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SECURITIES AND FIDUCIARY DUTY CASES IN TEXAS

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This quarterly newsletter summarizes recent federal and state court decisions of interest to practitioners litigating securities and fiduciary duty claims in Texas. Decisions of note this quarter include:

- SEC Enforcement Actions – In *Jarkesy v. SEC*, the Fifth Circuit held that the SEC's use of administrative law judges (ALJs) to adjudicate securities fraud enforcement actions seeking monetary relief violated the respondents' Seventh Amendment right to a jury trial and also employed unconstitutionally appointed ALJs.

- Securities Fraud Class Actions – Magistrate Judge Andrew Edison issued a discovery proportionality ruling in the McDermott securities fraud litigation requiring defendants to accept plaintiffs' search terms; review up to 1.3 million documents from 50 custodians; and produce relevant, non-privileged documents.

- Rulings in Arbitration Cases – Various courts addressed motions to compel arbitration in securities and fiduciary duty cases. Two courts affirmed the denial of motions to compel arbitration because the movant failed to submit authenticated copies of the documents containing the alleged arbitration provisions. Another court affirmed the denial of a motion to compel arbitration because it found the movant waived his right to arbitrate by filing the initial suit and actively participating in litigation for over two years. Finally, a federal district court granted a motion to compel arbitration where the subscription agreement contained an arbitration provision that delegated questions of arbitrability to the arbitrator under American Arbitration Association rules.

- Texas Supreme Court Ruling on Fiduciary Duty of Corporate Directors – The Texas Supreme Court reversed a jury finding that a father who was the sole director of a closely held corporation owed an informal fiduciary duty to his son based on their relationship of trust and confidence. The Court held as a matter of law that "a corporation's director cannot owe an informal duty to operate or manage the corporation in the best interest of or for the benefit of an individual shareholder. A director's fiduciary duty in the management of a corporation is solely for the benefit of a corporation."

For convenience, the cases summarized below are hyperlinked to Westlaw.

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CASE SUMMARIES

I. FEDERAL CASES

A. Fifth Circuit

1. *Jarkesy v. SEC*, No. 20-61007, 34 F.4th 446 (5th Cir. 2022) (Elrod, J.)

On May 18, 2022, a divided panel of the United States Court of Appeals for the Fifth Circuit vacated a decision by the Securities and Exchange Commission (SEC) that George Jarkesy, Jr. and his investment adviser Patriot28, L.L.C. committed securities fraud, holding that the adjudication by an administrative law judge (ALJ) was unconstitutional.

The Court (Judges Elrod and Oldham) held that "(1) Petitioners were deprived of their constitutional right to a jury trial; (2) Congress unconstitutionally delegated legislative power to the SEC by failing to provide it with an intelligible principle by which to exercise the delegated power; and (3) statutory removal restrictions on SEC ALJs violate Article II." 34 F. 4th at 447. Judge Davis dissented, noting that SEC enforcement actions involve "public rights" to which the right to a jury trial does not attach. He also would have found that the SEC's discretion to institute enforcement proceedings before an ALJ or in federal court is not unconstitutional, and the restrictions on removing ALJ's do not violate Article II.

Jarkesy is the latest in a series of cases questioning the constitutionality of the SEC's use of ALJs. The Fifth Circuit issued its opinion in *Jarkesy* just two days after the Supreme Court granted certiorari in *SEC v. Cochran*, 20 F.4th 194 (5th Cir. 2022), a case where the Fifth Circuit, sitting *en banc*, ruled that defendant could challenge the constitutionality of the SEC's ALJs in district court before her case was heard administratively.[1]

Background

Jarkesy created two hedge funds and appointed Patriot28 as the investment adviser. The funds secured over 100 investors and managed over $20 million in assets.

The SEC instituted an administrative action against Jarkesy and Patriot28 alleging securities fraud and seeking both monetary and equitable relief. Before the trial started, the petitioners sued to enjoin the proceedings, claiming violations of several constitutional rights. The US District Court for the District of Columbia and the US Court of Appeals for the DC Circuit decided that no jurisdiction existed, and the petitioners were required to continue the administrative process and then appeal.

After an evidentiary hearing, an SEC ALJ found that the petitioners were liable. The Commission affirmed. The ALJ and the SEC rejected the petitioners' constitutional arguments. The SEC ordered the petitioners to cease and desist from committing further violations and to pay disgorgement and a civil penalty. Jarkesy was also barred from various industry activities. The petitioners appealed.

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[1] See 4Q21 Quarterly Newsletter, at 4.

The Fifth Circuit decision

The Fifth Circuit vacated the SEC's decision and remanded for further proceedings, holding as follows.

Denial of Seventh Amendment right to a jury trial

The Court held that the SEC's use of an ALJ to adjudicate the claims deprived the petitioners of their Seventh Amendment right to a jury trial because the SEC's enforcement proceeding was similar to traditional actions at law to which the right to a jury trial attaches. The Court noted that while Congress has the power to assign certain proceedings involving "public rights" to administrative adjudication, thereby eliminating the right to a jury, Congress cannot assign adjudication of claims that are similar to traditional actions at law to ALJs because such claims concern more than just public rights.

Relying on Supreme Court precedent,[2] the Fifth Circuit examined the SEC's enforcement action using a two-stage analysis: (1) whether the claims in the action "arise 'at common law' under the Seventh Amendment" and (2) if so, whether Congress was permitted to assign the claims to agency adjudication without a jury trial.

Key factors in the analysis include whether (1) Congress created a new cause of action and remedies that were previously unknown under common law, and (2) a jury trial would effectively dismantle the statutory scheme or impede swift resolution of the claims created by the statute.

Applying these factors, the Fifth Circuit determined that (1) fraud claims existed under common law, and (2) a civil penalty was a type of remedy under common law that could be enforced in the courts. Thus, the right to a jury trial applied to the SEC's penalties action. Even though the SEC's action included equitable components, they did not invalidate the right to a jury trial for the civil penalties that the SEC sought.

The Court further concluded that the SEC's claims were not the type of claims that could be properly assigned to agency adjudication under the public-rights doctrine because securities fraud claims are not new; such claims existed at common law. The Court also found that jury trials would not dismantle the statutory scheme or impede swift resolution of such claims, especially because the statutory scheme allows the SEC to bring claims either administratively or in Article III courts where the right to a jury trial applies.

The Court rejected the SEC's argument that an enforcement action is automatically transformed into a public-rights action suitable for administrative adjudication. Traditionally, securities and fraud claims were resolved in the federal courts, and just because the SEC is the plaintiff does not require an administrative proceeding: "Congress cannot change the nature of a right, thereby circumventing the Seventh Amendment, by simply giving the keys to the SEC to do the vindicating."

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[2] *Tull v. United States*, 481 U.S. 412, 417, 107 S.Ct. 1831, 95 L.Ed.2d 365 (1987); *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 109 S.Ct. 2782, 106 L.Ed.2d 26 (1989); *Atlas Roofing Co. v. Occupational Safety & Health Rev. Comm'n*, 430 U.S. 442, 455, 97 S.Ct. 1261, 51 L.Ed.2d 464 (1977).

Judge Davis argued in his dissent that the SEC's enforcement action satisfied the definition of a "public right" based on a long line of Supreme Court cases and rulings by the 9th, 10th, and 11th Circuits. *Id*. at *16 n.26. The majority improperly relied on factors stated in *Granfinanciera v. Nordberg*, 492 U.S. 33 (1989) to reach a contrary result. *Granfinanciera* was a bankruptcy action between private parties that addressed when a private right of action might involve "public rights." The factors considered in that private action do not apply to government enforcement actions. If a cause of action "inheres in ... the Federal Government in its sovereign capacity," then "Congress may effectively supplant a common law cause of action." *Id.* at *38-39. Accordingly, *Granfinanciera* did not abrogate the long line of cases holding that "cases in which the Government sues in its sovereign capacity to enforce public rights created by statutes within the power of Congress to enact." *Id.* at *16 (citing *Atlas Roofing v. Occupational Safety & Health Rev. Comm'n*, 430 U.S. 442, 450 (1977)).

Unconstitutional Congressional delegation of legislative power

Next, the Court held that Congress unconstitutionally delegated legislative power to the SEC when it gave it full discretion to choose whether to bring actions in an Article III court or before an ALJ. The Court ruled that the power to determine which cases are decided by an ALJ versus an Article III court is legislative in nature. When Congress delegates such legislative power, it must offer an "intelligible principle" for exercising such power. Here, the Court determined that Congress had "offered no guidance whatsoever" as to that principle. Therefore, the delegation was unconstitutional.

The dissent disagreed, arguing that Congress fulfilled its legislative duty when authorizing the SEC to bring enforcement actions either in federal court or in agency proceedings. According to the dissent, the SEC's forum-selection authority is no different than a prosecutor's discretion to choose between criminal statutes with different penalties for the same conduct. *Id.* at *20-21 (citing *United States v. Batchelder*, 442 U.S. 114 (1979), in which the Supreme Court upheld prosecutors' authority to make these decisions).

Unconstitutional ALJ removal restrictions

Finally, the Court held that statutory restrictions on the removal of the SEC's ALJs were unconstitutional. Resolving an issue left open by the Supreme Court in *Lucia v. SEC*, 38 S.Ct. 2044, 201 L.Ed.2d 464 (2018), the Fifth Circuit found the statutory removal protections for SEC ALJs are unconstitutional.

SEC ALJs can only be removed for good cause by the Merits System Protection Board, whose members in turn can only be removed for cause by the President. The Fifth Circuit held that this this two-layer, for-cause removal standard is unconstitutional under the Supreme Court's decision in *Free Enterprise Fund v. Public Co. Accounting Oversight Bd.*, 561 U.S. 477, 498, 130 S.Ct. 3138, 177 L.Ed.2d 706 (2010). Consequently, the Court held SEC ALJs are unconstitutionally shielded from removal.

The dissent again disagreed, arguing that the majority applied a rigid, categorical standard rather than the functional analysis required by Supreme Court precedents. It noted that the Supreme Court in *Free Enterprise* declined to extend its holding to federal ALJs. And since ALJs perform

solely an adjudicative function rather than enforcement or policy-making functions, multiple layers of removal protection do not interfere with the President's ability to "take Care that the Laws be faithfully executed." *Id.* at *24.

The SEC has requested *en banc* review of the panel decision.

B. District Courts

1. Securities Class Actions

(a) ***Edwards v. McDermott International, Inc.*, Civ. Action No. 4:18-cv-04330, 2022 WL 1568279 (S.D. Tex. May 18, 2022) (Edison, M.J.)**

In this opinion, Magistrate Judge Andrew Edison ruled on a dispute over the proper scope of document discovery for an ongoing, putative securities fraud class action. While we do not normally report on discovery disputes, the opinion describing the number of documents to be searched and reviewed – and the potentially exorbitant costs to do so – serves as a powerful reminder of the "in terrorem effect" that securities class actions have on settlement valuation.[3]

As we previously reported,[4] on April 14, 2021, Judge George Hanks denied defendants' motions to dismiss claims brought under §§10(b) and 14(a) of the Securities Exchange Act of 1934. The parties proceeded to document discovery. The Court required defendants to collect documents from 50 custodians chosen by the plaintiffs and to confer on appropriate search terms. After conferring for several months on search terms, the parties reached an impasse. Plaintiffs' proposed search terms yielded 773,508 search hits (with an additional 519,337 family-member documents), and defendants' proposed search terms yielded approximately 650,000 documents to be reviewed. As the Court stated:

> The present dispute focuses on the proportionality requirement. Simply put, are Plaintiffs' proposed search terms—which will require Defendants to review close to 1.3 million documents—proportional to the needs of the case? Or are Defendants' proposed search terms—which will result in the review of about half as many documents—more proportional to the needs of the case? There is no cut-and-dried application of the proportionality factors that leads to one inescapable

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[3] In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737-42 (1975), Judge Rehnquist discussed the legislative history of §10(b) of the 1934 Act and the potential for abuse of the liberal discovery process in securities fraud class actions. "The prospect of extensive deposition of the defendant's officers and associates and the concomitant opportunity for extensive discovery of business documents, is a common occurrence in this and similar types of litigation. To the extent that this process eventually produces relevant evidence which is useful in determining the merits of the claims asserted by the parties, it bears the imprimatur of these Rules and of the many cases liberally interpreting them. But to the extent that it permits a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an in terrorem increment of the settlement value, rather than a reasonably founded hope that the process will reveal relevant evidence, it is a social cost rather than a benefit." *Id.* at 741.

[4] See 2Q21 Quarterly Newsletter, at 8-12.

> conclusion. I can see respected jurists reaching different outcomes based on the same underlying facts.

Id. at *2.

The Court then reviewed the six factors identified in Rule 26(b)(1) for assessing proportionality:

- *Importance of the Issues at Stake*. The Court concluded "there can be little debate that the issues at stake in this case are meaningful.
- *Amount in Controversy*. The Court stated the $1 billion in damages Plaintiffs were seeking to recover weighed heavily in favor of allowing the requested discovery.
- *Parties' Relative Access to Relevant Information*. The Court noted plaintiffs had no other way to obtain access to McDermott's emails and electronic communications maintained except through discovery.
- *Parties' Resources*. Since neither side offered evidence of McDermott's post-bankruptcy resources or the limits of its D&O policies, the Court viewed this factor as neutral.
- *Importance of Discovery in Resolving the Issues*. The Court stated that the search terms appeared to be tailored to obtaining documents relevant to the claims and defenses and it is "awful likely that the sought-after documentation is relevant and highly probative."
- *Whether the Burden or Expense of Proposed Discovery Outweighs its Likely Benefit*. The Court could not say with absolute certainty whether the plaintiffs' proposed search terms will provide substantially more information than defendants' proposed terms, but it was swayed by denial of defendants' motions to dismiss. "The discovery door has been flung wide open, and Plaintiffs should be allowed to probe inside. The purported damages in this case are huge, and that indicates to me that Plaintiffs' proposal is proportional to the needs of the case. It is a close call, but I ultimately conclude that the scales tip in favor of Plaintiffs on the proportionality analysis."

The Court ordered defendants to apply plaintiffs' proposed search terms and produce relevant and non-privileged documents on a rolling basis. *Id.* at *4. For those interested in more details about the document requests, the searches run by the parties before going to court, and other cases cited to support the parties' proportionality analysis, see the letter briefs submitted to the Court.

2. Enforcement Matters

(a) *SEC v. Crumbley*, Civ. Action No. 3:16-cv-0172-L, 2022 WL 1505868 (N.D. Tex. May 11, 2022) (Lindsay, J.)

The SEC brought this civil enforcement action against defendants Kenneth W. Crumbley, Jr. and Sedona Oil & Gas Corporation, alleging that they engaged in a three-year scheme that

defrauded investors out of more than $3.3 million. Crumbley settled with the SEC and consented to the entry of the following judgment:

> [Crumbley] shall pay disgorgement of ill-gotten gains, prejudgment interest thereon, and a civil penalty pursuant to Section 20(d) of the Securities Act [15 U.S.C. § 77t(d)] and Section 21(d)(3) of the Exchange Act [15 U.S.C. § 78u(d)(3)]. The [c]ourt shall determine the amounts of the disgorgement and civil penalty upon motion of the Commission. Prejudgment interest shall be calculated from January 21, 2016, based on the rate of interest used by the Internal Revenue Service for the underpayment of federal income tax as set forth in 26 U.S.C. § 6621(a)(2).

The SEC filed an unopposed motion for entry of final judgment, including a calculation of disgorgement, penalty, and pre-judgment interest.

The SEC is authorized to seek, and the court is authorized to order, disgorgement "that does not exceed a wrongdoer's net profits and is awarded for victims." *Id.* at *1 (citing *Liu v. SEC*, 140 S. Ct. 1936, 1940 (2020); *Allstate Ins. Co. v. Receivable Fin. Co., L.L.C.*, 501 F.3d 398, 413 (5th Cir. 2007)). The Court accepted the SEC's calculation of $118,955.36 in ill-gotten gains, noting that "District courts have broad discretion in calculating the amount to be disgorged." *Id.* at *2. The party seeking disgorgement has the burden of "distinguishing between that which has been legally and illegally obtained." In actions by the SEC involving securities violations, however, "disgorgement need only be a reasonable approximation of profits causally connected to the violation." *Id.*

The Court also granted the SEC's request that the third-tier penalty be imposed. Under both the Securities Act and the Exchange Act, the maximum penalty that can be awarded is the greater of the gross amount of pecuniary gain to a defendant as a result of the violations or the amount set by statute, which for individuals is $7500 for tier one, $80,000 for tier two, and $160,000 for tier three. The Court explained the tiers as follows:

- A first-tier penalty can be imposed for any violation of the Securities Act or Exchange Act without any evidence of scienter.
- A second-tier penalty can be imposed upon a showing that that the violation "involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement."
- Finally, a third-tier penalty is appropriate when, in addition to the showing of fraud, the violation "directly or indirectly resulted in substantial losses to other persons."

The Court examined the following five factors to determine the penalty: "(1) the egregiousness of the defendant's conduct; (2) the degree of scienter; (3) whether the conduct created substantial losses or the risk of substantial losses to other persons; (4) whether the conduct was isolated or recurrent; and (5) the cooperation of the defendant with law enforcement authorities." *Id.* at *3. The Court imposed the highest tier penalty because it found that Crumbley "participated in activities that involved fraud, deceit, and manipulation in clear disregard of federal security laws," knowingly misled investors to obtain large investments that he "misappropriated

for his" personal use, caused substantial investor losses, and continued his scheme for several years.

3. Others

(a) *Carr v. Barnett*, Civ. Action No. 3:18-CVC-03109-N, 2022 WL 1570739 (N.D. Tex. May 18, 2022) (Godbey, J.)

Judge Godbey granted summary judgment for plaintiff on his claims for sale of an unregistered security against Defendants Barnett Energy Development LLC (BED) and Barnett Energy #21 (Gafford-Turner) (the "Partnership"). Through a networking event, Carr was introduced to Phil Barnett, the president of BED, which managed a general partnership that owned a working interest in an oil and gas well. Carr ultimately executed an agreement to purchase a general partnership interest and delivered a check for $99,378 payable to the Partnership. When he received no communications about the status of the oil well and conversations with Barnett and others failed to reassure him, Carr asked to rescind the agreement and get his money back. No refund was made so Carr filed this action for violation of the Securities Act of 1933 and the Texas Securities Act. The corporate defendants did not contest the motion, but we include it here as a refresher on when a general partnership interest may be deemed a security.[5]

The Court ruled that Carr's investment in the partnership was an "investment contract" under the three-part test set forth in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946): (1) an investment of money, (2) in a common enterprise, and (3) on the expectation of profits to be derived solely from the efforts of others. *See SEC v. Arcturus Corp.*, 928 F.3d 400, 409 (5th Cir. 2019) (quoting *Williamson v. Tucker*, 645 F.2d 404, 417-18 (5th Cir. 1981)). Noting the strong presumption that a general partnership interest does not qualify as a security, the Court nevertheless ruled that Carr's interest was a security because he met his burden to show that he was so dependent on the promoter or a third party that he was unable to exercise meaningful partnership powers. *Carr*, 2022 WL 1570739, at *3-4. The Court cited the three factors set forth in *Williamson*, any one of which may be sufficient to show that a general partner still expected profits to be derived solely from the efforts of others:

> (1) an agreement among the parties leaves so little power in the hands of the partner ... that the arrangement in fact distributes power as would a limited partnership; or (2) the partner ... is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner ... is so dependent on some unique entrepreneurial or managerial ability of the promotor or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership ... powers.

[5] Carr also filed claims against two individual defendants. The claims against the individual who introduced him to Phil Barnett were dismissed by agreement, and the claims against Phil Barnett were initially stayed after he filed for bankruptcy. The Court reopened the claims against Barnett after he was discharged from bankruptcy, but the motion for summary judgment at issue in this opinion did not address those claims.

Id. at *3.

The Court ruled Carr proved the first factor based on the language in agreements he executed. Specifically, the Private Placement Memorandum stated that BED "will exclusively manage and control all aspects of the business of the partnership and will make all decisions concerning the business of the partnership" and that investors "will not be permitted to take part in the management or in the decision making of the partnership." *Id.* at *4. Because the defendants produced no evidence to suggest that the parties had a different practice, the Court ruled that Carr's general partnership interest was a security under the *Howey* test.

The Court reached the same conclusion under Texas state law, noting that the Texas Supreme Court had adopted the *Howey/Forman* test to determine whether a transaction constitutes an investment contract. *Id.* at *6 (citing *Life Partners, Inc. v. Arnold*, 464 S.W.3d 660, 670 (Tex. 2015)). Under Texas law, the focus is on the "economic realities" of a transaction. When evaluating whether an investment was made with the expectation of profits from the efforts of others, Texas courts ask whether others made "those essential managerial efforts which affect the failure or success of the enterprise." *Id.* (quoting *Life Partners*, 464 S.W.3d at 673 (quoting *Searsy v Com. Trading Corp.*, 560 S.W.2d 637, 638 (Tex. 1977)). To qualify as an investment contract security, "the transaction must be such that, in reality, the seller, or another party other than the purchaser, exercises the predominant managerial or entrepreneurial control on which the purchaser's anticipation of profits is based." *Id.* at *6 (quoting *Life Partners*, 464 S.W.3d at 674-75).

After determining that Carr's general partnership interest qualified as an investment contract, the Court quickly concluded that no registration statement was filed, that BED and the Partnership were statutory sellers, and that the two defendants were jointly and severally liable to Carr for return of the purchase price plus pre-judgment interest. Several other claims by Carr remained pending, including claims for fraud and breach of fiduciary duty.

(b) Miscellaneous Arbitration Rulings

Texas courts of appeals and a Texas federal district court ruled on a number of motions to compel arbitration of securities and fiduciary duty claims.

Two courts affirmed the denial of motions to compel arbitration because the movant failed to submit authenticated copies of the documents that contained the alleged arbitration provisions. *See Calton & Assoc. Inc. v. Auguillard*, No. 01-21-00148-CV, 2022 WL 1250565 (Tex. App – Houston [1st Dist] Apr. 28, 2022) and *Constant v. Gillespie*, No. 05-20-00734-CV, 2022 WL 1564555 (Tex. App. – Dallas (May 18, 2022).

In *Courtright v. Allied Custom Homes, Inc.*, No. 01-21-00002-CV, 2022 WL 1309857 (Tex. App – Houston [1st Dist.] May 3, 2022, pet. filed), the Court affirmed the denial of another motion to compel arbitration because it found the movant (Leonard Cartwright) waived his right to arbitrate by filing the initial suit and actively participating in litigation for over two years. "When, as here, implied waiver is at issue, the party seeking to establish the waiver defense must show that (1) the party seeking arbitration substantially invoked the judicial process in a manner

inconsistent with the right to compel arbitration and (2) this inconsistent conduct caused the nonmoving party to suffer detriment or prejudice." *Id.* at *7. This standard was easily met when the movant sought to compel arbitration only after a receiver was appointed over his company and the receiver filed claims against him.

Finally, in *Burstein v. AutoLotto*, Case No. A-21-CV-793-LY, 2022 WL 1229291 (W.D. Tex. Apr. 26, 2022), Judge Yeakel adopted the magistrate's report and recommendation and granted a motion to compel arbitration of claims arising from a subscription agreement that contained an arbitration clause. First, because defendant claimed the agreement as a whole was fraudulently induced (as opposed to the arbitration clause specifically), the fraudulent inducement claims were subject to arbitration. Second, because the parties specified that the arbitration would be governed by the rules of the American Arbitration Association (AAA), the Court found that any questions regarding the scope of the arbitration clause were delegated to the arbitrator to decide: "In this case, because the Arbitration Clause expressly incorporates the AAA Rules, there is clear and unmistakable evidence that the parties agreed to arbitrate arbitrability." *Id*. at 6. Whether individual claims were subject to arbitration was a question for the arbitrator, not the court, to decide.

II. STATE COURT CASES

A. Texas Appellate Courts

1. *In re DeMattia*, No. 05-01-00460-CV, 2022 WL 1089914 (Tex. App. – Dallas, Apr. 12, 2022) (Nowell, J.)

In a mandamus action, the Dallas Court of Appeals ruled that Mark DeMattia, a former managing member of Restoration Specialists, LLC (Restoration), was entitled to advancement of his legal expenses. DeMattia was sued by Restoration for breach of fiduciary duties and theft of trade secrets after he allegedly copied Restoration's project history files. When Restoration refused to advance his legal fees, DeMattia counterclaimed for breach of contract and moved for summary judgment. The trial court denied his motion, and DeMattia filed this mandamus action. Although Restoration was a Texas LLC, the Court based its decision on Delaware precedent.

The Court first ruled that mandamus was appropriate relief in the context of a claim for advancement of legal fees "because the act of proceeding to trial without advancement would defeat the substantive right at stake." *Id.* at *3 (citing *In re Aguilar*, 344 S.W.3d 41, 45 (Tex. App.—El Paso 2011, orig. proceeding).

The Court then interpreted the provisions of Restoration's corporate regulations (Regulations) providing for indemnification and advancement of legal expenses for Members and former Members. Section 9.6 of the Regulations provided in relevant part:

> To the fullest extent permitted by the Act:[6] (a) the Company shall indemnify each Member who was, is, or is threatened to be made a party to any threatened, pending, or completed action, suit, or proceeding ("**Proceeding**"), any appeal thereof, or any inquiry or investigation preliminary thereto, *by reason of the fact that he or she is or was a Member*; (b) the Company shall pay or reimburse a Member for expenses incurred by such Member (i) in advance of the final disposition of a Proceeding to which such Member was, is, or is threatened to be made a party, and (ii) in connection with his or her appearance as a witness or other participation in any Proceeding.

Id. at *3 (emphasis added by Court).

Restoration argued that the indemnification and advancement provisions in Section 9.6 should be read separately. While the indemnification provision referred to both present and former Members ("is or was a Member"), the advancement provision was stated in the present tense ("the Company shall pay") and only referred to advancing expenses of existing Members ("expenses incurred by such a Member"). Accordingly, Restoration claimed it was not required to advance DeMattia's legal expenses because he was no longer a Member of the LLC. The Court disagreed.

Because Texas case law concerning advancement was limited, the Court looked to Delaware for guidance. In *Weinstock v. Lazard Debt Recovery GP, LLC*, 2003 WL 21843254 (Del. Ch. Aug. 8, 2003), the Delaware Chancery Court interpreted a similar advancement provision and held that it applied to a former member. Applying *Weinstock's* reasoning to Restoration's Regulation, the Court stated:

> The use of the capitalized term "Proceeding" in the Regulations' advancement provision is an "obvious linkage" to the immediately preceding indemnity provision that defines such "Proceeding" as an "action, suit, or proceeding" to which a Member is or was "made a party ... by reason of the fact that he or she is or was a Member." Like in *Weinstock*, given this "obvious linkage" between the provisions, the absence of the "is or was a Member" language in the advancement provision was merely to avoid redundancy, as the term "Proceeding" was already defined to encompass actions against former members. Further, the advancement provision's use of the term "such Member" creates an even stronger linkage than the one in *Weinstock*, as there is a direct relationship between the "is or was a Member" language of the indemnity provision and the advancement provision.

After interpreting the advancement provision, the Court rejected Restoration's other arguments. First, the Court rejected Restoration's argument that the provision was ambiguous, and, therefore, not subject to summary judgment. "[C]ontractual ambiguity does not arise simply because the parties advance conflicting interpretations of the contract; rather, for an ambiguity to exist, both interpretations must be reasonable. *Id.* at *5. It ruled that Restoration's interpretation of

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[6] The "Act" referenced in the Regulations was the Texas Limited Liability Company Act, and the Regulations were later amended to add a reference to the Texas Business Organizations Code. The Court noted that under current law, an LLC's governing documents may adopt indemnification and advancement provisions in the Texas Business Organizations Code, including Section 8.105(d) that expressly permits advancement of reasonable expenses to both current and former officers/governing persons. *Id.* at 4.

the contract was not reasonable and noted that reading the contract as Restoration proposed would require the Court to disregard the definition of "Proceeding" set forth in Section 9.6(a) and referenced again in Section 9.6(b).

Second, requiring Restoration to advance DeMattia's fees was not likely to skew the litigation dynamics. Restoration cited an analogous worker's compensation decision in which the Texas Supreme Court ruled attorney's fees could not be recovered. The Court rejected the analogy because the Supreme Court expressly excluded situations in which *recovery was provided for by statute or by contract between the parties.* Since the Regulations created a contract between the corporation and its Members, the case was inapplicable.

Third, it rejected the argument that DeMattia had unclean hands, noting that "all lawsuits involve allegations of wrongdoing by the other party; Restoration's argument would render the contract term meaningless and predetermine the merits of its claim." *Id.* at *6.

Finally, the Court concluded the opinion by discussing the recurring dynamic in corporate advancement disputes:

> Corporate advancement practice has an 'admittedly maddening aspect.' That is because, at the time that an advancement dispute ripens, it is often the case that the corporate board has drawn harsh conclusions about the integrity and fidelity of the corporate official seeking advancement. The board may well have a firm basis to believe that the official intentionally injured the corporation and is therefore reluctant to advance funds for his defense, fearing that the funds will never be paid back and resisting the idea of seeing further depletion of corporate resources at the instance of someone perceived to be a faithless fiduciary. But the Delaware courts have determined that to 'give effect to this natural human reaction as public policy would be unwise' because the possibility exists that the company's allegations are untrue or cannot be proven. In that circumstance, it would be difficult to conceive of an argument that would properly leave the corporate official holding the bag for all of his legal fees and expenses; moreover, to do so would make the company's prelitigation promise illusory. Thus, Delaware courts have 'often been required to uphold the indemnification and advancement rights of corporate officials accused of serious misconduct.'

Id. at *7 (citations omitted).

2. *In re Estate of Poe*, No. 20-0178, 2022 WL 2183306 (Tex. June 17, 2022) (Huddle, J.)

On appeal from a probate trial, the Texas Supreme Court considered whether a corporate director, in addition to his fiduciary duties to a corporation, could be liable for breach of an informal relationship of trust and confidence to a shareholder. The Court held, "as a matter of law, a corporation's director cannot owe an informal duty to operate or manage the corporation in the

best interest of or for the benefit of an individual shareholder. A director's fiduciary duty in the management of a corporation is solely for the benefit of a corporation." *Id.* at *8.

Background and trial court judgment

The plaintiff, Richard Poe, was the sole shareholder of a closely held corporation that owned car dealerships and other assets. His father, Dick Poe, was the sole director of the corporation. Richard granted his father an irrevocable proxy to vote his shares and annually elected his father the sole director of the corporation. On his deathbed, Dick caused the corporation to issue additional shares, which he purchased for $3.2 million. Due to the number of additional shares, majority control of the corporation shifted from Richard to Dick's estate (the Estate). Richard claimed that his father's attorney and two co-executors of his will conspired to wrest control of the corporation from him and persuaded his father to issue the additional shares when he lacked the mental capacity to do so.

Richard sued the Estate for breach of fiduciary duty, alleging that his father (1) breached his fiduciary duty to the corporation by entering into a self-dealing transaction, and (2) breached the fiduciary duty he owed to his son as a result of their informal relationship of trust and confidence. Richard also sued the two executors and his father's attorney for breaching their fiduciary duties to the corporation and for conspiring to make his father breach his duties. The probate court dismissed both the mental capacity claim and the claims against the individual defendants before trial; the remaining claims against the estate (Dick) were submitted to the jury. In a 10-2 decision, the jury found that Dick breached his fiduciary duties to both the corporation and to his son, and the jury answered "no" to the question of whether the share transaction was valid and enforceable. In a second phase of the trial, the probate court addressed Richard's conspiracy claims against the individual defendants. It directed a verdict for the individual defendants. It also rendered a judgment declaring the share issuance invalid and unenforceable, ordering the return of the $3.2 million Dick paid for the shares, and entering a take-nothing judgment on Richard's individual claims. Both sides appealed.

Appeal

On appeal, the Estate challenged four of the trial court's questions and instructions to the jury. Three related to whether Dick owed an informal fiduciary duty to Richard.[7] The Estate argued these jury questions were improper because Dick, as a corporate officer, only owed a fiduciary duty to the corporation. The fourth question related to the statutory safe-harbor defense under TEX. BUS. ORG. CODE §21.418(b) which the Court described to the jury as follows:

> Is the share issuance valid and enforceable under the Texas Business Organizations Code?
>
> The share issuance is valid and enforceable if any one of the following conditions is satisfied:

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[77] The three questions were (1) Did a relationship of trust and confidence exist between Dick and Richard? (2) If "yes" to question 1, did that relationship terminate before May 1, 2015? (3) If "yes" to question 1, did Dick breach his fiduciary duty to Richard with respect to his management of [the corporation]?

(1) the material facts as to the share issuance were disclosed to or known by:
   a. [the] board of directors, and the board of directors in good faith authorized the share issuance by the approval of the majority of the disinterested directors, or
   b. the shareholders entitled to vote on the share issuance, and the share issuance is specifically approved in good faith by a vote of the shareholders; or

(2) the share issuance is fair to [the corporation] when it is authorized, approved, or ratified by the board of directors or the shareholders.

The Estate argued the language following the question should have been limited to a single condition: whether the share issuance was fair to the corporation. The Estate argued the other conditions did not apply and were likely to confuse the jury.

On the issues raised by the Estate, the El Paso Court of Appeals affirmed. It found no error in the questions relating to the informal duty between Dick and Richard but stated they were "substantial, and in some respects raise important questions under Texas law." As to the statutory, safe-harbor question, the Court of Appeals held it contained "superfluous language," but any error was harmless because there was sufficient evidence to support the jury's failure to find the transaction was fair to the corporation.

<u>Texas Supreme Court Opinion</u>

The Texas Supreme Court granted the petition for review. It began by summarizing the law governing fiduciary duties of corporate directors. Under Texas law, the business and affairs of a corporation are managed by its board of directors. A director's fiduciary status creates three broad duties: care, loyalty, and obedience. These duties are owed to the corporation, not to any shareholder or majority of shareholders. While Texas has recognized that an "informal" fiduciary duty may arise from "a moral, social, domestic, or purely personal relationship of trust and confidence, it has "never recognized an informal fiduciary duty within the context of the operation or management of a corporation, in which the corporation's directors have clearly defined duties to exercise their business judgment for the sole benefit of the corporation." *Id.* at *7. "Absent a contractual or other legal obligation, the officer or director has no duty to conduct the corporation's business in a manner that suits an individual shareholder's interests when those interests are not aligned with the interests of the corporation and the corporation's shareholders collectively." *Id.* at *7 (quoting *Ritchie v. Rupe*, 443 S.W.3d 856, 888-89 (Tex. 2014)). It noted that disputes in closely held corporations may be prevented and resolved through shareholders' agreements and that the Legislature granted corporate founders and owners "broad freedom to dictate for themselves the rights, duties, and procedures that govern their relationship with each other and with the corporation." *Id.* (quoting *Ritchie*, 443 S.W.3d at 868 (quoting *Int'l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 577 (Tex. 1963)).

Applying this rule to the questions about an informal duty between Dick and Richard, the Court held the instruction was legally improper, stating:

> Here, the jury was asked whether Richard justifiably placed trust and confidence in Dick "to operate [the corporation] in a manner that was consistent with Richard's best interest." We have never held, in *Ritchie* or elsewhere, that a corporation's director while owing formal fiduciary duties to the corporation requiring him to manage the corporation's affairs for the sole benefit of the corporation, simultaneously owes an informal fiduciary duty to a shareholder to operate a corporation for that shareholder's benefit or consistent with the shareholder's best interest. On the contrary, *Ritchie* suggests those two duties are incompatible. *We reaffirm this principle today and hold that a director cannot simultaneously owe these two potentially conflicting duties. By electing to form and own [] as a corporation, the parties disclaimed the existence of duties regarding the management of the corporation's affairs beyond those that exist by statute or arise from the corporation's formation documents or other agreement.*

Id. at *8 (emphasis added, citations omitted).

With respect to the safe-harbor question, the Court agreed that the trial court abused its discretion by including two conditions (approval by the board of directors or by the shareholders) for which there was no evidence. The Court also ruled the inclusion of the other conditions was likely confusing to the jury. "The jury's deliberation . . . should have focused solely on whether the share issuance was fair to [the corporation] at the time it was authorized, approved, or ratified by Dick. But due to the erroneous submission of the informal-fiduciary duty theory, a significant amount of Richard's evidence focused on its alleged unfairness to Richard." *Id.* at *11 (citations omitted). Rather than focusing on evidence about the price of the share issuance, which was hotly contested, the jury could have improperly considered evidence that Richard was groomed to take over for his father, that the share issuance "cut [him] out," that Dick never told him about the share issuance, and that he was not notified until after Dick's death. Based on its review of the record and considering the probable effect of the probate court's errors on the minds of the jury, the Court concluded "the errors probably caused the rendition of an improper judgment." The Court (1) reversed and rendered judgment that Richard take nothing on his claim for breach of an informal duty and (2) reversed and remanded for further consideration of the breach of Dick's formal duty to the corporation.[8]

N. Scott Fletcher
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July 2022

[8] Without much discussion, the Court also affirmed the appellate court's judgment with respect to Richard's claims against the individual defendants. The Court of Appeals had reversed the trial court's directed verdict on these claims, ruling there was sufficient evidence for the jury to consider whether Dick's lawyer conspired with him regarding the share issuance and whether the other defendants should disgorge monies received for services allegedly rendered to the estate.

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