



Steven P. Watten
Strasburger & Price, LLP
2801 Network Boulevard
Suite 600
Frisco, TX 75034
(469) 287-3939
Steve.Watten@strasburger.com
[vCard](#)
[Bio](#)
[Website](#)

[LinkedIn](#)
[Twitter](#)
[Blog](#)
[JD Supra](#)

Partnerships and LLCs

Fiduciary Duties, Exculpation, and Indemnification in Texas Business Organizations

DUTIES

An overview:

- Partners in both general partnerships and limited partnerships have duties at law to the partnership and other partners.
- The trend in partnership cases is for the courts to discuss duties of partners in terms of fiduciary duties or fiduciary like duties.
- The most recent bankruptcy cases have used fiduciary language to be able to refuse to discharge obligations of the debtor.
- The LLC statutory provisions do not provide that managers and managing members of LLCs have defined duties to the LLC or to the other members. No case to date has found that there are informal fiduciary duties owed by managers or managing members to members or between members.
- To date no bankruptcy case has attempted to analyze the matter of discharge of an obligation which arose out of a breach of fiduciary duty.
- Governing persons, officers and agents of LLCs are designated as agents of the LLC (BOC § 101.254). See generally Restatement (Third) of Agency for sections dealing with an agent's duties of loyalty and performance.

PARTNER DUTIES

- Where did Fiduciary Duties originate?
- 1914 UPA Sec. 21, "Partner Accountable as Fiduciary."
- 1928 Justice Cardozo defined "Fiduciary":
 - "Many forms of conduct permissible in a workaday world for those acting at arms length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive is

then the standard of behavior.”

- “Punctilio of honor, or the highest standard of honor, is the term used to describe the level of scrupulousness that a fiduciary must abide by.”
- Texas cases defined “fiduciary duties” – primarily loyalty cases rather than care cases – Courts used term “ Trustee” to mean partner
- 1994 UPA Section 4.04 was amendment to:
 - Partners -- duty of care and duty of loyalty; “Fiduciary” not used – provided that partners were not “trustees”
 - Permitted modifications of duties so long as restriction was not manifestly unreasonable;
 - Defined the standards of discharging duties, in good faith and in a manner partner reasonably believes to be in the best interest of the partnership.
- BOC effective 2006; Sections 152.204 through 152.207 carry forward the definitions and performance standards of TRP Section 4.04.
- The BOC broke up Section 4.04 into 4 sections:

152.204 General Standards of Partner’s Conduct
152.205 Partner’s Duty of Loyalty;
152.206 Partner’s Duty of Care;
152.207 Standards of Conduct Applicable to Person Winding Up Partnership Business.
- General Standards of Partner’s Conduct
 - (BOC § 152.204)
- A partner owes to partnership and the partners two duties: loyalty and care.
- A partner shall discharge its duties to partnership and partners under the Code, the agreement and exercise any rights and powers in (1) good faith and (2) in a manner partner reasonably believes to be in the best interest of partnership.

- Duty of Care (BOC § 152.206)
 - “A partner’s duty of care to the partnership and partners is to act in the conduct ... of ... partnership business with the care an ordinarily prudent person would exercise in similar circumstances.”
 - “A partner is presumed to satisfy the duty of care if the partner acts on an informed basis and in compliance with BOC §152.204 (b).
 - BOC §152.206(b) provides that an error in judgment does not by itself constitute a breach of the duty of care.
 - The unanswered question: what level of misconduct does it take to be held liable for breach of the duty of care? This question is not answered in the TRPA, nor in the BOC, nor has it been answered by case law.
- Duty of Loyalty
 - BOC § 152.205 defines the duty of loyalty:
 - 1) account to the partnership and hold for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business or from use of partnership property;
 - 2) refrain from dealing with the partnership on behalf of a party having an interest adverse to the partnership;
 - 3) refrain from competing with the partnership or dealing with the partnership in a manner adverse to the partnership.
 - The BOC specifically provides that a partner does not breach a duty merely because his conduct furthers his own interest and that a partner is not a trustee and should not be held to a trustee standard. See BOC §152.204(c) and (d)
- Obligation of Good Faith
 - BOC § 152.204(b) requires a partner to discharge its duties in “good faith and in a manner the partner reasonably believes to be in the best interest of the partnership.” The standard for discharge of the duty in good faith is not a

separate duty, but a standard of conduct when discharging the duty.

- Duty to Disclose, Render Information
 - BOC § 152.213(a) requires that partners be furnished complete and accurate information on request.
 - Partnership cases have traditionally imposed upon partners a duty to disclose in certain circumstances, such as when a partner is purchasing the partnership interest of a fellow partner.
- Limited Partnerships
 - General Partner Duties
 - BOC § 153.152 defines the rights and powers (subject to restrictions) and the liabilities of a general partner as those of a partner in a partnership without limited partners. BOC § 153.003 provides a linkage back to Chapter 152 for matters not provided for in Chapter 153.
 - General partner owes duties of loyalty and care to limited partnership and to limited partners. Not a “trustee.” But courts seem to ignore the “not a trustee” language in Chapter 152, and persist in analogizing general partners to “trustee.”
 - Note that a partner or a general partner in the case of a limited partnership may, in good faith and with ordinary care, rely on information, options, reports, or statements of specified persons when discharging a duty.
 - Limited Partner Duties
 - Confusion: Chapter 153 links to Chapter 152 by reason of BOC § 153.003 and Chapter 1 defines “partner” to include both general and limited partners. Who is the “partner” . Remedial work required!
 - BOC § 153.003(b) and (c) were added to clarify that limited partners are not subject to the duties of a general partner based solely on the limited partner’s status as a limited partner.

- Let's pause here and evaluate the impact of the 1994 amendments --- have Courts followed the TRPA revisions?
- Both the Federal Courts and the Texas Courts have had trouble adopting the narrowing of fiduciary duties as presented in TRPA.
- Seven cases are discussed:
 - See *Ingram v. Deere*, 288 SW3d 886 (Tex 2009) where the TX Sup Court in footnote 1 characterized TRPA Section 4.04 as “recognizing the [un]waivable duties of care and loyalty and the obligation of good faith required of partners” and cited *Bohatch v. Butler & Binion*, 977 SW2d 543 (Tex 1998) for the proposition that the Texas recognizes as a matter of common law that “the relationship between ***partners *** is fiduciary in character.” In *Ingram* the court found a lack of evidence that the parties were partners in the first place.
 - In *re Gupta*, 394 F.3d 347 (5th Cir. 2004) is a case in which federal district court had, based on a Texas court decision, held that a money judgment against a chapter 7 debtor for breach of fiduciary duty was excepted from discharge under section 523(a) of the Bankruptcy Code. The 5th Circuit took note that “Texas partnership law was significantly amended in 1994**” The Court says “this is not to say that Texas partners no longer owe special duties to each other. *** Under these provisions, certain duties that partners owe to each other may rise to the level of a “fiduciary” for purposes of Section 523(a)(4).
 - In *re Leal*, 360 B.R. 231, 235 (Bankr. S.D. 2007) the court, notwithstanding the language of TRPA §4.04, redefined the duties of partners and called them fiduciary duties, including a duty of care and loyalty. The court then split partnership opportunity away from the duty of loyalty and added as separate duties a “strict duty of good faith and candor.” The court concluded “Thus, the partnership relation imposes upon all partners an obligation of the utmost good faith, fairness and honesty in their dealing with each other with respect to ... partnership business.”

- In re Houston Drywall, 2008 WL 2754526 (Bankr. S.D. Tex 2008): the court stated: “[i]n Texas, it is axiomatic that a partner owes a fiduciary duty to the other partners ...” citing BOC § 152.205 and Texas case law, and that [i]n limited partnerships, Texas courts have analogized the fiduciary duty owed by a general partner to a limited partner to the relationship between trustee and beneficiary.”
- A fiduciary duty requires an agent to exercise ‘the most perfect loyalty and the utmost good faith, the strictest integrity, and the fairest dealing on the part of the agent to his principle. *** In limited partnerships, Texas courts have analogized the fiduciary duty owed by a general partner to a limited partner to the relationship between trustee and beneficiary.” page 31
- Zinda v. McCann Street Ltd., 178 S.W.3d 883, 890 (Tex.App. 2005), the court held that “[t]he relationship among the various parties was a partnership; thus, the appellees owed fiduciary duties to Zinda. Partners have a duty to one another to make full disclosure of all matters affecting the partnership and to account for all partnership profits and property.” The appellees and Zinda were all limited partners in the McCann Street Ltd., a limited partnership. The court ultimately found that the duties had been discharged.
- In McBeth v. Carpenter, 565 F.3d 171 (5th Cir.2009), the 5th Circuit said “under Texas law, managing partners owe trust obligations to the partnership, having a duty of loyalty and due care as well as being under an obligation to discharge their duties in good faith and in the reasonable belief that they are acting in the best interest of the partnership. *** Texas courts have long held that ‘[i]t is axiomatic that a managing partner in a general partnership, owes his co-partners the highest fiduciary duty recognized in the law.’ *** it is clear that the issue of control has always been the critical fact looked to by the courts in imposing this high level of responsibility.’

- “More specifically, in determining the liability of limited

partners to other limited partners, Texas courts have applied the general principles of partnership noting that partners have a duty to one another to make full disclosure of all matters affecting the partnership and to account for all partnership profits and property. Citing *Zinda v. McCann St. Ltd*, 178 SW3d 883 (Tex.App.2005)

- One last partnership case: In re Robert Warren Jones, 2011 WL 479063 (Bkrcty. ND. Tex) Feb, 2011;
- The case involved the bankruptcy of Jones who was the president, director and 51% owner of Beaute Management, Inc. which was in turn the general partner of Simple Beaute, Ltd., a Texas limited partnership formed in 2001. One of the plaintiffs was Tiffany Mullen (Mullen) who was a 38.61% limited partner of Simple Beaute Ltd.. Mullen argued that Mr. Jones should be denied his general discharge pursuant to Section 727(a)(2) of the Bankruptcy Code (Code).
- The court found that Jones owed a direct duty to Mullen using fiduciary duty theory and was liable in damages.
- The court came to this conclusion based on the following.
 - The court held that the same level of fiduciary duty should apply to a managing partner of a managing partner, since the line of cases that hold that the a managing partner of a partnership owes to the partners the highest fiduciary obligation known at law makes clear that the issue of control is critical fact looked to by the courts in imposing this level of responsibility.
 - Moreover, one is acting in a “fiduciary capacity” when “the business which he transacts, or the money or property which he transacts, or the money or property which he handles is not his own or for his benefit, but for the benefit of another person, as to whom he stands in a relation implying or necessitating great confidence and trust implying or necessitating great confidence and trust on the one part and a high degree of good faith on the other party.

- The court discusses *In re Gupta*, 394 F.3d 347 (2004). In *Gupta*, the 5th Circuit did not tackle the meaning or the ramifications of the new Tx partnership law, for purposes of “fiduciary capacity” of partners and Section 523(a)(4). The 5th circuit merely noted that partners still owe special duties to each other”; certain duties that partners owe to each other may rise to the level of a fiduciary for purpose of 5239a(4); and it would appear that, at least as to the duty to account for money owed to the partnership, a partner’s duty to account may constitute a pre-existing , express or technical trust and analogous to those of the corporate officers in *Davis and Moreno*.

MEMBER DUTIES

Limited Liability Companies

- BOC
 - BOC does not define or impose fiduciary duties on managers or managing members of an LLC.
 - However, BOC § 3.102 permits governing persons “in discharging a duty or exercising a power, ... [to], in good faith and with ordinary care, rely on” various types of information presented by the listed parties.
 - BOC § 1.002(37): “Governing person” -- a person serving as part of the governing authority of an entity.”
 - BOC § 1.002(35)(A) “Governing authority means a person... entitled to manage and direct the affairs of an entity under this code and the governing documents ...” It includes “(iii) the managers of a [LLC] that is managed by managers;.”
 - BOC § 3.105 permits officers of a domestic entity to in good faith and with ordinary care, rely on” various types of information presented by the listed parties.
 - BOC §§: 101.401, 101.402 and 101.052, permit the company agreement of an LLC 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.”

- These provisions, at the very least, imply that the managers or member managers owe a duty or duties of some nature to the LLC and, possibly, to its members.
- It should be noted that the duties of corporate officers and directors to the corporation and to the shareholders are not defined in the BOC, but are based in common law with the BOC permitting certain actions by officers and directors of corporations to be made in reliance upon certain information derived from specified persons.
- Assuming that similar public policy considerations should apply to LLCs that in the first place applied to both corporations and partnerships, LLC managers and managing members owe duties to at least the LLC, and probably to the members.
- Case Law
 - As of this date, no Texas case has held that there is a fiduciary duty running from the Managers to the LLC or to the Members, nor has a Texas case held that there is a fiduciary duty running from the managing members to the LLC or to the other members.
 - For further discussion of fiduciary duties in LLCs see William P. Bowers, George W. Coleman and Patrick L. O’Daniel, *Texas Limited Liability Companies Under the Business Organizations Code* , Data Trace Publishing Company, page 1-30.
 - The Court of Appeals in *Pinnacle Date Services, Inc. v. Gillen*, 104 S.W.3d 188, 198 (Tex.App. - 2003) reversed, in part, a summary judgment as to claims of breach of fiduciary duty, breach of the duty of loyalty and other claims; and remanded. As to breach of fiduciary duty claims, the court commented:
 1. “... an informal relationship may give rise to a fiduciary duty where one person trusts in and relies on another But not every relationship involving a high degree of trust and confidence rises to the stature of a fiduciary relationship;”
 2. “Accordingly, ... to impose such a relationship in a business transaction, the relationship must exist before,

and apart from, the agreement made the basis of the suit.”

3. “It has been well established that the directors of a corporation stand in a fiduciary relationship to the corporation and its stockholders.”

4. “Further, the duty of loyalty dictates that corporate officers must act in good faith and must not allow his or her personal interest to prevail over the interests of the corporation.”

5. The court concluded ”[t]here is nothing introduced into the record that would warrant a summary judgment, and the trial court erred by granting one with respect to breach of fiduciary duty and duty of loyalty.”

- While it appears that the appeals court was at least arguing that there are fiduciary duties owed, no cases have followed up on this conclusion.
- In *Cox v. Southern Garrett, L.L.C.*, 245 S.W.3d 574 (Tex.App. – Houston 2007, no pet.) the Houston Court of Appeals dismissed claims of breach of fiduciary duty on the ground that the plaintiff was not a member of the LLC at the time of the alleged breach of fiduciary duty. Mr. Cox argued that there had been a breach of fiduciary duties owed to him by the other LLC owners in connection with the repurchase of Mr. Cox’s interest. The court rejected the claim on the basis that Mr. Cox was not a member of the LLC at the time of the alleged breach of fiduciary duty.
- A federal district court in *Gadin v. Societe Captrade*, 2009 WL 1704049, (S.D. Tx. 2009), a 35% minority LLC member sued the 65% majority LLC member for breach of fiduciary duty. The court, in discussing the breach of fiduciary duty claim, pointed out that “Texas recognizes two types of relationships that give rise to fiduciary duties: form and informal.”
- Also, the court noted that the Texas LLC Act (now included in the BOC) did not address the duties owed by a manager to the LLC and the members and further noted that Texas courts have not yet held that as a matter of law a fiduciary duty exists among members of an LLC. The court refused to dismiss the case because, as it stated, the

“existence of a fiduciary duty is a fact-specific inquiry that takes into account the contract governing the relationship as well as the particularities of the relationship between the parties.”

- In the course of its discussion, the court made the following points:
 1. To prevail on the claim for breach of fiduciary duty, the plaintiffs must establish: a) the existence of fiduciary relationship between the parties; b) a breach by the defendant of his duty; and (c) the breach resulted in injury.
 2. Texas recognizes both formal and informal fiduciary relationships. In a formal relationship, the duty is owed as a matter of law. In an informal relationship, a fiduciary duty may rise where one person trusts in and relies on another, whether the relation is moral, social, domestic, or purely personal one.
- Entertainment Merchandising Technology, LLC v. Houchin, __ F.Supp.3rd __, 2010 WL 1286540 (N.D. Tex. 2010). Ps brought federal action to be declared co-inventors and co-owners of invention. Also, brought state action for breach of fiduciary duty. Ct. pointed out that Ps must establish 3 elements: (1) the existence of a fiduciary relationship; (2) breach by D of D’s fiduciary duty to Ps; (3) injury to Ps as a result.

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