imposed only in specific relationships deemed by our Supreme Court as 'special' and therefore appropriate for the implication of such a duty for the protection of the disadvantaged party."

The implied contractual duty of good faith and fair dealing under Texas law is different from the standard of good faith that appears in fiduciary relationships.

7. Implied Covenants Arising From Contract. In *Amoco Production Co. v. Alexander*, 622 S.W.2d 563, 568 (Tex. 1981), the Supreme Court discussed three categories of implied duties ("implied covenants") arising from oil and gas leases: (1) the implied duty to develop the premises, (2) the implied duty to protect the leasehold, and (3) the implied duty to manage and administer the lease. The standard of care under these implied covenants is "that of a reasonably prudent operator under the same or similar facts and circumstances." *Id.* at 567-8. Part of the duty to protect the leasehold is the "implied covenant to protect from local drainage." *Id.* at 568. "There is no implied covenant when the oil and gas lease expressly covers the subject matter of an implied covenant." *Yzaguirre v. KCS Res., Inc.*, 53 S.W.3d 368, 373 (Tex. 2001). "Implied covenants are not favored in Texas law and, therefore, courts imply covenants in written contracts only in rare circumstances." *In re Estate of Scott*, No. 04-19-00592-CV, *4 (Tex. App.--San Antonio May 27, 2020, no pet.) (memo. op.). "Covenants will be implied only where necessary to give effect to the actual intent of the parties as reflected by the contract or conveyances as a whole.... 'It is not enough to say that an implied covenant is necessary in order to make a contract fair, or without such a covenant it would be improvident or unwise, or that the contract would operate unjustly.' ... Covenants are implied when deemed fundamental to the purpose of the contract as expressed in the instrument and only where the contract does not expressly address the subject matter of the covenant sought to be implied." *In re XTO Energy Inc.*, 471 S.W.3d 126, 135 (Tex. App.--Dallas 2015, no pet.) (citations omitted). *See Cont'l Potash v. Freeport-McMahon, Inc.*, 115 N.M. at 704, 858 P.2d 66, 80 (1993) ("[I]mplied covenants are not favored in law, especially when a written agreement between the parties is apparently complete.... The general rule is that an implied covenant cannot co-exist with express covenants that specifically cover the same subject matter.").

8. Preexisting Fiduciary Duties Between Contracting Parties. "[W]hile a fiduciary or confidential relationship may arise from the circumstances of a particular case, to impose such a relationship in a business transaction, the relationship must exist prior to, and apart from, the agreement made the basis of the suit." in *Schlumberger Technology Corp. v. Swanson*, 959 S.W.2d 171, 177 (Tex. 1997).

9. Tortious Interference With Contract or Prospective Business Relations. In *Raymond v. Yarrington*, 73 S.W. 800, 803 (Tex. 1903), the Court wrote: "We are of opinion that the rule that, where one knowingly induces another to break his contract with a third person, such third person has a right of action against the one so causing the breach for any damages resulting to him by such breach, is supported by a decided preponderance of authority and by the better principle." In *Clements v. Withers*, 437 S.W.2d 818, 822 (Tex. 1969), the Supreme Court said that "[a]ctual malice need not be shown to recover compensatory damages for the tort of interference with an existing contractual relationship.

Intentional and knowing interference must be shown, but there may be liability even though the interferer's motive be to save money for himself or another. On the other hand, to support the recovery of punitive damages in such a case, there must be a finding of actual malice: ill-will, spite, evil motive, or purposing the injuring of another.... The existence of such malice may not be necessary in a case where the defendant's acts are accompanied by fraud or other aggravating circumstances."

In *Sakowitz, Inc. v. Steck*, 669 S.W.2d 105, 107 (Tex. 1984) the Court said: "To establish the necessary elements for her claim of tortious interference, [the plaintiff] had to show (1) that the defendant *maliciously* interfered with the contractual relationship and (2) without *legal justification* or *excuse*." (Italics added.) In this context, malice was defined as an act without excuse or just cause. *Id*. at 107. In *Sakowitz*, Steck sued her former employer Sakowitz for tortious interference with her employment contract with a new employer, when she was fired after Sakowitz sent a letter to Steck's new employer asserting that the her employment was a breach of Steck's covenant not to compete with Sakowitz. *Sakowitz*, at 107. The Supreme Court held: "Sakowitz was privileged to assert its claim to the noncompetition agreement, grounded upon estoppel theory or an oral contract, even though that claim may be doubtful, so long as it asserted a colorable legal right." *Sakowitz*, at 107.

In *Sterner v. Marathon Oil Co.*, 767 S.W.2d 686 (Tex. 1989), the Supreme Court changed the law, holding that legal justification or excuse was an affirmative defense and not a part of the plaintiff's case-in-chief. *Id.* at 690. "Under the defense of legal justification or excuse, one is privileged to interfere with another's contract (1) if it is done in a bona fide exercise of his own rights, or (2) if he has an equal or superior right in the subject matter to that of the other party." *Sterner,* at 691.

The elements of tortious interference with a contract were revamped in *Victoria Bank & Trust Co. v. Brady*, 811 S.W.2d 931, 939 (Tex. 1991): "The elements of a cause of action for tortious interference are (1) the existence of a contract subject to interference, (2) the act of interference was *willful and intentional*, (3) such intentional act was a proximate cause of plaintiff's damage and (4) actual damage or loss occurred." (Italics added.) The Court went on: "Under the defense of legal justification or excuse, one is privileged to interfere with another's contractual relations (1) if it is done in a bona fide exercise of his own rights, or (2) if he has an equal or superior right in the subject matter to that of the other party.... One may be 'privileged' to assert a claim 'even though that claim may be doubtful, so long as it asserted a colorable legal right.' ... However, the defense of legal justification or excuse only protects good faith assertions of legal rights." *Id.* at 939-40.

In *Southwestern Bell Telephone Co. v. John Carlo Texas, Inc.*, 843 S.W.2d 470, 472 (Tex. 1992), the Court wrote: "Interference with contract is tortious only if it is intentional." The Court further noted that "intentional interference does not require intent to injure, only that 'the actor desires to cause the consequences of his act, or that he believes that the consequences are substantially certain to result from it.'" (Citing RESTATEMENT (SECOND) OF TORTS § 8A.)

"Texas law protects existing as well as prospective contracts from interference." *Sterner v. Marathon Oil Co.*, 767 S.W.2d 686, 689 (Tex. 1989). The contract need not be enforceable to be protected from tortious interference. *Id.* at 689. Protection extends to contracts terminable at will because "until terminated, the contract is valid and subsisting, and third persons are not free to tortiously interfere with it." *Id.* at 689. In *Trammel Crow Co. No. 60 v. Harkinson*, 944 S.W.2d 631, 632 (Tex. 1997), the Court held that a real estate broker's claim for conspiracy to tortiously interfere with an oral commission agreement was barred because the underlying claim was legally barred by the requirement of the Real Estate License Act § 20(b) that the agreement must be in writing and signed.

Texas also recognizes the tort of interference with prospective business relations. *Wal-Mart Stores v. Sturges*, 52 S.W.3d 711 (Tex. 2001) ("to establish liability for interference with a prospective contractual or business relation the plaintiff must prove that it was harmed by the defendant's conduct that was either independently tortious or unlawful. By 'independently tortious' we mean conduct that would violate some other recognized tort duty.").

In *Maxey v. Citizen's Nat'l Bank*, 507 S.W.2d 722, 726 (Tex. 1974), the Court said: "an officer or director may not be held liable in damages for inducing the corporation to violate a contractual obligation, provided that the officer or director acts in good faith and believes that what he does is for the best interest of the corporation." *Accord*, *Holloway v. Skinner*, 898 SW 2d 793, 795 (Tex. 1995).

10. Promissory Estoppel. The RESTATEMENT (SECOND) OF CONTRACTS, § 90, says: "A promise which the promisor should reasonably expect to induce action or forbearance of a definite and substantial character on the part of the promisee and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise." In *Wheeler v. White*, 398 SW 2d 93, 96 (Tex. 1965), the Court said: "The function of the doctrine of promissory estoppel is, under our view, defensive in that it estops a promisor from denying the enforceability of the promise." In *English v. Fischer*, 660 S.W.2d 521, 524-25 (Tex. 1983), the Court wrote: "The requisites of promissory estoppel are: (1) a promise, (2) foreseeability of reliance thereon by the promisor, and (3) substantial reliance by the promisee to his detriment."

11. Third-Party Beneficiaries. "A third party may recover on a contract made between other parties only if the parties intended to secure a benefit to that third party, and only if the contracting parties entered into the contract directly for the third party's benefit.... A third party does not have a right to enforce the contract if she received only an incidental benefit... 'A court will not create a third-party beneficiary contract by implication.'" ... Rather, an agreement must clearly and fully express an intent to confer a direct benefit to the third party." *Stine v. Stewart*, 80 S.W.3d 586 (Tex. 2002) (per curiam) (citations omitted).

K. LENDERS. The relationship between a bank and its customers does not usually create a special or fiduciary relationship. *Farah v. Mafrige & Kormanik, P.C.*, 927 S.W.2d 663, 675 (Tex. App.--Houston [1st Dist.] 1996, no writ); *Manufacturers Hanover Trust Co. v. Kingston Investors Corp.*, 819 S.W.2d 607, 610 (Tex. App.--Houston [1st Dist.] 1991, no writ). "We have been cited no authority and have found none in Texas which imposes a duty of good faith and fair dealing on lenders in general to their borrowers." *Nautical Landings Marina, Inc. v. First Nat'l Bank*, 791 S.W.2d 293, 296 (Tex. App.--Corpus Christi 1990, writ denied). "However, when a special relationship between a borrower and lender has been found, it has rested on extraneous facts and conduct, such as excessive lender control over, or influence in, the borrower's business activities." *Farah v. Mafrige & Kormanik, P.C.*, 927 S.W.2d 663, 675 (Tex. App.--Houston [1st Dist.] 1996, no writ). In *Federal Deposit Ins.*

Corp. v. Coleman, 795 S.W. 2d 706, 708-09 (Tex. 1990), the Court said that "the relationship between a creditor and guarantor does not ordinarily import a duty of good faith." A "claim for breach of good faith and fair dealing is not cognizable in the context of mortgager and mortgagee." *Motten & Evans v. Chase Home Finance*, Civil Action No. H-10-4994 (S.D. Texas, Houston Division, June 28, 2011). A bank has a duty to use reasonable care whenever it provides information to its customers or potential customers. *Federal Land Bank Ass'n of Tyler v. Sloane*, 825 S.W.2d 439, 442 (Tex. 1991).

L. EMPLOYER AND EMPLOYEE.

1. At-Will Employment. "For well over a century, the general rule in this State, as in most American jurisdictions, has been that absent a specific agreement to the contrary, employment may be terminated by the employer or the employee at will, for good cause, bad cause, or no cause at all." *Montgomery County Hospital District v. Brown*, 965 S.W.2d 501, 502 (Tex. 1998). Employment is presumed to be at will. *Midland Judicial Dist. Cmty. Supervision & Corr. Dep't v. Jones*, 92 S.W.3d 486, 487 (Tex. 2002) (per curiam). "[I]n Texas, the employment relationship is generally at-will unless the parties enter into an express agreement that provides otherwise." *City of Midland v. O'Bryant*, 18 S.W.3d 209, 215 (Tex. 2000). "The Legislature has created a few narrow exceptions, prohibiting, for example, discharge based on certain forms of discrimination[8] or in retaliation for engaging in certain protected conduct. But Texas courts have created only one: prohibiting an employee from being discharged for refusing to perform an illegal act." *Sawyer v. E.I. DuPont De Nemours & Co.*, 430 S.W.3d 396, 399 (Tex. 2014), citing *Sabine Pilot Service, Inc. v. Hauck*, 687 S.W.2d 733, 735 (Tex. 1985). The cause of action for an employee suing under *Sabine Pilot* is in tort, not contract. *Safeshred, Inc. v. Martinez*, 365 S.W.3d 655, 660 (Tex. 2012).

2. Employers' Duties to Employees. Employers' duties to employees arise under Federal statutes and regulations, state statutes, and common law. "There is no cause of action based on a duty of good faith and fair dealing in the context of an employer/employee relationship." *City of Midland v. O'Bryant*, 18 S.W.3d 209, 215 (Tex. 2000).

a. Unlawful Employment Practices. Title VII of the Civil Rights Act of 1964 provides that "[i]t shall be an unlawful employment practice for an employer ... to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin." 42 U.S.C. § 2000e-2(a)(1). An unlawful employment practice is established if a suspect category is a motivating factor for an employment practice, even when there are other motivating factors. The Texas Commission on Human Rights Act ("TCHRA") was enacted in Chapter 21 of the Texas Labor Code. Texas Labor Code § 21.051 prohibits an employer from refusing to hire, firing, or discriminating in any other manner against a person "because of race, color, disability, religion, sex, national origin, or age." In 2019, the accounting firm of Deloitte LLP published a survey of bias in the workplace, involving 3,000 respondents from companies with more than 1,000 employees. They found that 42% of women, 38% of men, 56% of LGBT, 54% of persons with disabilities, 54% of Hispanics, 44% of Asians, and 44% of African Americans, reported that they had experienced discrimination at work at least once a month.[10]

The State of Texas has waived governmental immunity for claims under the TCHRA. *Alamo Heights Ind. Sch. Dist. v. Clark*, 544 S.3d 755 (Tex. 2018).

Racial Discrimination. The Department of Justice explains: "Discrimination on the basis of race involves denying equal employment opportunity to any person because that person is of a particular race or has personal characteristics associated with a particular race (e.g., hair texture, facial features). Discrimination on the basis of color involves denying equal employment opportunity to any person because of that person's skin color or complexion. Race or color discrimination also may include treating a person unfavorably because of his or her association with someone or some group generally associated with a particular race or color (e.g., marriage)."[11]

National Origin. The Department of Justice explains: "Discrimination on the basis of national origin involves denying equal employment opportunity to any person because that person is from a different country or part of the world, or because of ethnicity or accent, or because that person is perceived to be of a particular ethnicity. In some circumstances, national origin discrimination may involve discrimination based on unjustified English-fluency requirements and English-only rules and policies. It also may include treating a person unfavorably because of his or her association with someone or some group generally associated with a particular national origin (e.g., civic or cultural organization)."[12]

Gender Discrimination. The Department of Justice explains: "Discrimination on the basis of sex involves denying equal employment opportunity to any person because of that person's sex. Sex discrimination also involves treating a woman unfavorably because she is pregnant or based on gender stereotype."[13] Federal Regulations on sexual harassment are set out at 29 CFR Part 1604.11 (7-1-2016). In *Price Waterhouse v. Hopkins*, 490 U.S. 228, 251 (1989), the U.S. Supreme Court said "we are beyond the day when an employer could evaluate employees by assuming or insisting that they matched the stereotype associated with their group, for [i]n forbidding employers to discriminate against individuals because of their sex, Congress intended to strike at the entire spectrum of disparate treatment of men and women resulting from sex stereotypes." (Internal quotations marks omitted). To be actionable, gender discrimination must play a motivating part in making an employment decision. The Supreme Court explained: "In saying that gender played a motivating part in an employment decision, we mean that, if we asked the employer at the moment of the decision what its reasons were and if we received a truthful response, one of those reasons would be that the applicant or employee was a woman." *Id.* at 250.The employer can present objective evidence as to its probable decision in the absence of an impermissible motive. *Id.* at 252. Texas Labor Code § 21.051 prohibits "sex discrimination." Texas Labor Code § 21.106 includes in "sex discrimination" consideration of pregnancy, childbirth or a related medical condition. It is not unlawful employment discrimination when a prohibited activity is not intended to contravene prohibited practices and "is justified by business necessity." Texas Labor Code § 21.115. Employment discrimination laws do not apply to employees who are a parent, spouse, or child of the employer. Texas Labor Code § 21.117.

Age Discrimination. The Federal Age Discrimination in Employment Act of 1967 prohibits discrimination and harassment against employees or job applicants who are at least 40 years old. The Texas Commission on Human Rights Act, at Texas Labor Code § 21.051, prohibits work-place discrimination based on age for persons over age 40. The Supreme Court has said that "[t]he purpose of the TCHRA, codified in chapter 21 of the Texas Labor Code, was to 'correlat[e] ... state law with federal law in the area of discrimination in employment," *Schroeder v. Tex. Iron Works, Inc.,* 813 S.W.2d 483, 485 (Tex. 1991), and to "conform with federal law under Title VII the Civil Rights Act of 1964, ... and the Age Discrimination in Employment Act." *Caballero v. Central Power & Light Co.*, 858 S.W.2d 359, 361 (Tex.1993). In *Bell Helicopter Textron, Inc. v. Burnett*, No. 02-16-00489-CV (Tex. App.–Fort Worth June 14, 2018, no pet.) (an age discrimination case), the court held that the Labor Code does not cap the trial court's awards for front pay and for future mental anguish.

<u>Retaliation.</u> The Department of Justice explains: "Discrimination on the basis of retaliation involves taking an adverse action against a person because he or she has opposed a discriminatory employment practice (e.g., race discrimination, military status discrimination), has complained about discrimination, or has assisted in the investigation of a complaint of discrimination. Retaliation could take the form of refusing to hire, discharging, failing to promote, harassing, or discriminating against a person with respect to any other term, condition or privilege of employment."[14] An employer cannot retaliate against an employee who engages in a "protected activity," which is voicing opposition to any practice made an unlawful employment practice under 42 U.S.C. § 2000e-3(a). A plaintiff must prove that: (1) s/he engaged in protected activity; (2) an adverse employment action occurred; and (3) a causal link exists between the protected activity and the adverse employment action. *Turner v. Baylor Richardson Medical Center*, 476 F.3d 337, 348 (5th Cir. 2007). One Federal district court in Texas ruled that an informal complaint is protected activity. *Eura v. The Sage Corporation*, Cv. No. 5:12-CV-1119-DAE (U.S. Dist. Ct., W.D. Texas, Nov. 19, 2014) ("Although neither the Supreme Court nor the Fifth Circuit have ruled definitively as to whether informal complaints can constitute opposition, the majority of circuits find that informal complaints come within the opposition clause requirements"). For retaliation protections to apply, the employee must have a reasonable belief that unlawful employment practices were occurring. *Long v. Eastfield Coll.*, 88 F.3d 300, 304 (5th Cir. 1996). [Comment: "Reasonable belief" is a mixed objective and subjective standard.] Retaliation against an employee for engaging in a protected activity is also prohibited by Texas Labor Code § 21.055. Section 21.056 prohibits "aiding and abetting discrimination." The Texas Supreme Court has said: "A retaliation claim is related to, but distinct from, a discrimination claim, and one may be viable even when the other is not. Unlike a discrimination claim, a retaliation claim focuses on the employer's response to an employee's protected activity, such as making a discrimination complaint. The TCHRA's prohibition against retaliation does not protect employees from all ostracism, discipline, or even termination following a discrimination complaint. Rather, a remedy exists only when the evidence establishes that a materially adverse employment action resulted from the employee's protected activities." *Alamo Heights Ind. Sch. Dist. v. Clark*, 544 S.3d 755 (Tex. 2018).

<u>Equal Pay.</u> The Federal Equal Pay Act of 1963 requires employers to give all employees equal pay for equal work, regardless of gender. 29 U.S.C. § 206(d).

<u>Family Medical Leave.</u> The Federal Family and Medical Leave Act ("FMLA") applies to private sector employers with 50 or more employees who have worked 20 or more work weeks in the current or prior years. 29 U.S.C. § 2601. The FMLA also applies to public agencies and elementary and secondary public or private schools. The FMLA applies to employees who have worked for the employer for more

than 12 weeks and have at least 1,250 hours of service during the 12 months prior to taking medical leave.[15] The FMLA "entitles eligible employees of covered employers to take unpaid, job-protected leave for specified family and medical reasons, with continuation of group health insurance coverage under the same terms and conditions as if the employee had not taken leave."[16] The employee can take up to 12 weeks of unpaid job-protected leave per year. The protection extends to one year after the birth or adoption of a child. It also applies to an employee who is unable to perform the functions of the position, or who must miss work to recevie medical treatment for a serious health condition. An employee can take FMLA leave to care for a spouse, child, or parent with a serious health condition. *Id.* An employer can refuse to restore a "key" employee, meaning that the employee is salaried and among the highest-paid 10% of the employer's employees within 75 miles, if restoring employment would cause substantial and grievous economic injury to its operations.[17] On September 1, 2020, a class action was filed against Deloitte Touche Tohmatsu, Ltd. for refusing to reinstate former employees who were offered and took FMLA leave for more than 12 weeks. *Knight v. Deloitte Touche Tohmatsu Ltd.*, No. 1:20-cv-07114 (S.D.N.Y., Sept. 1, 2020).

b. Hostile Work Environment. Employers have a duty under Federal and state law to protect employees from harassment from other employees. A hostile work environment claim is established by proof that the plaintiff: (1) is a member of a protected class, (2) was subject to unwelcome harassment, (3) the harassment was based on the employee's membership in the protected class, (4) the harassment affected a term or condition of his/her employment; and (5) that the employer knew or should have known about the harassment and failed to take prompt remedial action. The primary federal law is Title VII of the Civil Rights Act of 1964. Texas Labor Code § 21.1065 defines and prohibits sexual harassment of unpaid interns. In *Turner v. Baylor Richardson Medical Center*, 476 F.3d 337, 347 (5th Cir. 2007), the court said: "We determine whether a hostile work environment exists using a totality-of-the-circumstances test that focuses on 'the frequency of the discriminatory conduct; its severity; whether it is physically threatening or humiliating... and whether it unreasonably interferes with an employee's work performance.'" *Id.* at 347. In *Alamo Heights Ind. Sch. Dist. v. Clark*, 544 S.W. 3d 755 (Tex. 2018), the Court said: "Sexual harassment is a form of sex-based discrimination and, as such, requires proof that the alleged mistreatment was "because of" the employee's gender. Anti-discrimination laws – in their current incarnation – do not guarantee a pleasant working environment devoid of profanity, off-color jokes, teasing, or even bullying."

c. Overtime. The Federal Fair Labor Standards Act (FLSA) governs claims for overtime pay. The FLSA applies to (a) employers with two or more employees engaged in interstate commerce and annual gross sales of at least $500,000, or (b) an employee who engages in interstate commerce. The FLSA requires employers to pay hourly workers at least the minimum wage and provides that employers must pay time-and-a-half for work beyond 40 hours per week. The overtime requirement does not apply to salaried employees who manage at least two full-time employees, with authority to hire, fire, and promote. And it does not apply to administrative employees or learned professionals or creative professionals. It is reported that in 2016 FLSA overtime lawsuits were settled for just over $400 million. Overtime FLSA settlements included: FedEx, $240 million; Walmart and Sam's Club, $62.2; Los Angeles Children's Hospital, $27 million; Bank of America, $14 million; Avis Budget Car Rental, $7.8 million.[18] In 2007, Walmart was ordered to pay more than $62 million. Under the FLSA, a jury found that Walmart saved $1 million by refusing to allow employees to record their time in a computerized pay system and saved $48 million by denying rest breaks. This is one of may lawsuits filed against Walmart for worker-related claims. In *Fast v. Cash Depot Ltd.*, No. 16-C-1637 (U.S. Dist. Ct. E.D. Wisconsin Nov. 6, 2018), the court ruled that the attorney for the class-action plaintiffs could not recover attorneys' fees when before class certification the employer voluntarily paid all that was owed and no judgment was rendered for the plaintiffs.

d. Disabilities. Under Texas Labor Code § 21.128, an employer must "make a reasonable workplace accommodation to a known physical or mental limitation of an otherwise qualified individual with a disability who is an employee or applicant for employment, unless the [employer] demonstrates that the accommodation would impose an undue hardship on the operation of the business ...." The disability protections apply only to a physical or mental condition that does not impair an individual's ability to reasonably perform a job. Texas Labor Code § 21.105. The Federal Americans With Disabilities Act of 1990 (ADA), and the Fair Housing Act of 1968, prohibit discrimination based on disabilities. Many of the claims under the Fair Housing Act involve prohibitions against pets pitted against the need for "assistance animals," "service animals," and "emotional support animals." Federal regulations define a "service animal" as an animal "individually trained to do work or perform tasks for the benefit of an individual with a disability." 28 CFR § 36.104. Under the ADA, support animals are limited to dogs. Emotional support animals are not service animals under the ADA. The Federal Equal Employment Opportunity Commission does not have a specific regulation relating to service animals in the workplace.

3. Employee's Fiduciary Duties to His/Her Employer. An employee must act primarily for the benefit of the employer in matters connected with employment. *Daniel v. Falcon Interest Realty Corp.*, 190 S.W.3d 177, 185 (Tex. App.--Houston [1st Dist.] 2005, no pet.). In *Abetter Trucking Co. v. Arizpe*, 113 S.W.3d 503, 508 (Tex. App.--Houston [1st Dist.] 2003, no pet.), the court said:"[t]he employee has a duty to deal openly with the employer and to fully disclose to the employer information about matters affecting the company's business." In *Wooter v. Unitech Int'l, Inc.*, 513 SW 3d 754, 763 (Tex. App.--Houston [1st Dist.] 2017, pet. denied), Justice Bland wrote:

> An employee may not (1) appropriate the company's trade secrets; (2) solicit the former employer's customers while still working for his employer; (3) solicit the departure of other employees while still working for his employer; or (4) carry away confidential information. *Abetter Trucking Co. v. Arizpe*, 113 S.W.3d 503, 512 (Tex. App.--Houston [1st Dist.] 2003, no pet.).

However, Justice Bland continued:

> "'[a]n at-will employee may properly plan to go into competition with his employer and may take active steps to do so while still employed'" and may secretly do so with other employees, without disclosing his plans to his employer. *Id.* (quoting *Augat v. Aegis*, Inc., 409 Mass. 165, 565 N.E.2d 415, 419 (1991)). An employee also may use his general skills and knowledge obtained through employment to compete with the former employer.

> *Sharma v. Vinmar Int'l, Ltd.*, 231 S.W.3d 405, 424 (Tex. App.--Houston [14th Dist.] 2007, no pet.). Thus, an employee's duty to his employer does not require an employee to disclose his plans to compete; he may secretly join with other employees to plan a competing company without violating any duty to his employer. *Abetter Trucking*, 113 S.W.3d at 511.

In *Johnson v. Brewer & Pritchard, P.C.*, 73 S.W.3d 193, 200 (Tex. 2002), the Court held that "an associate [attorney] owes a fiduciary duty to his or her employer not to personally profit or realize any financial or other gain or advantage from referring a matter to another law firm or lawyer, absent the employer's agreement otherwise."

4. Whistleblowers.

<u>Federal law.</u> Under Title VIII of the Sarbanes-Oxley Act of 2002, an employee of a publicly-traded company who is terminated for reporting fraudulent activity, environmental law abuses, or safety violations, can apply to the Department of Labor for help in securing reinstatement, back pay with interest, and special damages including attorneys' fees, expert witness fees, and costs. 18 U.S.C. §1514A(b).

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 established "bounty" provisions that allow the SEC to reward whistleblowers with an "award amount" ranging from 10% to 30% of monetary sanctions imposed on wrongdoers whose bad actions were revealed by the whistleblower. According to the summary accompanying new final rules issued by the SEC on September 23, 2020, "information provided by whistleblowers has led to enforcement actions in which the Commission has obtained more than $2.5 billion in financial remedies, including more than $1.4 billion in disgorgement of ill-gotten gains and interest, of which almost $750 million has been or is scheduled to be returned to harmed investors. In recognition of the important contributions of whistleblowers, the Commission has ordered over $523 million paid to 97 individuals in 80 enforcement actions whose original information led to the success of Commission actions and, in some instances, related actions brought by other enforcement authorities against wrongdoers." On October 22, 2020, the SEC announced a new award of over $114 million to a whistleblower.[19] On November 3, 2020, an award of $28 million was approved.[20] On November 6, 2020, an award of $3.6 million was approved.[21]

<u>Qui Tam.</u> The Federal False Claims Act, passed in 1863 in response to fraud by vendors supplying the Union Army during the Civil War, as amended throughout the years, permits private persons to sue government contractors for fraud on the government and to keep a portion of any recovery ("qui tam"). In 2009, an individual was awarded $51.5 million in connection with his False Claims Act complaint against Pfizer Inc. for illegal practices in marketing four drugs. Pfizer pleaded guilty to various civil and criminal charges and paid $2.3 billion to the government.[22]

<u>State law.</u> Texas has a Whistleblower Act that applies only to public employees. Under Texas Government Code Chapter 554, a government employer may not suspend, terminate, or take adverse personnel action against a public employee who in good faith reports a violation of law by his/her

employing government agency. Tex. Gov't Code § 554.002(a). "Good Faith" in this context has both subjective and objective components: (1) the employee must believe that the conduct reported was a violation of law and (2) the employee's belief must be reasonable in light of the employee's training and experience. *Wichita County v. Hart*, 917 S.W.2d 779, 784 (Tex. 1996). An employee-victim can sue for injunction, actual damages, court costs, and reasonable attorney fees. *Id.* at § 554.003. The employee can also be reinstated to his/her former position, and recover lost wages, fringe benefits, and seniority rights. *Id.* 554.003(b). There are caps on the recovery for future pecuniary losses, emotional pain, suffering, inconvenience, mental anguish, loss of enjoyment of life, and other nonpecuniary losses. *Id.* at § 554.003. A supervisor who violates Chapter 554 can receive a civil penalty of up to $15,000. As to causation, the complainant must show that, without the protected conduct, the retaliatory firing would not have occurred when it did. *Texas Department of Human Services v. Hinds*, 904 S.W.2d 629 (Tex. 1995).

5. Employer's Duties to the Public. "As a general rule, there is no legal duty in Texas to control the actions of third persons absent a special relationship, such as master/servant or parent/child." *Triplex Communications, Inc. v. Riley*, 900 S.W.2d 716, 720 (Tex. 1995). In *Graff v. Beard*, 858 S.W.2d 918, 920 (Tex. 1993), the Court wrote: "[u]nder Texas law, in the absence of a relationship between the parties giving rise to the right of control, one person is under no legal duty to control the conduct of another, even if there exists the practical ability to do so." In *Otis Engineering Corp. v. Clark*, 668 S.W.2d 307, 309 (Tex. 1984), the Supreme Court held "that an employer breached a duty of care to the public when he directed an intoxicated employee to drive home and the employee caused a fatal car crash." The decision was premised on "the employer's negligent exercise of control over the employee." *Greater Houston Transp. Co. v. Phillips*, 801 S.W.2d 523, 526 (Tex. 1991).

a. Respondeat Superior. "No general duty to control others exists, but a special relationship may sometimes give rise to a duty to aid or protect others. Employment is such a relationship." *Pagayon v. Exxon Mobil Corp.*, 536 S.W.3d 499, 504 (Tex. 2017). "Under the doctrine of respondeat superior, an employer is vicariously liable for the negligence of an agent or employee acting within the scope of his or her agency or employment, although the principal or employer has not personally committed a wrong." *Baptist Mem'l Hosp. Sys. v. Sampson*, 969 S.W.2d 945, 947 (Tex. 1998). Additionally, "as a general rule, the actions of a corporate agent on behalf of the corporation are deemed the corporation's acts." *Holloway v. Skinner*, 898 S.W.2d 793, 795 (Tex. 1995).

b. Negligent Hiring, Training, and Supervision. The Texas Supreme Court has "not ruled definitively on the existence, elements, and scope of [torts such as negligent retention and supervision of an employee by an employer] and related torts such as negligent training and hiring." *Waffle House, Inc. v. Williams*, 313 S.W.3d 796, 804 n. 27 (Tex. 2010). However, the Supreme Court has reviewed the sufficiency of the evidence regarding such claims. *JBS Carriers, Inc. v. Washington*, 564 S.W.3d 830, 842 (Tex. 2018). Texas courts of appeals have written that "[n]egligent hiring, retention, and supervision claims are all simple negligence causes of action based on an employer's direct negligence rather than on vicarious liability." *Dangerfield v. Ormsby*, 264 S.W.3d 904, 912 (Tex. App.--Fort Worth 2008, no pet.); *Morris v. JTM Materials, Inc.*, 78 S.W.3d 28, 49 (Tex. App.--Fort Worth 2002, no pet.). "The basis of responsibility for negligent hiring is the employer's own negligence in hiring an incompetent individual whom the employer knows, or by the exercise of reasonable care, should have known to be incompetent or unfit, thereby creating an unreasonable risk of harm to others." *Castillo v. Gulf Coast Livestock Market, LLC*, 392 S.W.3d 299, 306 (Tex. App.--San Antonio 2012, no pet.).

Some courts of appeals have stated that an employer has a duty to adequately hire, train, and supervise employees. *See Patino v. Complete Tire, Inc.*, 158 S.W.3d 655, 660 (Tex. App.--Dallas 2005, pet. denied). In *Golden Spread Council, Inc. No. 562 v. Akins*, 926 S.W.2d 287, 290 (Tex. 1996), the Supreme Court held that the Boy Scouts of American had no duty to screen an adult volunteer about whom it had no knowledge and over whom it had no right of control.

While some Texas courts have mentioned negligent supervision in the context of negligent hiring, so far Texas court have not recognized an independent tort of negligent supervision as a ground for liability of the employer. *Castillo v. Gared, Inc.*, 1 S.W.3d 781, 785 (Tex. App.–Houston [1st Dist.] 1999, pet. denied) (discussing three cases that mentioned but did not adopt the tort of negligent supervision). The boundaries of respondeat superior and negligent supervision are being tested in cases involving the Catholic Church and the Boy Scouts of America.

M. SELLER TO BUYER; BUYER TO SELLER. The historically significant case of *Laidlaw v. Organ*, 15 U.S. 178 (1817), written by Chief Justice John Marshall, addressed whether the law not only prohibits affirmative misrepresentations in a purchase-sale but also imposes on a buyer the duty to disclose information the other party would want to know. Chief Justice Marshall made short shrift of the suggested duty, saying:

> The question in this case is, whether the intelligence of extrinsic circumstances, which might influence the price of the commodity, and which was exclusively within the knowledge of the vendee, ought to have been communicated by him to the vendor? The court is of the opinion that he was not bound to communicate it.

Chief Justice Marshall cited no authority for the Court's decision, but did offer a policy argument, that "[i]t would be difficult to circumscribe the contrary doctrine within proper limits, where the means of intelligence are equally accessible to both parties." *Id.* at 194. However, the Chief Justice went on to state a rule against affirmatively misleading the other contracting party: "But at the same time, each party must take care not to say or do any thing tending to impose upon the other." *Id.* at 194.

In *Mitchell v. Zimmerman*, 4 Tex. 75, 1849 WL 3970, *3 (Tex. 1849), the Court addressed a lease for real estate where the lessor misrepresented that 140 acres were suitable for cultivation, when in truth it was less than fifty acres. Justice Wheeler made a number of broad and important statements regarding the duties attending the creation of contracts. He wrote:

> If the party, says Story, intentionally misrepresents a material fact or produces a false impression by words or acts, in order to mislead or obtain an undue advantage, it is a case of manifest fraud. (1 Story Eq., sec. 192.) It is a rule in equity that all the material facts must be known to both parties to render the agreement just and fair in all its parts. (2 Kent Com., 491.)

> And if there be any intentional misrepresentation or concealment of material facts in the making of a contract, in cases in which the parties have not equal access to the means of information, it will vitiate and avoid the contract. (2 Kent Com., 482; 2 Bail. R., 324.) It is immaterial whether the misrepresentation be made on the sale of real or personal property, or whether it relates to the title to land or some collateral thing attached to it. (7 Wend. R., 380.)

In *Smith v. National Resort Communities, Inc.*, 585 S.W.2d 655, 658 (Tex. 1979), the Supreme Court held that "a seller of real estate is under a duty of disclosing material facts which would not be discoverable by the exercise of ordinary care and diligence on the part of the purchaser, or which a reasonable investigation and inquiry would not uncover." p. 658.

A comprehensive analysis of case law on the duty of disclosure in arm's-length transactions is set out in Zeiler & Krawiec, *Common-Law Disclosure Duties and the Sin of Omission: Testing the Meta-Theories*, 91 VA. L. REV. 1795 (2005).

N. SPOUSES. Spouses have fiduciary duties to each other. Speaking generally, the fiduciary obligation arises from the inherent trust between spouses, but a fiduciary duty also emanates from a position of exclusive control over sole management community property. The most frequently-litigated fiduciary duty is the duty of a spouse who manages or disposes of the other spouses's undivided one-half ownership interest in community property. Additionally, courts have applied fiduciary standards to transactions between spouses. Occasionally the fiduciary obligation arises from one spouse's acting as the other spouse's financial advisor or legal representative.

In *Wiley and Co. v. Prince*, 21 Tex. 637, *3 (1858), Chief Justice Hemphill wrote:

> There is no relation in which more influence, more dominion can be exercised by one person over another than that exercised by the husband over the wife. They are separate in this state as to property, but in other respects the legal existence, the powers of the wife, are merged in the husband, and his conduct in obtaining gifts or suretyships from her property should therefore be watched with the most scrupulous attention.

Under the law at the time that Chief Justice Hemphill wrote, the spouses each *owned* one-half of the community property assets, but the husband had *exclusive control* over *all* community property. This control over the property of another is a classic trustee-beneficiary relationship. While the last of the wife's disabilities of coverture were finally extinguished by the Texas Marital Property Act of 1967, the Family Code has carried forward the legal notion of a spouse's "sole management, control, and disposition" over certain categories of community property. See Tex. Fam. Code ch.3, subch. B. The managing spouse's control over the other spouse's one-half community property interest in a community property asset justifies a fiduciary duty. And control is a factor when one spouse is dealing with property, separate or community, that is the homestead of both spouses. See Tex. Fam. Code § 5.001 (neither spouse can convey or encumber an interest in the homestead without the joinder of the other spouse, subject to the exceptions in Chapter 5 or "other rules of law").

1. The Existence of a Fiduciary Duty. Many court of appeals cases agree that a marriage relationship creates a fiduciary duty between spouses. *Knight v. Knight*, 301 S.W.3d 723, 731 (Tex. App.--Houston [14th Dist.] 2009, no pet.) ("A fiduciary duty exists between a husband and a wife as to the community property controlled by each spouse"); *Smith v. Deneve*, 285 S.W.3d 904, 911 (Tex. App.--Dallas 2009, no pet.) (saying, in dicta, "[t]he marital relationship is a fiduciary one"); *Solares v. Solares*, 232 S.W.3d 873, 881 (Tex. App.--Dallas 2007, no pet.) ("A fiduciary duty exists between spouses"); *Miller v. Ludeman*, 150 S.W.3d 592, 597 (Tex. App.–Austin 2004, pet. denied) ("Husbands and wives generally owe a fiduciary duty to one another"); *Hubbard v. Shankle*, 138 S.W.3d 474, 483 (Tex. App.--Fort Worth 2004, pet. denied) ("the relationship between a husband and wife is ordinarily a fiduciary relationship");" *Toles v. Toles*, 113 S.W.3d 899, 916 (Tex. App.--Dallas 2003, no pet.) ("A fiduciary duty exists between spouses"); *Connell v. Connell*, 889 S.W.2d 534 (Tex. App.--San Antonio 1994, writ denied) ("It is established law that the relationship between a husband and wife is a fiduciary relationship, and the spouses are bound by that fiduciary duty in dealing with the community estate"); *Buckner v. Buckner*, 815 S.W.2d 877, 880 (Tex. App.--Tyler 1991, no writ). ("It has long been recognized in Texas that a confidential relationship does exist between a husband and his wife."); *Daniel v. Daniel*, 779 S.W.2d 110, 115 (Tex. App.--Houston [1st Dist.] 1989, no writ) ("Because of the confidential relationship between a husband and a wife, courts have imposed the same duties of good faith and fair dealing on spouses as required of partners and other fiduciaries"); *Bohn v. Bohn*, 455 S.W.2d 401, 406 (Tex. Civ. App.--Houston [1st Dist.] 1970, writ dism'd) ("a confidential relationship exists between husband and wife has been recognized in Texas"). In *Daniel v. Daniel*, 779 S.W.2d 110, 115 (Tex. App.--Houston [1st Dist.] 1989, no writ), the court said that, "[b]ecause of the confidential relationship between a husband and a wife, courts have imposed the same duties of good faith and fair dealing on spouses as required of partners and other fiduciaries."

<u>Ends Upon Filing Divorce and Hiring Independent Professionals.</u> Several Texas appellate courts have said that the fiduciary relationship between spouses ends at the start of a contested divorce in which the spouses each hire independent attorneys or financial advisors. *Bass v. Bass*, 790 S.W.2d 113, 119 (Tex. App.--Fort Worth 1990, no writ) ("Although marriage may bring about a fiduciary relationship ..., such a relationship clearly does not continue when a husband and wife hire numerous independent professional counsel to represent them respectively in a contested divorce proceeding"); *Parker v. Parker*, 897 S.W.2d 918, 924 (Tex. App.--Fort Worth 1995, writ denied) ("While marriage may bring about a fiduciary relationship, such a relationship terminates in a contested divorce when a husband and wife each have independent attorneys and financial advisers"); *Boyd v. Boyd*, 67 S.W.3d 398, 405 (Tex. App.--Fort Worth 2002, no pet.) ("The fiduciary duty arising from the marriage relationship does not continue when a husband and wife each hire independent professional counsel to represent them in a contested divorce proceeding"); *Toles v. Toles*, 113 S.W.3d 899, 916 (Tex. App.--Dallas 2003, no pet.) ("A fiduciary duty exists between spouses.... However, that relationship terminates in a contested divorce when a husband and wife each have independent attorneys."); *Ricks v. Ricks*, 169 S.W.3d 523, 526 (Tex. App.–Dallas 2005, no pet.) ("The fiduciary duty arising from the marital relationship ceases in a contested divorce when the husband and wife each hire independent attorneys to represent them"); *Boaz v. Boaz*, 221 S.W.3d 126, 133 (Tex. App.--Houston [1st Dist.] 2006, non pet.) ("adverse parties who have retained professional counsel, including husbands and wives in a suit for divorce, do not owe fiduciary duties to one another"). The Austin Court of Appeals, however, in *Sheshunoff v. Sheshunoff*, 172 S.W.3d 686, 701 n. 21 (Tex. App.--Austin 2005, pet. denied), rejected a categorical rule that hiring

separate counsel in a divorce always eliminates fiduciary obligations. It makes sense that the duty of disclosure that exists between spouses would be supplanted, at least to some extent if not entirely, by the discovery rules of procedure that govern the disclosure of information in a lawsuit. However, if the relationship giving rise to a fiduciary obligation between spouses exists independent of the marriage, like a partnership relationship or an agency relationship, one would think that those duties are not altered by the filing of a divorce. And in instances where a spouse convinces the other spouse to enter into a settlement unbeknownst to his or her attorneys, the rule might not apply.

<u>Ends Upon Granting of Divorce.</u> Several cases sensibly hold that the fiduciary duty between spouses ends upon the granting of a divorce. *Grossnickle v. Grossnickle*, 935 S.W.2d 830, 846 (Tex. App.--Texarkana 1996, writ denied) (no fiduciary duty after divorce); *In re Marriage of Notash*, 118 S.W.3d 868, 872 (Tex. App.--Texarkana 2003, no pet.) ("The fiduciary duty between husband and wife terminates on divorce"); *Camacho v. Montes*, 2006 WL 2660744, *3 (Tex. App.--Amarillo 2006, no pet.) (mem. op.) ("The formal fiduciary relationship between Frances and Delfino as husband and wife terminated on their divorce"); *Solares v. Solares*, 232 S.W.3d 873, 881 (Tex. App.--Dallas 2007, no pet.) ("in a contested divorce where each spouse is independently represented by counsel, the fiduciary relationship terminates"); *Robbins v. Robbins*, 550 S.W.3d 846 (Tex. App.--Ft. Worth, 2018, no pet.) (ex-wife failed to prove a fiduciary duty owed to her by her ex-husband with regard to the sale of their former marital residence). However, Texas Family Code Section 9.001 creates a post-divorce fiduciary duty with regard to a former spouse who receives property awarded in the decree of divorce to the other spouse.

2. The Duty to Disclose. Several cases identify a spouse's duty to disclose. In *Buckner v. Buckner*, 815 S.W.2d 877, 880 (Tex. App.--Tyler 1991, no writ), the court said: "The husband must disclose the material facts within his knowledge and the legal consequences flowing from them to his wife." In *Izzo v. Izzo*, 2010 WL1930179, *7 (Tex. App.--Austin 2010, pet. denied) (memo. op.), the Court said: "The fiduciary duty between spouses extends to a duty to disclose material information in business transactions"). According to one decision, the duty to disclose does not extend to personal behavior. In *Freeman v. Freeman*, No. 03-97-00626-CV, *5 (Tex. App.--Austin Dec. 3, 1998, pet. denied), hiding the fact that a child born into marriage was not the husband's child was held not to breach fiduciary duty.

3. The Fairness Standard. In *Bohn v. Bohn*, 455 S.W.2d 401, 406 (Tex. Civ. App.–Houston [1st Dist.] 1970, writ dism'd), the court said, in connection with an interspousal transfer, that the spouse who received the property had the burden of "affirmatively showing that he acted in good faith, and that the gift was voluntarily and understandingly made." In *Matthews v. Matthews*, 725 S.W.2d 275, 279 (Tex. App.–Houston [1st Dist.] 1986, writ ref'd n.r.e.), which involved the enforceability of a post-marital partition agreement, the Court said: "Appellant and appellee, as husband and wife, owed each other special fiduciary duties. . . . The fiduciary relationship requires that appellant demonstrate the basic fairness of the transaction."

4. Duty Regarding Community Property. Although every community asset is owned one-half by each spouse, the Texas Family Code gives sole management and control to a spouse over community property that would have belonged to the spouse if single when acquired (like wages, dividend income on stock in his/her name, etc.). Tex. Fam. Code § 3.102. This creates a tension between two interests, as described in *Givens v. Girard Life Ins. Co. of Am.*, 480 S.W.2d 421, 427-28 (Tex. Civ. App.--Dallas 1972, writ ref 'd n.r.e.):

> Reconciliation of the managerial power of one spouse with the interest of the other spouse as equal owner is a problem inherent in the concept of management by one spouse of marital property owned in common. This concept has come down to us from the laws of Spain and Mexico, and is carried forward in the statutes above mentioned without substantial change, except that the managerial powers of the husband have been restricted and those of the wife have been extended with respect to classes of property not now before us.
>
> Our review of the authorities reveals that the husband's power to make gifts of community property has always been limited, though the limits have never been clearly defined.

In the context of claims for misappropriation of community property, a spouse may sue either for intentional fraud, or constructive fraud, or both. Actual or intentional fraud exists when a spouse transfers community property with the intent to deprive the other spouse of his or her interest in the property. For actual fraud, the burden of proving fraudulent intent is on the claimant, and the question of whether the conveyance was "fair" is not an issue. *See Jean v. Tyson-Jean*, 118 S.W.3d 1, 9 (Tex. App.--Houston [14th Dist.] 2003, pet. denied) (distinguishing actual fraud from constructive fraud); *In re Soza*, 542 F.3d 1060, 1072 (5th Cir. 2008) (distinguishing actual from constructive fraud in Texas law). See Tex. Fam. Code § 6.707 (transfers of property or debts incurring during pendency of divorce are void with respect to the other spouse "if the transfer was made or the debt incurred with the intent to injure the rights of the other spouse").

Constructive fraud does not depend upon the state of mind (or scienter) of the acting spouse. Constructive fraud is constructive because fraudulent intent is attributed by operation of law to the acting spouse, based on the circumstances, without regard to his/her actual motivation.

THE TEXAS PATTERN JURY CHARGES (FAMILY & PROBATE 2020) distinguishes the two types of fraud in this manner:

> PJC 206.1 Confidence and Trust Relationship between Spouses
>
> > A relationship of confidence and trust exists between a husband and wife with regard to that portion of the community property that each controls. This relationship requires that the spouses use the utmost good faith and frankness in their dealings with each other.
> >
> > Because of the nature of the spousal relationship, conduct of a spouse affecting the property rights of the other spouse may be fraudulent even though identical conduct would not be fraudulent as between nonspouses.
>
> PJC 206.2A Actual Fraud by Spouse against Community Estate—Instruction
>
> > A spouse commits fraud if that spouse transfers community property or expends

community funds for the primary purpose of depriving the other spouse of the use and enjoyment of the assets involved in the transaction. Such fraud involves dishonesty of purpose or intent to deceive.

PJC 206.4A Constructive Fraud by Spouse against Community Estate—Instruction

A spouse may make moderate gifts, transfers, or expenditures of community property for just causes to a third party. However, a gift, transfer, or expenditure of community property that is capricious, excessive, or arbitrary is unfair to the other spouse. Factors to be considered in determining the fairness of a gift, transfer, or expenditure are—

1. The relationship between the spouse making the gift, transfer, or expenditure and the recipient.

2. Whether there were any special circumstances tending to justify the gift, transfer, or expenditure.

3. Whether the community funds used for the gift, transfer, or expenditure were reasonable in proportion to the community estate remaining.

See Justice Ann Crawford McClure and John F. Nichols, Sr., *Fraud, Fiduciaries, and Family Law*, 43 TEX. TECH. L. REV. 1081 (2011).

O. PARENT-CHILD. The Texas Supreme Court has said that parents "generally stand" in the role of fiduciaries as to their children *S.V. v. R.V.*, 933 S.W.2d 1, 8 (Tex. 1996). However, the contours of the parental fiduciary duties are unclear. Texas Family Code § 51.001 lists the rights and duties of a parent. Section 151.001(a)(4) gives parents the duty to manage the estate of the child, including acting as agent if required by a state, the U.S.A., or a foreign government, except when a guardian of the estate has been appointed. A parent managing a child's property would seem to be in a trustee-beneficiary relationship The parents also have the right to services and earnings of the child under Section 151.001(a)(5), except where the Texas Department of Family and Protective Services has been appointed managing conservator of the child. This seems to suggest parental ownership, rather than just a parental management right. A parent has a right to receive child support payments for a child, as well as the right (not duty) to hold or disburse funds for the benefit of the child. Tex. Fam. Code § 151.001(a)(8). This sounds like a trustee-beneficiary relationship. In *Farish v. Farish*, 982 S.W.2d 623, 627-628 (Tex. App.–Houston [1st Dist.] 1998, no pet.), the appellate court wrote extensively that child support is an obligation owed by a parent to the child.

The ownership of Internal Revenue Code § 529 Prepaid Tuition Plans may be fact-specific. Privately-managed 529 accounts are tax-sheltered accounts whose income is not taxed if the funds are withdrawn to pay IRS-approved college expenses. Earnings withdrawn for other purposes are subject to income tax and a 10% penalty. However, the tax treatment does not determine ownership, under state law. The account holder would appear to be the owner of the funds. Section 541(b)(6) of the U.S. Bankruptcy

Code excludes funds in a 529 Plan from a debtor's estate. *See In the Matter of Dunston v. Chapter 7 Trustee v. Skidmore College*], No. 14-41799-EJC, Adversary No. 15-04048-EJC (Bnkr. S.D. Georgia, Savannah Division, Jan. 31, 2017). The court in *Taylor v. Taylor*, No. 3:12-CV-0037 (LEK/DEP) (U.S. Dist. Ct., N.D., New York), assessed the ownership issue as a question of whether the depositor made the transfer to the 529 account with donative intent, making a gift of the beneficial interest to the child.

Although the Texas Uniform Transfers to Minor Act does not expressly say so, custodians of TUTMA accounts are undoubtedly fiduciaries to the minor transferee. A TUTMA transfer is irrevocable, and "the custodial property is indefeasibly vested in the minor." Section 141.012(b). The custodian has all the rights, powers, duties, and authority provided in this chapter, and the minor or the minor's legal representative does not have any right, power, duty, or authority with respect to the custodial property except as provided by this chapter The care and use of custodial property and the powers of a TUTMA custodian are spelled out in Sections 141.013 - 141.015. In *In re Crumley*, 428 B.R. 349 (Bankr. Ct., N.D. Texas 2010), the court wrote: "Custodial assets under TUTMA are the property of the child, rather than the parent. TEX. PROP. CODE ANN. § 141.012(b) (Vernon 2007) ('A transfer made under § 141.010 is irrevocable, and the custodial property is indefeasibly vested in the minor.'). Under TUTMA, however, a custodian 'may expend for the minor's benefit as much of the custodial property as the custodian considers advisable for the use and benefit of the minor ...' TEX. PROP. CODE ANN. § 141.014(a) (Vernon 2007). In this respect, distributions from TUTMA accounts are similar to child support payments received by a custodial parent. *See Farish v. Farish*, 982 S.W.2d 623, 627 n. 2 (Tex. App. 1998) (child support payments are properly characterized as related to the care and welfare of the child, not for the benefit of the parent)."

P. THE DUTY TO DISCLOSE. "As a general rule, a failure to disclose information does not constitute fraud unless there is a duty to disclose." *Bradford v. Vento*, 48 S.W.2d 749, 755 (Tex. 2000). "Generally, no duty of disclosure arises without evidence of a confidential or fiduciary relationship." *Ins. Co. of N. Am. v. Morris*, 981 S.W.2d 667, 674 (Tex. 1998). A duty to disclose has been recognized: (i) in a formal or informal fiduciary relationship; (ii) when a partial disclosure leads to a duty to fully disclose; (iii) when new information causes an earlier disclosure to become misleading or untrue; (iv) when a partial disclosure conveys a false impression; (v) in connection with estoppel by silence; and (vi) when a person "by force of circumstances is under a duty to another to speak." *A. R. Clark Investment Co. v. Green*, 375 S.W.2d 425, 435 (Tex. 1964) (involving estoppel by silence). A recent case seems to expand the scope of the duty to disclose. In *Bombardier Aero. Corp. v. Spep Aircraft Holdings, LLC*, 572 S.W.3d 213, 219-220 (Tex. 2019), the Court said:

> Fraud by non-disclosure, a subcategory of fraud, occurs when a party has a duty to disclose certain information and fails to disclose it. *Schlumberger Tech. Corp. v. Swanson*, 959 S.W.2d 171, 181 (Tex. 1997). To establish fraud by non-disclosure, the plaintiff must show: (1) the defendant deliberately failed to disclose material facts; (2) the defendant had a duty to disclose such facts to the plaintiff; (3) the plaintiff was ignorant of the facts and did not have an equal opportunity to discover them; (4) the defendant intended the plaintiff to act or refrain from acting based on the non-disclosure; and (5) the plaintiff relied on the non-disclosure, which resulted in injury.... In general, there is no duty to disclose without evidence of a confidential

> or fiduciary relationship.... There may also be a duty to disclose when the defendant: (1) discovered new information that made its earlier representation untrue or misleading; (2) made a partial disclosure that created a false impression; or (3) voluntarily disclosed some information, creating a duty to disclose the whole truth.

"[W]here there is a duty to speak, silence may be as misleading as a positive misrepresentation of existing facts.... There is an analogy to the rule considered by us in considerable depth, and with approval, in *Champlin Oil & Refining Co. v. Chastain*, 403 S.W.2d 376 (Tex. 1965), that an estoppel may arise as effectually from silence, where there is a duty to speak, as from words spoken." *Smith v. National Resort Communities, Inc.*, 585 S.W.2d 655, 658 (Tex. 1979).

W. Page Keeton, in *Fraud--Concealment and Non-Disclosure*, 15 TEX. L. REV. 132-33, (1936), advocated that a reasonable man standard be applied to non-disclosure of information in a transaction. The duty of disclosure in business transactions is examined in Deborah A. DeMott, *Do You Have The Right to Remain Silent: Duties of Disclosure in Business Transactions*. 19 DELAWARE J. OF BUS. LAW 65 [1994].

Q. THE DUTY TO PRESERVE INFORMATION. There are different sources for the duty to preserve information. The destruction of evidence in advance of a Federal or state investigation is a criminal offense. Destroying evidence relevant to a state court civil proceeding can also have consequences under civil law.

1. Criminal Exposure for Destroying Evidence. Chapter 73 of Title 18 of the United States Code relates to obstruction of justice. Sections 1512(b)(2)(A) and (B), which relate to witness tampering, provide in relevant part:

> Whoever knowingly uses intimidation or physical force, threatens, or corruptly persuades another person, or attempts to do so, or engages in misleading conduct toward another person, with intent to ... cause or induce any person to ... withhold testimony, or withhold a record, document, or other object, from an official proceeding [or] alter, destroy, mutilate, or conceal an object with intent to impair the object's integrity or availability for use in an official proceeding ... shall be fined under this title or imprisoned not more than ten years, or both.

Texas Penal Code § 37.09, Tampering With or Fabricating Physical Evidence, prohibits altering, destroying, concealing evidence knowing that an investigation or official proceeding is in progress, or knowingly making, presenting, or using evidence with the intent of an investigation or proceeding.

2. Spoliation. "Spoliation" is "the improper destruction of evidence relevant to a case." *Buckeye Retirement Co., LLC v. Bank of America, N.A.*, 239 S.W.3d 394, 401 (Tex. App.--Dallas 2007, no pet.). In *Trevino v. Ortega*, 969 S.W.2d 950, 960 (Tex. 1998), the Court decided that spoliation is not a tort in Texas but that sanctions could be imposed by a court in a case impacted by spoliation. *Id*. at 952-53. The Court set out a hierarchy of sanctions, ranging from telling the jury that the party negligently or intentionally destroyed evidence and therefore the jury *should* presume that the lost evidence was unfavorable, to placing the burden of proof on the issue upon the spoliating party. Or the court can dismiss claims or defenses. The standard of culpability is "knew or should have known" of impending litigation and the destruction or failure to preserve must be intentional or negligent. *Id.* at 957. In *Wal-Mart Stores, Inc. v. Johnson*, 106 S.W.3d 718, 723 (Tex. 2003), the Court held that a party has a duty to preserve evidence when "it knew, or should have known, that there was a substantial chance there would be litigation and that the [evidence] would be material to it." In *Brookshire Bros. v. Aldridge*, 438 S.W.3d 9 (Tex. 2014), the Court said that spoliation has two elements: a duty to preserve evidence and breach of this duty by destroying or failing to preserve evidence. "[S]uch a duty arises only when a party knows or reasonably should know that there is a substantial chance that a claim will be filed and that evidence in its possession or control will be material and relevant to that claim." *Id.* at 20 (citation and internal quotation marks omitted). The Court went on: "A party cannot breach its duty without at least acting negligently." *Id.* at 20-21 & n. 8. Any sanction must be based on intent to conceal discoverable evidence or negligently and irreparably depriving the opposing party of access to the evidence. *Id.* at 23-26.

3. Standing Orders in Divorce. Many Courts in Texas have "Standing Orders" that automatically apply to every divorce filed in those courts. The Dallas County District Court Standing Orders prohibit:

> "4.5 Tampering with the tangible or intellectual property of one or both of the parties, including any document, electronically stored or recorded information, that represents or embodies anything of value, and causing pecuniary loss to the other party."
>
> 4.12 Destroying, disposing of, or altering, any financial records of the parties, including canceled checks, deposit slips, and other records from a financial institution, a record of credit purchases or cash advances, a tax return, and a financial statement.
>
> 4.13 Destroying, disposing of, or altering any email, text message, video message, or chat message or social media message or other electronic data or electronically stored information relevant to the subject matter of the suit for dissolution of marriage, regardless of whether the information is stored on a hard drive in a removable storage device, in cloud storage, or in another electronic storage medium.
>
> 4.14 Modifying, changing, or altering the native format or metadata of any electronic data orelectronically stored information relevant to the subject matter of the suit for dissolution of marriage, regardless of whether the information is stored on a hard drive in a removable storage device, in cloud storage, or in another electronic storage medium.
>
> 4.15 Deleting any data or content from any social network profile used or created by either party or a child of the parties."[23]

R. VICARIOUS LIABILITY.

1. A Principal's Liability for Acts of the Agent. The RESTATEMENT (THIRD) OF AGENCY, ch. 7

suggests that a principal is directly liable to third parties if its agent commits a tort and the principal was negligent in selecting, training, retaining, supervising, or otherwise controlling the agent. *Id.* §§ 7.031 & 7.05(1). The Restatement suggests that a principal is vicariously liable to third parties if the agent commits a tort while acting within the scope of employment or while acting with apparent authority. *Id.* at §§ 7.03(2) & 7.07. "Apparent authority in Texas is based on estoppel. It may arise either from a principal knowingly permitting an agent to hold herself out as having authority or by a principal's actions which lack such ordinary care as to clothe an agent with the indicia of authority, thus leading a reasonably prudent person to believe that the agent has the authority she purports to exercise.... [¶] A prerequisite to a proper finding of apparent authority is evidence of conduct by the principal relied upon by the party asserting the estoppel defense which would lead a reasonably prudent person to believe an agent had authority to so act." *Ames v. Great Southern Bank*, 672 S.W.2d 447, 450 (Tex. 1984).

"A principal is liable for the fraudulent acts and misrepresentations of its authorized agent, even though the principal had no knowledge of the fraud and did not consent to it, whether or not the principal derives a benefit from it." *III Forks Real Estate, L.P. v. Cohen*, 228 S.W.3d 810, 815 (Tex. App.--Dallas 2007, no pet.). Punitive damages can be imposed on the principal under the standards of RESTATEMENT (SECOND) OF TORTS § 909, which says that a principal or master is liable for exemplary damages because of the acts of his agent, but only if:

(a) the principal authorized the doing and the manner of the act, or
(b) the agent was unfit and the principal was reckless in employing him, or
(c) the agent was employed in a managerial capacity and was acting in the scope of employment, or
(d) the employer or a manager of the employer ratified or approved the act."

A corporation can be subject to exemplary damages for actionable harm caused by a "vice principal," a term which includes "(a) corporate officers; (b) those who have authority to employ, direct, and discharge servants of the master; (c) those engaged in the performance of nondelegable or absolute duties of the master; and (d) those to whom a master has confided the management of the whole or a department or division of his business." *Hammerly Oaks, Inc. v. Edwards*, 958 S.W.2d 387, 391 (Tex. 1997).

The "doctrine of ostensible agency may render a principal liable for the conduct of a person who is not in fact the principal's agent ... when the principal's conduct should equitably prevent it from denying the existence of an agency." *Baptist Mem'l Hosp. Sys. v. Sampson*, 407 S.W.2d 871, 948 (Tex. App.--[14th Dist.] 2013, no pet.)."Ostensible agency in Texas is based on the notion of estoppel, that is, a representation by the principal causing justifiable reliance and resulting harm." *Id.* at 948.

Texas Family Code Section 3.201, Spousal Liability, provides that a spouse is personally liable for acts of the other spouse acting as agent for the first spouse. However, a "spouse does not act as an agent for the other spouse solely because of the manage relationships." *Id.* at § 3.201(c).

2. Respondeat Superior. "Respondeat superior imposes liability on the employer that is responsible for the acts of his employee, acting in the scope of his employment, where the negligence of the employee is shown to have been the proximate cause of injury." *DeWitt v. Harris County*, 904 S.W.2d 650, 654 (Tex. 1995). "In order to impose liability upon an employer for the tort of his employee under the doctrine of respondeat superior, the act of the employee must fall within the scope of the general authority of the employee and must be in furtherance of the employer's business and for the accomplishment of the object for which the employee was hired." *Dieter v. Baker Service Tools*, 739 S.W.2d 405, 407 (Tex. App.--Corpus Christi 1987, writ denied). Because the basis for respondeat superior is the employer's right to control the employee's activities, one who hires an independent contractor is generally not vicariously liable for the tort or negligence of the contractor, because the independent contractor has sole control over the means and methods of the work. *Baptist Mem'l Hosp. Sys. v. Sampson*, 969 S.W.2d 945, 947 (Tex. 1998).

3. Knowing Participation in a Breach of Fiduciary Duty. In *Kinzbach Tool Co. v. Corbett-Wallace Corp.*, 138 Tex. 565, 160 S.W.2d 509, 514 (1942), the Supreme Court recognized a claim when a third party knowingly participates in an employee's breach of fiduciary duty and the third party improperly benefits from the breach. In *Paschal v. Great W. Drilling, Ltd.*, 215 S.W.3d 437, 450 (Tex. App.--Eastland 2006, pet. denied), the court held that a wife was liable when she knowingly participated in her husband's embezzlement of funds from his employer and the funds were placed in a joint account.

4. Conspiracy. In *Massey v. Armco Steel Co.*, 652 S.W.2d 932, 934 (Tex. 1983), the Supreme Court wrote: "An actionable civil conspiracy is a combination by two or more persons to accomplish an unlawful purpose or to accomplish a lawful purpose by unlawful means." The Court continued: "The essential elements are: (1) two or more persons; (2) an object to be accomplished; (3) a meeting of minds on the object or course of action; (4) one or more unlawful, overt acts; and (5) damages as the proximate result." *Id.* at 934. In *Tilton v. Marshall*, 925 S.W.2d 672, 681 (Tex. 1996), the Court wrote: "Civil conspiracy, generally defined as a combination of two or more persons to accomplish an unlawful purpose, or to accomplish a lawful purpose by unlawful means, might be called a derivative tort.... That is, a defendant's liability for conspiracy depends on participation in some underlying tort for which the plaintiff seeks to hold at least one of the named defendants liable." (Citation omitted.) In *Agar Corp. v. Electro Circuits Int'l, LLC*, 580 S.W.3d 136, 142 (Tex. 2019), the Supreme Court determined that civil conspiracy is not an independent tort, and that the damages in question are damages arising from the underlying tort. *Id.* at 142. In *Chu v. Hong*, 249 S.W.3d 441, 444 n. 4 (Tex. 2008), the Supreme Court cited the Texas Pattern Jury Charges' suggestion that a "conspiracy question should be conditioned on findings of a statutory violation or tort (other than negligence) that proximately caused damages." Notwithstanding *Chu v. Hong*'s approval of the Pattern Jury Charge conditioning conspiracy liability on a statutory violation or tort, the Fifth Circuit has ruled that "civil conspiracy can[not] be premised on the violation of statutes that do not provide a private right of action." *Tummel v. Milane*, 787 Fed. Appx. 226, (Dec. 6, 2019) (per curiam). Notably, conspiracy cannot be based upon underlying negligent conduct. *Juhl v. Airington*, 936 S.W.2d 640, 644 (Tex. 1996). Conspiracy is an intentional or knowing tort, in the sense that liability is founded on participating in a plan with the intent to accomplish an unlawful purpose or to accomplish a lawful purpose by unlawful means, or with knowledge thereof. *Schlumberger Well Surveying Corp. v. Nortex Oil & Gas Corp.*, 435 S.W.2d 854, 857 (Tex. 1968). The party must agree to the injury to be accomplished; just agreeing to the conduct that resulted in injury "is not enough." *Chu v. Hong*, 249 S.W.3d 441, 446 (Tex. 2008). "A party who joins in a conspiracy is jointly and severally liable 'for all acts done by any of the conspirators in furtherance of the unlawful combination.'" *Bentley v. Bunton*, 94 S.W.3d 561, 619 (Tex. 2002).

Under the "intracorporate conspiracy doctrine," a corporation cannot conspire with itself. *Wilhite v. H.E. Butt Co.*, 812 S.W.2d 1, 5 (Tex. App.--Corpus Christi 1991, no writ); *Christopher v. General Computer Sys., Inc.*, 560 S.W.2d 698, 709 (Tex. Civ. App.--Dallas 1977, writ ref'd n.r.e.). "This is because the acts of a corporation's agents are deemed to be the acts of the corporation itself." *Vosko v. Chase Manhattan Bank, N.A.*, 909 S.W2d 95, 100 n. 7 (Tex. App.--Houston [14th Dist.] 1995, writ denied). "Nor can a parent and subsidiary corporation, or their employees or agents acting within the scope of their employment, conspire." *Id.*

5. Aiding and Abetting a Tort. Texas courts have not "precisely articulated an aiding and abetting theory of liability." *C.W. v. Zirus*, No. SA-10-CV-1044-XR , (U.S. Dist. Ct. W.D. Texas, September 4, 2012.) In *Chu v. Hong*, 249 S.W.3d 441, 444 n. 4 (Tex. 2008), the Supreme Court commented on aiding and abetting a breach of fiduciary duty: "Assuming such a claim exists and is somehow different from a conspiracy to breach his fiduciary duty, it too is excluded by *Schlueter* for the reasons noted above." In *Juhl v. Airington*, 936 S.W.2d 640, 643-44 (Tex. 1996), the Supreme Court considered whether to adopt RESTATEMENT (SECOND) OF TORTS § 876 (1977), which it called the "concert of action theory." *Id.* at 644. The elements described in Restatement § 876 are that liability can be imposed when the defendant:

> "(a) does a tortious act in concert with the other or pursuant to a common design with him, or
>
> (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or
>
> (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person."

Id. at 644, quoting Restatement § 876. In *Juhl*, the Supreme Court recognized that whether the tort existed in Texas was an open question but, because the facts of the case did not rise to the level of "substantially assisting and encouraging a wrongdoer in a tortious act," the Court neither adopted nor rejected the tort. *Id.* at 644. The Court did say, however, that such a tort would require allegations of specific intent, or at least gross negligence on the part of the third party. *Id.* at 644. In *III Forks Real Estate, L.P. v. Cohen*, 228 S.W.3d 810, 815 (Tex. App.--Dallas 2007, no pet.), the trial and appellate courts rejected a wife's liability for aiding and abetting a fraud by her husband, due to lack of proof of substantial assistance.

6. Intentional Acts of Third Parties. RESTATEMENT (SECOND) OF TORTS § 448 (1965) states:

> The act of a third person in committing an intentional tort or crime is a superseding cause of

> harm to another resulting therefrom, although the actor's negligent conduct created a situation which afforded an opportunity to the third person to commit such a tort or crime, unless the actor at the time of his negligent conduct realized or should have realized the likelihood that such a situation might be created, and that a third person might avail himself of the opportunity to commit such a tort or crime.

Restatement Section 448 thus recognizes liability based on knowing or negligent culpability as to the risk of a third peson committing a tort or crime. In *Centeq Realty, Inc. v. Siegler*, 899 SW 2d 195,197 (Tex, 1995), the Court said that "[g]enerally, a person has no legal duty to protect another from the criminal acts of a third person." However, "a landlord who retains control over the security and safety of the premises owes a duty to a tenant's employee to use ordinary care to protect the employee against an unreasonable and foreseeable risk of harm from the criminal acts of third parties." *Id.* at 197. That duty extends to guests and others. *Id.*

S. DUTY OF CONFIDENTIALITY. There are duties of confidentiality that must be considered in a variety of relationships. The Texas Rules of Evidence (TRE) recognize privileges between attorney-client, TRE 503; Spousal Privilege, TRE 504; Priest-Penitent, TRE 505; physician-patient, TRE 509; mental health provider, TRE 510. Additionally, the Health Insurance Portability and Accountability Act of 1996 ("HIPAA") imposes duties of confidentiality on protected health information, but that restriction is on health care providers and their contractors, but not employers generally. Texas Occupations Code § 901.457 provides for an Accountant-Client Privilege which prohibits an accountant from disclosing information gained in an engagement without the consent of the client. This privilege does not apply to reporting on financial statements, to Federal subpoenas, or to a court order signed by a judge that targets the information.

Balanced against these privileges, a person has a duty to report if he observes a felony, Tex. Penal Code § 38.171. Under Texas Family Code § 261.101, anyone who has cause to believe that a child's physical or mental health or welfare has been adversely affected by abuse or neglect must report it immediately to (1) any local or state law enforcement agency; or (2) the Department of Family and Protective Services.

In employment relationships parties often agree to non-disclosure agreements. This obligation of confidentiality is contractual. Litigants can agree, or courts can impose, confidentiality requiring information produced in pretrial discovery. Tex. R. Civ. P. 76a gives non-parties standing to intervene to participate in the hearing to seal court records (i.e., documents filed with the court not otherwise non-public, and unfiled discovery concerning matters that have a probable adverse effect upon the general public health or safety, or the administration of public office, or the operation of government).

The SEC fined a company $180,000 for including a provision in its non-disclosure agreements with departing employees that they could not disclose company information to the SEC.[24]

V. ALTERING DUTIES BY AGREEMENT. There is broad flexibility for parties in Texas to alter and sometimes waive what would otherwise be applicable fiduciary duties.

A. CORPORATIONS. TBOC § 7.001 (a), (b) & (c) generally permit domestic entities other than a partnership or LLC to waive in the certificate of formation liability of a governing person to the entity or its owners for acts or omissions as a governing person. However, the entity cannot eliminate or limit the duty of loyalty, or waive a claim for an act or omission "not in good faith" that breaches a duty to the entity or involves misconduct or a knowing violation of the law, or from which the individual "received an improper benefit," or an action for liability that is prescribed by statute. TBOC § 7.001(c).

B. PARTNERSHIPS. TBOC § 7.001(d) permits a general partnership agreement to limit or eliminate the liability of a "governing person" to the partnership or its partners except for a breach of loyalty or a claim for an act or omission "not in good faith" that breaches a duty to the entity or involves misconduct or a knowing violation of the law, or from which the individual "received an improper benefit," or an action where liability is prescribed by statute. TBOC § 7.001(c) & (d). TBOC § 152.002 provides that "a partnership agreement governs the relations of the partners and between the partners and the partnership," except as provided in Subsection (b). Subsection (b) provides that a partnership agreement or the partners may not: (1) unreasonably restrict a partner's right of access to books and records under Section 152.212; (2) eliminate the duty of loyalty under Section 152.205, except that the partners by agreement may identify specific types of activities or categories of activities that do not violate the duty of loyalty if the types or categories are not manifestly unreasonable; (3) eliminate the duty of care under Section 152.206, except that the partners by agreement may determine the standards by which the performance of the obligation is to be measured if the standards are not manifestly unreasonable; (4) eliminate the obligation of good faith under Section 152.204(b), except that the partners by agreement may determine the standards by which the performance of the obligation is to be measured if the standards are not manifestly unreasonable; (5) vary the power to withdraw as a partner under Section 152.501(b)(1), (7), or (8), except for the requirement that notice be in writing; (6) vary the right to expel a partner by a court in an event specified by Section 152.501(b)(5); (7) restrict rights of a third party under Chapter 152 or other partnership provisions, except for a limitation on an individual partner's liability in a limited liability partnership as provided by this chapter; (8) select a governing law not permitted under Sections 1.103 and 1.002(43)(C); or various deviations from the provisions of Chapters 1, 2, 3, 4, 5, 10, 11 and 12, other than certain exceptions, unless the provision says in the governing documents that it can be waived and further specifies the person(s) entitled to approve a modification or the vote or other method to approve modification. TBOC § 152.002(c) & (d).

C. LIMITED LIABILITY COMPANIES. The liability of a governing person may be limited or eliminated in a limited liability company by its certificate of formation or company agreement as to monetary damages for an act or omission by the person in the person's capacity as a governing person, except that liability cannot be limited or eliminated for breach of loyalty to the organization or its owners or member, or an action not in good faith that constitutes a breach of duty of the person to the organization; or involves intentional misconduct or a knowing violation of law. TBOC § 7.001(d)(3). However, TBOC § 101.401 allows "[t]he company agreement of a limited liability company [to] expand or restrict any duties, including fiduciary duties, and related liabilities that a member, manager, officer, or other person has to the company or to a member or manager of the company."

D. EXPRESS TRUSTS. The trust agreement for an express trust can impose or relieve or alter duties of the trustee. Texas Property Code § 114.007(c) provides that a settlor can include in the terms of the trust provisions expressly "1) relieving the trustee from a duty or restriction imposed by this subtitle or by common law; or (2) directing or permitting the trustee to do or not to do an action that would otherwise violate a duty or restriction imposed by this subtitle or by common law." However, the trust agreement cannot relieve a trustee of "a breach of trust committed: (A) in bad faith; (B) intentionally; or (C) with reckless indifference to the interest of a beneficiary"; nor can it relieve the trustee from "any profit derived by the trustee from a breach of trust." Tex. Prop. Code § 114.007(a). If an exculpatory clause is inserted in a trust "as a result of an abuse by the trustee of a fiduciary duty to or confidential relationship with the settlor," it is ineffective. Tex. Prop. Code § 114.007(b).

"[T]he settlor can reduce or waive the prudent man standard of care by specific language in the trust instrument." G. Bogert & G. Bogert, LAW OF TRUSTS AND TRUSTEES § 541, p. 172 (rev. 2d ed. 1993); see also RESTATEMENT (SECOND) OF TRUSTS §174, Comment d (1957) ("By the terms of the trust the requirement of care and skill may be relaxed or modified"). However, "trust documents cannot excuse trustees from their duties under ERISA." *Central States, Southeast & Southwest Areas Pension Fund*, 472 U.S. 559, 568 (1985).

In *Texas Commerce Bank v. Grizzle*, 96 S.W.3d 240, 249 (Tex. 2002), the Court ruled that Texas Property Code § 113.059 "allows an exculpatory clause to relieve a corporate trustee from liability for self-dealing defined as misapplying or mishandling trust funds, including failing to promptly reinvest trust monies, unless those activities violate the prohibitions in §§113.052 [loans to trustee] and 113.053 [sales to insiders]." The Legislature repealed Section 113.059 in 2005, and in 2005 amended Section 111.0035 to preclude a trust agreement from limiting the trustee's duty to (i) provide an accounting upon request by the beneficiary of an irrevocable trust; (ii) to "act in good faith and in accordance with the purposes of the trust," or (iii) eliminating a common law duty to keep the beneficiary of a trust who is 25 years old or older informed about his/her right to distributions from the trust.

Texas Property Code § 114.007 provides:

> (a) A term of a trust relieving a trustee of liability for breach of trust is unenforceable to the extent that the term relieves a trustee of liability for:
>
> > (1) a breach of trust committed:
> >
> > > (A) in bad faith;
> > > (B) intentionally; or
> > > (C) with reckless indifference to the interest of a beneficiary; or
> >
> > (2) any profit derived by the trustee from a breach of trust.
>
> (b) A term in a trust instrument relieving the trustee of liability for a breach of trust is ineffective to the extent that the term is inserted in the trust instrument as a result of an abuse by the trustee of a fiduciary duty to or confidential relationship with the settlor.

> (c) This section applies only to a term of a trust that may otherwise relieve a trustee from liability for a breach of trust. Except as provided in Section 111.0035, this section does not prohibit the settlor, by the terms of the trust, from expressly:
>
> > (1) relieving the trustee from a duty or restriction imposed by this subtitle or by common law; or
> >
> > (2) directing or permitting the trustee to do or not to do an action that would otherwise violate a duty or restriction imposed by this subtitle or by common law.

In *Neuhaus v. Richards*, 846 S.W.2d 70, 74-75 (Tex. App.--Corpus Christi 1992), judgm't set aside w.r.m.), 871 S.W.2d 182 (Tex. 1994), the court acknowledged that "[t]he settlor may within the trust instrument relieve the trustee of certain duties, restrictions, responsibilities, and liabilities imposed on him by statute. … Thus, if the language of the trust instrument unambiguously expresses the intent of the settlor, the instrument itself confers the trustee's powers and neither the trustee nor the courts may alter those powers. However, exculpatory clauses are strictly construed, and the trustee is relieved of liability only to the extent that the trust instrument clearly provides that he shall be excused."

In *Martin v. Martin*, 363 S.W.3d 221, 223-24 (Tex. App.--Texarkana 2012, pet. granted, judgm't vacated w.r.m.), the court, faced with a trust agreement that relieved the trustee of the duty of loyalty, said "We hold that statutory provisions impose certain duties on the trustee that cannot be waived."

In *Goughnour v. Patterson*, No. 12-17-00234-CV (Tex. App.--Tyler 2019, pet. filed 5-13-19) (memo op.), the court enforced an exculpatory clause when there was no evidence of gross negligence or willful breach of trust.

VI. REMEDIES FOR BREACH OF FIDUCIARY DUTY.

A. RESCISSION. Where a fiduciary transacts with the beneficiary, the transaction is presumptively fraudulent and will be upheld only if the fiduciary proves that the transaction was fair. *Archer v. Griffith*, 390 S.W.2d 735, 740 (Tex. 1964). In *Stephens County Museum, Inc. v. Swenson*, 517 S.W.2d 257, 739 (Tex. 1974), the Court said that "equity indulges the presumption of unfairness and invalidity, and requires proof at the hand of the party claiming validity and benefits of the transaction that it is fair and reasonable." In *Transamerican Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979), a divided Court (4-1-4) held that the Investment Advisors Act of 1940 permitted a client to seek rescission of an investment advisors contract. In *Smith v. National Resort Communities, Inc.*, 585 SW 2d 655, 660 (Tex. 1979), the Court said: "[r]escission is an equitable remedy and, as a general rule, the measure of damage is the return of the consideration paid, together with such further special damage or expense as may have been reasonably incurred by the party wronged on account of the contract."

B. DAMAGES. To prevail on a breach-of-fiduciary-duty claim, a party must prove the existence of a fiduciary duty, a breach of the duty, causation, and damages. *Las Colinas Obstetrics-Gynecology-Infertility Ass'n v. Villalba*, 324 S.W.3d 634, 645 (Tex. App.--Dallas 2010, no pet.). An injured party can sue for damages, and "courts may fashion equitable remedies such as profit disgorgement and fee forfeiture to remedy a breach of fiduciary duty." *ERI Consulting Engineers, Inc. v. Swinnea*, 318 SW 3d 867, 873 (Tex. 2010). Under Tex Prop. Code § 114.008(a)(3), a trustee who breaches his trust can be ordered to pay money or restore property. In *Frost Nat'l Bank of San Antonio v. Kayton*, 526 S.W.2d 654, 665-66 (Tex. App.–San Antonio 1975, writ ref'd n.r.e.), the appellate court applied the law of damages for reasonable cost of repairs for the administrator of an estate negligently failing to insure against loss from a hurricane.

"Recovery against a breaching fiduciary is not limited to an accounting of profits received by the fiduciary, but can also include exemplary damages." *Manges v. Guerra*, 673 SW 2d 180, 184 (Tex, 1984). "As a general rule, the Texas Civil Practice and Remedies Code restricts the maximum amount of exemplary damages a trial court may award." *Bennett v. Grant*, 525 SW 3d 642, 649 (Tex. 2017) (citing Tex. Civ. Prac. & Rem. Code § 41.008(b)). Under Section 41.008(b), exemplary damages are limited to two times the amount of economic damages, plus an amount equal to any noneconomic damages found by the jury, not to exceed $750,000, or $200,000.

C. UNJUST ENRICHMENT. "A party may recover under the unjust enrichment theory when one person has obtained a benefit from another by fraud, duress, or the taking of an undue advantage." *Heldenfels Bros v. City of Corpus Christi*, 832 SW 2d 39, 41 (Tex. 1992). To establish a claim for unjust enrichment, the claimant must show that the defendant holds money which in equity and good conscience belongs to the claimant. Unjust enrichment arises under the law of implied or quasi-contract and is not available when a valid, express contract exists. *TransAmerica Natural Gas Corp. v. Finkelstein*, 933 S.W.2d 591, 600 (Tex. App.--San Antonio 1996, writ denied).

D. DISGORGEMENT. In *Kinzbach Tool Co. v. Corbett-Wallace Corp.*, 160 S.W.2d 509 (Tex. 1942), the Court held that an agent was required to forfeit a secret commission received from a conflicting interest even though the principal was unharmed. In *Burrow v. Arce*, 997 S.W.2d 229, 237-45 (Tex. 1999), the Court said that the disgorgement remedy applies to attorneys who breach their fiduciary duty to a client. The Court adopted the rule as stated in the proposed RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 49 ("A lawyer engaging in clear and serious violation of duty to a client may be required to forfeit some or all of the lawyer's compensation for the matter."). *Id.* at 245. The client is not required to prove actual damages. *Id* at 240.

In *ERI Consulting Engineers, Inc. v. Swinnea*, 318 S.W.3d 867, 873 (Tex. 2010), the court said: "courts may fashion equitable remedies such as profit disgorgement and fee forfeiture to remedy a breach of fiduciary duty. For instance, courts may disgorge all ill-gotten profits from a fiduciary when a fiduciary agent usurps an opportunity properly belonging to a principal, or competes with a principal."

In *Liu v. S.E.C.*, No. 18–1501, 591 U.S. ___ (June 22, 2020), the U.S. Supreme Court held that the SEC may seek disgorgement as equitable relief for securities fraud under the Securities Act of 1933 and the Securities Exchange Act of 1934. "Equity courts have routinely deprived wrongdoers of their net profits from unlawful activity, even though that remedy may have gone by different names." *Id.* at 6. The disgorgement award may not exceed the wrongdoer's net profits after taking into account receipts and payments. *Id.* at 18-19. The Court intimated, but did not hold, that the disgorged funds should be awarded to victims and not to the government-at-large. *Id.* at 15-17. The SEC has sought disgorgement for violations of the Foreign Corrupt Practices Act ("FCPA") since 2004.

E. INJUNCTIONS. Many of the statutory schemes discussed in this Article permit government lawyers to seek injunctive relief against violation of statutes. The SEC routinely obtains agreed injuctions prohibition transgressors from continuing to violate Federal securities laws. Injunctions in private litigation in Texas courts against fiduciaries are governed by the Texas law of injunctions, Tex. Civ. Prac. & Rem. Code ch. 65. "Ordinarily, injunctive relief may only be granted upon a showing of (1) the existence of a wrongful act; (2) the existence of imminent harm; (3) the existence of irreparable injury; and (4) the absence of an adequate remedy at law." *Jim Rutherford Inv. v. Terramar Beach Com.*, 25 SW 3d 845, 849 (Tex. App.–Houston [14th dist.] 2000, pet. denied).

F. RECEIVER. To remedy a breach of trust that has or might occur, Tex Prop. Code § 114.008(a)(5) authorizes a court to appoint a receiver to take possession of trust property and administer an express trust. TBOC §§ 11.401-ff. govern the appointment of a receiver for a domestic or foreign entity. A receiver can be appointed for specific property of a domestic or foreign entity under Section 11.403, or to rehabilitate a domestic entity under Section 11.404, or to liquidate a domestic entity under Section 11.405. Under Section 11.404(a), a rehabilitative receiver can be appointed at the request of an owner or member due to insolvency, deadlock, acts by governing persons that are illegal or oppressive or fraudulent, or company property is being misapplied or wasted. Section 11.404(a)(1). Under Section 11.404(a)(2) a receiver can be appointed for a domestic entity at the request of a creditor who had a judgment that was unsatisfied upon execution, or where the entity is insolvent but admitted the claim. Section 11.404(a)(3) permits appointment of a receiver whenever courts of equity have appointed a receiver. TBOC § 11.404(a)(1) authorizes the appointment of a rehabilitative receiver for an entity at the request of a owner in the event of: insolvency; deadlock; illegal, oppressive, or fraudulent actions by controlling persons; or the property of the entity is being misapplied or wasted. TBOC § 11.404(a)(2) authorizes a rehabilitative receiver at the request of a creditor when the entity is insolvent, the claim of the creditor has been reduced to judgment, and an execution on the judgment was returned unsatisfied; or when the entity is insolvent and has admitted in writing that the claim of the creditor is due and owing. ourts of equity have traditionally appointed a receiver. TBOC § 11.404(a)(3) permits the appointment in other circumstances where courts of equity have traditonally appointed a receiver. Under TBOC § 11.404(b), the court an appoint a receiver only when necessary to conserve the business and avoid damage to interested parties, and all other legal requirements are met, and all other available legal and equitable remedies are inadquate.

G. CONSTRUCTIVE TRUST. “”Whenever the legal title to property is obtained through means or under circumstances 'which render it unconscientious for the holder of the legal title to retain and enjoy the beneficial interest, equity impresses a constructive trust on the property thus acquired in favor of the one who is truly and equitably entitled to the same, although he may never, perhaps, have had any legal estate therein; and a court of equity has jurisdiction to reach the property either in the hands of the original wrongdoer, or in the hands of any subsequent holder, until a purchaser of it in good faith and without notice acquires a higher right and takes the property relieved from the trust.'" *Moore v. Crawford*, 130 U. S. 122, 128 (1889) (quoting 2 J . Pomeroy, Equity Jurisprudence §1053, pp. 628–629

(1886))" "[I]t has long been settled that when a trustee in breach of his fiduciary duty to the beneficiaries transfers trust property to a third person, the third person takes the property subject to the trust, unless he has purchased the property for value and without notice of the fiduciary's breach of duty. The trustee or beneficiaries may then maintain an action for restitution of the property (if not already disposed of) or disgorgement of proceeds (if already disposed of), and disgorgement of the third person 's profits derived therefrom." *Harris Trust & Savings Bank v. Salomon Smith Barney, Inc.*, 520 U.S. 238 (2000). Under Tex Prop. Code § 114.008(a)(9), a court can impose a lien or constructive trust on property, or trace trust property that the trustee wrongfully disposed of.

"Constructive trusts, being remedial in character, have the very broad function of redressing wrong or unjust enrichment in keeping with basic principles of equity and justice.... Moreover, there is no unyielding formula to which a court of equity is bound in decreeing a constructive trust, since the equity of the transaction will shape the measure of relief granted." *Meadows v. Bierschwale*, 516 S.W.2d 125, 131 (Tex. 1974).

"Equity will impose a constructive trust to prevent one who obtains property by fraudulent means from being unjustly enriched. 1 SCOTT ON TRUSTS, § 44.1, p. 251. "It is not essential for the application of the constructive trust doctrine that a fiduciary relationship exist between the wrongdoer and the beneficial owner. Actual fraud, as well as breach of a confidential relationship, justifies the imposition of a constructive trust." M*eadows v. Bierschwale*, 516 S.W.2d 125, 128 (Tex. 1974). Any constructive trust that is imposed is limited to specifically traceable property. *Id.* at 129 ("a constructive trust on unidentifiable cash proceeds is inappropriate").

In *Mowbray v. Avery*, 76 S.W.3d 663, 681 n. 27 (Tex. App.--Corpus Christi 2002, pet. denied), the court said: "In order to be entitled to a constructive trust, Mack must prove the following elements: (1) Breach of an informal relationship of special trust or confidence arising prior to the transaction in question, or actual fraud; (2) Unjust enrichment of the wrongdoer; (3) Tracing to an identifiable res."

"A party seeking to impose a constructive trust has the initial burden of tracing funds to the specific property sought to be recovered.... Once that burden is met, 'the entire... property will be treated as subject to the trust, except in so far as the trustee may be able to distinguish and separate that which is his own.'" *Wilz v. Flournoy*, 228 S.W.3d 674, 676 (Tex. 2007); *In re Marriage of Harrison*, 310 S.W.3d 209, 212 (Tex. App.--Amarillo 2010, pet. denied) (tracing failed).

See David Dittforth, *The Texas Constructive Trust and Its Peculiar Requirements*, 50 TEX. TECH. L. REV. 447 (2017-18).

H. DERIVATIVE ACTIONS. In *Wingate v. Hajdik*, 795 S.W.2d 717, 719 (Tex. 1990). the Court said: "Ordinarily, the cause of action for injury to the property of a corporation, or the impairment or destruction of its business, is vested in the corporation, as distinguished from its stockholders, even though it may result indirectly in loss of earnings to the stockholders. Generally, the individual stockholders have no separate and independent right of action for injuries suffered by the corporation which merely result in the depreciation of the value of their stock. This rule is based on the principle that where such an injury occurs each shareholder suffers relatively in proportion to the number of shares he owns, and each will be made whole if the corporation obtains restitution or compensation from the wrongdoer. Such action must be brought by the corporation, not alone to avoid a multiplicity of suits by the various stockholders and to bar a subsequent suit by the corporation, but in order that the damages so recovered may be available for the payment of the corporation's creditors, and for proportional distributions to the stockholders as dividends, or for such other purposes as the directors may lawfully determine." (Citations omitted.) Where the claim belongs to the corporation, and the corporate managers will not pursue the claim, shareholders can seek to do so by bringing a derivative proceeding. Shareholder derivative proceedings are governed by TBOC §§ 21.551 et seq. These statutory provisions include a requirement to make demand on the corporation, discovery limited to independence and disinterestedness, good faith, and reasonableness, and dismissal if the court finds that the corporate managers decide in good faith, after reasonable inquiry, that continuing the proceeding is not in the best interest of the corporation. However, procedural barriers are relaxed for closely-held corporations. TBOC § 21.563.

I. PIERCING THE CORPORATE VEIL. "The corporate form normally insulates shareholders, officers, and directors from liability for corporate obligations; but when these individuals abuse the corporate privilege, courts will disregard the corporate fiction and hold them individually liable." *Castleberry v. Branscum*, 721 S.W.2d 270, 271 (Tex. 1986). One basis for disregarding the corporate entity is the equitable doctrine of "alter ego." "Alter ego applies when there is such unity between corporation and individual that the separateness of the corporation has ceased and holding only the corporation liable would result in injustice." *Id.* at 272. Alter ego is just one of several grounds to pierce the corporate veil. As noted in *Castleberry*: "[m]any Texas cases have blurred the distinction between alter ego and the other bases for disregarding the corporate fiction and treated alter ego as a synonym for the entire doctrine of disregarding the corporate fiction.... However, . . . alter ego is only one of the bases for disregarding the corporate fiction ...." *Id.* at 272. To quote *Castleberry* further: "We disregard the corporate fiction, even though corporate formalities have been observed and corporate and individual property have been kept separately, when the corporate form has been used as part of a basically unfair device to achieve an inequitable result." *Id.* at 271. Continuing from *Castleberry*:

> Specifically, we disregard the corporate fiction:
>
> (1) when the fiction is used as a means of perpetrating fraud;
> (2) where a corporation is organized and operated as a mere tool or business conduit of another corporation;
> (3) where the corporate fiction is resorted to as a means of evading an existing legal obligation;
> (4) where the corporate fiction is employed to achieve or perpetrate monopoly;
> (5) where the corporate fiction is used to circumvent a statute; and
> (6) where the corporate fiction is relied upon as a protection of crime or to justify wrong.

Id. at 272. [Footnotes omitted.]

A post-*Castleberry* statute, TBOC § 21.233, Limitation for Liability for Obligations, eliminated piercing for contractual obligations (subject to an exception), and eliminated piercing for any type of claim based upon the failure to observe a corporate formality. The statute recognizes an exception "if the obligee demonstrates that the holder, beneficial owner, subscriber, or affiliate 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 holder, beneficial owner, subscriber, or affiliate." The effect of this statute was two-fold. First, shareholders cannot be held liable for a corporation's contractual liabilities based on piercing the corporate veil, absent actual fraud. Second, the failure to observe corporate formalities is not a ground for making shareholders liable to corporate creditors. However, the statute recognizes an exception to the bar against piercing for contact claims where "the obligee demonstrates that the holder, beneficial owner, subscriber, or affiliate 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 holder, beneficial owner, subscriber, or affiliate." In effect, contract claimants can still pierce if they can prove actual fraud. Thus, *Castleberry*'s reliance on constructive fraud for piercing was undone as to contract claims, but contract claimants can still pierce for claims based on actual fraud, and tort claimants can continue to rely on actual or constructive fraud. Jury instructions and questions for piercing the corporate veil are set out at TEXAS PATTERN JURY CHARGES (BUSINESS, CONSUMER, INSURANCE, & EMPLOYMENT 2018) ch. 108.

An informative article on the subject of piercing the entity veil is Elizabeth S. Miller, *The Limits of Limited Liability: Veil Piercing and Other Bases of Personal Liability of Owners, Governing Persons, and Agents of Texas Business Entities*, State Bar of Texas 19th ANNUAL CHOICE, GOVERNANCE & ACQUISITION OF ENTITIES (May 21, 2021).[25]

Texas law also recognizes the remedy of "reverse piercing." As explained in *Chao v. Occupational Safety & Health Review Comm'n*, 401 F.3d 355, 364 (5th Cir. 2005):

> In the typical corporate veil piercing scenario, the corporate veil is pierced such that individual shareholders can be held liable for corporate acts. . . . Here, the purpose of piercing the corporate veils . . . would be to hold the corporations liable for the acts of their individual shareholder . . . Therefore, this case presents a "reverse corporate veil piercing" situation. . . . This slight variation is of no consequence, however, because the end result under both views is the same--"two separate entities merge into one for liability purposes." . . . If alter ego is shown, courts reverse pierce the corporate veil to treat the individual and the corporation as "one and the same."

However, reverse piercing is also recognized in Texas divorces, and its meaning is different in that context. See Section VI.I.5 below.

1. Disregarding Formalities. TBOC § 21.233 eliminated failure to observe corporate formalities as a ground for piercing the corporate veil.

2. Actual Fraud. The term "actual fraud" is not defined in TBOC § 21.223. In *Castleberry* the Supreme Court described actual fraud as "involv[ing] dishonesty or purpose or intent to deceive." *Id.* at 273. The fraud must relate to the transaction in issue. *Viajes Gerpa, S.A. v. Fazeli*, 522 S.W.3d 524, 533-35 (Tex. App.--Houston [14th Dist.] 2016, pet. denied) (an alter ego case). In *Stover v. ADM*

Milling Co., No. 05-17-00778-CV (Tex. App.–Dallas Dec. 28, 2018, pet. denied) (memo. op.), the court said: "In the context of piercing the corporate veil, ... actual fraud is not equivalent to the tort of fraud").

3. Direct Personal Benefit. A shareholder can be held liable for a corporate contractual obligation if s/he "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 holder." TBOC § 21.233(b). In *Hong v. Harvey*, 551 S.W.3d 875, 887 (Tex. App.–Houston [14th Dist.] 2018, no pet.) (finding no direct personal benefit), the court said: "In cases in which the direct personal benefit showing has been met, evidence showed that funds derived from the corporation's allegedly fraudulent conduct were pocketed by or diverted to the individual defendant.... In contrast, evidence showing that fraudulently procured funds were used to satisfy a corporation's financial obligations cuts against the notion that the fraud was perpetrated primarily for the direct personal benefit of an individual."

4. Constructive Fraud. TBOC § 21.233 eliminated constructive fraud as a ground to pierce the corporate veil based on *contract claims*, not tort claims or breach of fiduciary duty claims. Unfortunately, the PJC for Business litigation does not directly address piercing the corporate veil for constructive fraud. The TEXAS PATTERN JURY CHARGES (FAMILY LAW & PROBATE 2018) PJC 205.2 does offer a fraud instruction that includes constructive fraud: "'Fraud' is the breach of some legal or equitable duty that, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive others, to violate confidence, or to injure public interests." The Committee said that the instruction is based on *Castleberry*, 721 S.W.2d at 273.

5. Reverse Piercing. As a creditor's claim, piercing the corporate veil permits a third party to impose liability on shareholders, thereby ignoring the existence of the corporation as an entity separate from its owners. In a divorce situation, a spouse is aiming to get the court to ignore the existence of the corporation as an entity separate and apart from its owners, with the result that the assets that once belonged to the corporation are now considered to be assets owned by the shareholders (likely the opposing spouse). This is called "reverse piercing." TBOC § 21.233 is phrased in terms of when a shareholder can and cannot be held liable for corporation's debts and obligations. It therefore has no impact on a reverse-piecing claim. Reverse piercing in a divorce was discussed in *Boyo v. Boyo*, 196 S.W.3d 409, 419-20 (Tex. App.--Beaumont 2006, no pet.) ("Reverse piercing is sometimes used to characterize as part of a community estate what would otherwise be a corporate asset.... In the context of a divorce, the evidence must show not only that there is unity of the corporation and the spouse, but also that the spouse's improper use of the corporation has damaged the community estate, and the loss cannot be remedied by reimbursement."); *Lifshutz v. Lifshutz*, 61 S.W.3d 511, 516-18 (Tex. App.--San Antonio 2001, pet. denied) ("Thus to properly pierce in a divorce case, the trial court must find something more than mere dominance of the corporation by the spouse. At the least, a finding of alter ego sufficient to justify piercing in the divorce context requires the trial court to find: (1) unity between the separate property corporation and the spouse such that the separateness of the corporation has ceased to exist, and (2) the spouse's improper use of the corporation damaged the community estate beyond that which might be remedied by a claim for reimbursement." [Footnotes omitted]); *Zisblatt v. Zisblatt*, 693 S.W.2d 944, 952 (Tex. App.--Fort Worth 1985, writ dism'd). In *Southwest Livestock & Trucking Co. v. Dooley*, 884 S.W.2d 805, 810 (Tex. App.–San Antonio 1994, writ denied), the appellate court refused wife's effort to apply the doctrine of piercing the corporate veil where the wife had unclean hands because she participated in and benefitted from the very acts upon which she based her piercing claim.

6. LLCs. TBOC § 101.002 extends the protection of TBOC § 21.233 to LLCs and their members, owners, etc. In *Walden v. Walden*, No. 03-09-00576-CV (Tex. App.--Austin March 16, 2012, pet. denied), the appellate court applied the standards for piercing the entity veil to an LLC. *Accord*, *McCarthy v. Wani Venture, A.S.*, 251 S.W.3d 573, 591 (Tex. App.--Houston [1st Dist.] 2007, pet. denied) (allowing piercing of LLC veil, saying "Texas courts and other jurisdictions, have applied to LLCs the same state law principles for piercing the corporate veil that they have applied to corporations"). Note that the TBOC provision does not protect against reverse-piercing claims such as would be asserted in a divorce. For background, see Natalie Smeltzer, *Piercing the Veil of a Texas Limited Liability Company: How Limited is Member Liability?*, 61 S.M.U. L. REV. 1663 (2008).

7. Limited Partnerships. "Texas courts have uniformly declined to apply the alter-ego theory to pierce a limited partnership's 'veil' to impose the entity's liabilities on a limited partner. The need for any equitable veil-piercing doctrine is fundamentally dubious as applied to the liabilities of a limited partnership. Unlike a person doing business with a corporation, a person doing business with a limited partnership always has recourse against any general partner in the same manner as partners are liable for the liabilities of a partnership without limited Partners." *Peterson Group, Inc. v. PLTQ Lotus Group*, 417 S.W.3d 46, 56 (Tex. App.–Houson [1st Dist.] 2013, pet. denied) (footnote omitted). In the divorce context, the appellate court in *Lifshutz v. Lifshutz*, 61 S.W.3d 511, 518 (Tex. App.--San Antonio 2001, pet. denied), held that the doctrine of piercing the veil did not apply to partnerships. *Accord*, *Pinebrook Properties, Ltd. v. Brookhaven Lake Property Owners Association*, 77 S.W.3d 487 (Tex. App.--Texarkana 2002, pet. denied) ("The theory of alter ego, or piercing the corporate veil, is inapplicable to partnerships").

8. Single Business Enterprise Theory. Under the "single business enterprise" doctrine, when separate corporations are not operated as separate entities, but instead integrate their resources to achieve a common business purpose, each constituent corporation can be held liable for the debts incurred in pursuit of that business purpose. *Paramount Petroleum Corp. v. Taylor Rental Ctr.*, 712 S.W.2d 534, 536 (Tex. App.--Houston [14th Dist.] 1986, writ ref'd n.r.e.); *Hideca Petroleum Corp. v. Tampimex Oil Int'', Ltd.*, 740 S.W.2d 838, 844 (Tex. App.--Houston [1st Dist.] 1987, no writ). The single business enterprise doctrine was rejected in *SSP Partners v. Gladstrong Inv.(USA)*, 275 SW 3d 444, 456 (Tex. 2008), as an alternative route to piercing the corporate veil.

J. NON-DISCHARGE IN BANKRUPTCY. Section 523(a)(2) of the Bankruptcy Code denies a discharge for any debt for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by (A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition, or (B) by use of a statement in writing that is materially false, regarding the debtor's or an insider's financial condition, on which the creditor reasonably relied, and which was published with the intent to deceive. Section 523(a)(4) excepts from discharge any debts incurred due to "fraud or defalcation while acting in a fiduciary capacity." 11 U.S.C. § 523(a)(4). Federal courts have ruled that the definition of fiduciary under the statute is a question of Federal law.

1. Fraud or Defalcation. The Section 523(a)(4) exception to dischargeability requires that the debt must have committed fraud or defalcation. What constitutes fraud and defalcation is a matter of state law. The elements of fraud under Texas law are discussed in Section V.A. "Defalcation" is not well-defined in Texas case law. Where the fraud or defalcation has been litigated in state court, a bankruptcy court is not bound by the terms of a state court judgment. *Brown v. Felsen*, 442 U.S. 127, 138 (1979). However, the state's doctrine of res judicata or collateral estoppel can be applied by the bankruptcy court. *Whitaker v. Moroney Farms Homeowners' Ass'n (In re Whitaker)*, No. 15-40926, * 3, 2016 U.S. App. LEXIS 5018 (5th Cir. March 18, 2016). In *Smith v. Saden*, No. 10-35051, 2016 Bankr. LEXIS 877 (S.D. Tex. Bankr. March 7, 2016), a plaintiff obtained a state court judgment against a defendant for breach of fiduciary duty and disgorgement. However, the plaintiff did not secure a jury finding of fraud or defalcation, so the exception to discharge was not determined by the state court judgment.

2. Fiduciary Capacity. Federal law governs what constitutes a fiduciary capacity for purposes of Section 523(a)(4). *Grogan v. Garner*, 498 U.S. 279, 284 (1991). There is a long history of this fiduciary-related exception to discharge in the succession of U.S. bankruptcy statutes. In *Chapman v. Forsyth*, 43 U.S. 202, 208 (1844), the Supreme Court limited fiduciary non-dischargeability under the Bankruptcy Act of 1841 to public officers, executors, administrators, guardians, trustees, and other "technical trusts." In *Upshur v. Briscoe*, 138 U.S. 365, 377-78 (1890), the Supreme Court held that the Bankruptcy Act of 1867 required the existence of a fiduciary capacity prior to and unrelated to the debt to be discharged. In *Davis v. Aetna Acceptance Co.*, 293 U.S. 328 (1934), Justice Cardozo wrote that the fiduciary relationship must predate the wrongful act, and not arise out of it. In modern times, some lower Federal courts have held that the term fiduciary capacity as used in the Bankruptcy Code includes only a trustee of an express trust. In *Matter of Cantrell*, 88 F.3d 344, 347 (5th Cir. 1996), the court held that "in the absence of an express trust and a recognizable corpus, 11 U.S.C. § 523(a)(4) is inapplicable." In *In re Welch*, 211 B.R. 788, 797 (Bankr. D. Conn. 1997), the court said: "It is generally accepted among courts of appeals that an express or technical trust must be present for a fiduciary relationship to exist, rather than 'a general fiduciary duty of confidence, trust, loyalty and good faith,' or 'an inequality between the parties' knowledge or bargaining power.'" Another Bankruptcy Court said that "[t]he term 'fiduciary' as used in section 523(a)(4) is restricted to 'the class of fiduciaries including trustees of specific written declarations of trust, guardians, administrators, executors or public officers and, absent special considerations, does not extend to the more general class of fiduciaries such as agents, bailees, brokers, factors, and partners.'" *In re Venable*, No. 00-6044W, 2002 WL 523908, at *3 (Bankr. M.D. N.C. Mar. 26, 2002). Thus, there seems to be agreement that a constructive trust does not lead to non-dischargeability. But the extent to which informal fiduciary relationships trigger non-dischargeability remains unclear. A good analysis of the confusion is set out in *Angelle v. Reed (In re Angelle)*, 610 F.2d 1335, 1338-39 (5th Cir. 1980).

VII. DIVIDING ENTITIES UPON DIVORCE. This Section of the Article discusses issues for divorcing spouses and the court to consider in dividing a business interest in a divorce.

A. OPTIONS FOR THE COURT IN THE PROPERTY DIVISION. Six options for the parties or the divorce court are discussed below.

1. Leaving/Make the Spouses Co-Owners of the Entity. If the spouses are already named co-owners of the business the divorce court can leave them as co-owners. If ownership is in the name of one spouse alone, awarding the non-named spouse an ownership interest in the business can encounter problems, but they may be surmountable.

a. Transfer Restrictions. There are no prohibitions in the Texas Business Organizations Code (TBOC) against transferring an ownership interest in a business entity to a spouse in a divorce, except for licensed professions (law, medicine, etc.). However, under the TBOC, the spouse of an LLC member or a partner can receive only an assignee's or transferee's interest in the LLC or partnership, which entitles the transferee to receive her share of future distributions, but only limited access to financial information and no management rights, and no right to force distributions. TBOC § 101.1115 (LLC) & § 152.406 (partnership).

Entities can restrict the transfer of ownership interests in their governing documents. Additionally, owners can enter into a buy-sell agreement giving the entity and non-transferring owners the option to purchase the departing spouse's interest. These buy-sell agreements usually are one of the following:

• a right-of-first-refusal to buy the interest on the same terms offered by a third party;
• a set figure (like $X per share);
• a formula (e.g., book value plus % pf net receivables but not goodwill);
• fair market value or fair value (determined by agreement, court, or arbitration);
• averaged appraised value (1, 2, or 3 appraisers).

Where the buy-sell provision is triggered upon divorce only when the non-owning spouse ends up with an ownership interest in the business, the parties or court can trigger or avoid triggering the buy-sell option by transferring or not transferring an ownership interest to the non-owning spouse. To avoid the trigger while still having co-ownership, the owner spouse would have to make a transfer that is approved in the buy-sell agreement (like a transfer into trust for the benefit of a spouse prior to divorce), or appoint the owning spouse as trustee to hold the non-owning spouse's share for her benefit. If a trust relationship is set up, the divorce settlement can let the law of express trusts define the fiduciary obligations of the owner-spouse, or specific fiduciary duties can be negotiated between the husband and the wife and put in writing.

Leaving the ex-spouses as co-owners avoids the need to value the business, but it can create problems after the divorce. If ex-spouses have equal control, an impasse can develop that may trigger lawsuits or require a court-appointed receiver. If one ex-spouse has exclusive control, there can be actual or perceived minority oppression leading to a suit for breach of an accounting, breach of fiduciary duty to the entity, breach of contract, fraud and constructive fraud, conversion, fraudulent transfer, conspiracy, unjust enrichment, or quantum meruit (but not minority oppression). *Ritchie v. Rupe*, 443 S.W.3d 856, 882, 885 (Tex. 2014). It may be difficult to establish an informal fiduciary duty owed by the controlling ex-spouse to the non-controlling ex-spouse, in light of the termination of the spousal fiduciary duty by virtue of the divorce. Even the controlling ex-spouse can dislike having to deal with an unhappy minority owner causing trouble. If there are other owners, splitting the community property interest may cause both ex-spouses to lose voting control, or one ex-spouse turn against the ex-spouse and join other minority owners in a voting block to create a new majority.

b. Phantom Income. If the entity is a pass-through entity for tax purposes, it is important that the non-controlling but co-owning spouse does not have to report tax on undistributed phantom income. The non-controlling spouse cannot avoid the obligation to report tax, but the entity could guarantee to distribute enough money to pay the tax on pass-through income. Or an entity can elect to be taxed as a C Corporation (IRS Form 8832), where the owners are taxed only on income that is distributed. Or a pass-through entity can be converted to a C Corporation.

c. Capital Calls. Under TBOC § 153.254, an assignee of a limited partner interest is not liable to fulfill capital calls unless the assignee becomes a limited partner. If the assignee spouse does not have the wherewithal to meet future capital calls, the capable spouse can advance the money for the capital call subject to later repayment, or the advancement of capital calls can dilute ownership in favor of the spouse covering the call.

2. Award Entity to One Spouse. The spouses or the divorce court can award the business to one spouse and award offsetting cash or property, or a promissory note or judgment, to the other spouse. This requires the entity to be valued. Because Internal Revenue Code § 1041 precludes the recognition of gain upon a transfer between spouses incident to divorce (see Section IX below), the capital gain tax and costs of sale upon ultimate sale of the business will fall entirely on the spouse who receives the business in the divorce. Thus, the net-after-closing-costs and net-after-tax analysis may cause a spouse to be unwilling to take the business unless an adjustment is made for the present value of projected future costs of sale and taxes.

If there is not enough other money/assets to offset half the value of the business, then the buying spouse will have to make payments over time to the selling spouse. This creates a debtor/creditor relationship between ex-spouses, with its attendant rules. An interest rate needs to be determined, and it should be (but often is not) commensurate with risk of non-collection, which would be higher than the prime rate and perhaps even higher than the prevailing commercial loan rate. A further upward adjustment of the interest rate would be warranted if the selling spouse has to take a second lien position behind other creditors as to some or all of the business's assets. There is also the sometimes thorny question of whether the debt should be reflected by a promissory note or a judgment. A promissory note in default must be reduced to judgment before it becomes enforceable, although it may be susceptible to a motion for summary judgment. A judgment can be enforced directly, without an intervening lawsuit. Enforcement procedures on the judgment can be suspended while payments are kept current and collateral is not compromised. Some business owners, however, may believe that the ability to get credit, etc. is impaired more by a judgment than by a promissory note. Then there is the issue of collateral or security for the debt, including personal guarantees of entity debt, the perfecting of liens and security interests, and liens in non-business assets. Also to be considered is the availability of a Texas Family Code ch. 9 post-divorce enforcement proceeding, and non-dischargeability in bankruptcy (as a domestic support obligation under 11 U.S.C. § 101(14a) or non-dischargeable debt under § 523(a)(15)). In an agreed-upon property division, the terms of sale can include an earn-out provision based on performance of the business after the divorce, and an earn-out can sometimes be used to circumvent a valuation dispute. There is no case law on whether a court can include an earn-out provision in a contested divorce decree. Earn-outs must be carefully crafted so that the metrics are not susceptible to manipulation by the business owner (for example, use gross revenue rather than net profit, or prohibit raising salaries or declaring bonuses as a way to reduce profits). And the departing spouse needs to have the ability to verify that the business is reporting information accurately. The Court must consider the effect of transfer restriction or buy-sell agreement if both spouses are owners at the time of divorce and the transfer of one spouse's ownership interest to the other spouse will trigger a buy-sell agreement.

3. Sell the Entity and Divide the Proceeds. The spouses can agree or the divorce court can order that the business be sold. *In re Marriage of A.W.E. & D.M.F.N.*, No. 05-19-01303-CV (Tex. App.–Dallas March 4, 2021, no pet.) (mem. op.) ("To the extent Wife argues Texas law does not allow the trial court in the divorce decree to order the sale of a community asset, Wife is mistaken. The trial court in a divorce proceeding has authority to order the sale of a community asset the court determines is not subject to partition in kind.") Selling the business avoids having to value the business in the divorce, since the sales price is by definition Fair Market Value (willing buyer/willing seller). However, dissension between the ex-spouses can scare off legitimate buyers, leaving only "vultures" looking for a bargain. If a receiver is appointed, it adds to the costs of sale. The receiver may reduce the price for a quick sale for cash, when a longer period of marketing or more strenuous negotiations might lead to a higher sales price or better terms of sale, including earnout payments. Sale of a partial interest is not feasible if there are other owners or transfer or buy-sell restrictions (unless the entity or the other owners agree to buy out the departing spouse). Neither spouse can be required to sign a covenant not to compete, which will chase off buyers or depress the sales price. If a covenant not to compete will be signed by one or both spouses, how much of the sale proceeds will be allocated to each covenant? Will the spouse be able to keep the amount paid for the covenant as his/her separate property? How does it affect the division of the sales proceeds if one or both spouses are required to work for the business for a period of time after the sale? If the ex-spouses disagree on these issues, what court has jurisdiction to can decide the question, or must the parties agree at the time of divorce to arbitrate such disputes?

4. Transfer Assets From Inside Entity to a Spouse. The TBOC is clear: assets of an entity do not belong to the owners of the entity. The spouses can agree to use cash or assets inside the entity to redeem the departing spouse's interest in the business. Doing so requires the consent of the entity, or reverse-piercing of the entity veil, or imposing a resulting or constructive trust which removes assets from the entity. The redemption will be taxed either as a dividend to the remaining spouse or capital gain to the departing spouse. There are also so-called "Hot Assets" inside an S Corporation or partnership that can be taxed at ordinary tax rates if they are distributed.

If the entity veil is pierced generally, the assets become owned by the spouses and are subject to division. If the entity veil is pierced only as to one or a few assets, then those assets become marital property to the extent of the spouse's ownership interest in the business. To pierce, does the entity have to be joined as a party? "Yes," if an asset is going to be pulled out of the entity and into the marital estate, the entity must be made a party to the divorce. But if the design is to seek a finding of alter ego for purposes of the divorce, but leave the assets intact, and just award offsetting assets or a money judgment to the other spouse, ownership of the entity's assets are not put in jeopardy so (probably) the entity need not be a party.

What do you do about a spouse retaining earnings inside a separate property entity? Retained earnings inside an entity are not marital property; they belong to the entity. *Thomas v. Thomas*, 738 S.W.2d 342, 344 (Tex. App.--Houston [1st Dist.] 1987, writ denied). When a spouse is allegedly bottling up earnings so that they do not become community property upon distribution, does the other spouse have a remedy? There is no case law on this point. In the Author's experience, family lawyers allege fraud, constructive fraud, and breach of fiduciary duty, and see where that leads. Another angle is to ask whether the owner-spouse contributed community labor that enhanced the value of the separate property entity, and if so, whether the community estate was adequately compensated. If not, a claim for reimbursement for under-compensation arises. Tex. Fam. Code § 3.402(a)(2); *Jensen v. Jensen*, 665 S.W.2d 107 (Tex. 1984). Also, the Court can also take such behavior into consideration in making a disproportionate division of the community estate.

5. Subdivide the Entity and Award Part to Each Spouse. The parties can subdivide an entity and award a portion to each spouse. (A divorce court would not have this power absent consent or reverse-piercing). An entity can be converted to one or more C Corporations, S Corporations, LLC's, or partnerships, with component parts awarded to each spouse. A corporation can have a spin-off, split-off, or split-up. In Texas, a merger can be a joinder of two or more corporations. It can also be a "divisive merger," where a corporation is split into two or more corporations. TBOC §1.002(55)(A). A divisive merger is the opposite of traditional merger; instead one entity divides into multiple entities; the dividing entity is not required to terminate, and may be one of surviving entities; assets and liabilities of the dividing entity are allocated among new entities formed; a divisive merger is NOT considered to be an assignment or transfer under Texas or Delaware state law; may be used to avoid transfer restrictions; this requires filings with Sec'y of State; and may trigger tax issues.

VIII. TAX ASPECTS OF THE PROPERTY DIVISION. While the tax aspects of a divorce are not necessarily complicated, they can become very complicated when the divorce involves business entities.

A. INTERNAL REVENUE CODE § 1041. Internal Revenue Code (IRC) Section 1041 precludes capital gain tax recognition for interspousal transfers, including transfers incident to divorce. IRC § 1041 does not recognize a capital gain where a spouse conveys an interest in property to the other spouse incident to divorce (within one year of cessation of marriage or related to cessation; presumption of unrelated if more than six years after divorce). However, if the spouses want to use entity money or property to redeem a spouse's interest in the entity, it will require a distribution of that property from the entity, and that distribution is subject to income taxation. Section 1041 does not apply where one spouse is a non-resident non-citizen.

B. TAX ASPECTS OF ACQUISITION, REDEMPTION, OR LIQUIDATION. If one spouse acquires the other spouse's interest incident to divorce, IRC § 1041 precludes capital gain recognition. The existing tax basis is carried forward. A capital gain tax is levied on the amount paid to the parting spouse after subtracting the departing spouse's tax basis in the entity; a dividend tax is levied on 100% of the amount distributed. A capital gain can be reported on an installment basis over a period of months or years, while a dividend must be reported in the year in which it was paid. If the entity acquires the interest, it is a redemption, and the Treasury Regs. under IRC § 1041 permit the spouses to choose between a capital gain to the departing spouse or a constructive dividend to the remaining spouse. It can be complicated if you don't make a § 1041 election. If the spouses do not elect, then whether IRC § 1041 applies depends on whether the entity assumed an obligation of the remaining spouse to buy-out the departing spouse. If other owners acquire the departing spouse's interest, it is not clear whether IRC § 1041 protects against capital gain recognition.

C. THE ASSIGNMENT OF INCOME DOCTRINE. The Assignment of Income Doctrine announced in *Lucas v. Earle*, 281 U.S. 111 (1930), provides that income from services is taxed to the party who performed the services, regardless of who receives the income. In *Kochansky v. Commissioner*, 92 F.3d 957 (9th Cir. 1996), a contingent fee earned by a lawyer in a community property state, half of which was awarded to his spouse in the divorce, was taxable entirely to the lawyer. Rev. Rul. 2002-22 recognized that Section 1041 exempts vested nonstatutory stock options from the Assignment of Income Doctrine. However, the ruling does not apply to unvested stock option or options that are subject to substantial contingencies at the time of transfer. The take-away is to allocate the tax burden explicitly in the settlement agreement or decree, to avoid guesswork. That leads to a question of whose tax rate to apply in determining the tax on the income when received, and whether the assignee trusts the assignor to pay over the net income, or the assignor trusts the assignee to pay the tax on the income received by the assignee.

E N D

Endnotes

1. *Code of Ethics and Minimum Standards for Guardianship Services* <https://www.txcourts.gov/media/1401036/Code-of-Ethics-and-Order-GC-Final-2016.pdf> [10-27-2020].

2. *Code of Ethics and Minimum Standards for Guardianship Services* <https://www.txcourts.gov/media/1401036/Code-of-Ethics-and-Order-GC-Final-2016.pdf> [10-27-2020].

3. Robert W. Calvert was born in Tennessee, the son of a sharecropper. His father died and his mother placed him in an orphanage in Texas where he grew to maturity. He graduated from the University of Texas Law School in 1931. He was a district attorney, a state representative, and Speaker of the Texas House of Representatives. He was elected to the Supreme Court in 1961, then served as Chief Justice from 1961 until 1972. Ruel Walter was born in Texas, graduated from UT Law, He served on the Texas Supreme Court from 1954 until 1976. Zollie Steakley was born in Texas, graduated from UT Law, served as Secretary of State, and joined the Supreme Court in 1961 to fill Robert Calvert's empty associate justice seat, where he served until 1981.

4. Benjamin N. Cardozo's series of lectures were published as THE NATURE OF THE JUDICIAL PROCESS (Yale University Press, 1921).

5. *FDIC, Trust Examination Manual* <https://www.fdic.gov/regulations/examinations/trustmanual/index.html> [11-22-2020].

6. *Texas Center for Legal Ethics Portal to Texas Disciplinary Rules of Professional Conduct* <https://www.legalethicstexas.com/Ethics-Resources/Rules/Texas-Disciplinary-Rules-of-Professional-Conduct>

7. *Code of Ethics and Minimum Standards for Guardianship Services* <https://www.txcourts.gov/media/1401036/Code-of-Ethics-and-Order-GC-Final-2016.pdf> [10-27-2020].

8. Good faith in worker's compensation situations under *Arnada* is discussed in David Brenner, *The Duty of Good Faith and Fair Dealing in Workers' Compensation Claims*, in the State Bar of Texas' ADVANCED WORKERS' COMPENSATION COURSE, ch. 14 (2005). The Supreme Court felt satisfied with legislative improvements to the Workers' Compensation Act and overruled *Aranda* in *Texas Mut. Ins. Co. v. Ruttiger*, 381 S.W.3d 430, 446 (Tex. 2012).

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