as circumstances in which there are high costs to efficient bargaining, which can be overcome by bringing labor inside the Coasian bubble. For example, Freeman and Lazear (1995) construct a model in which labor control can increase investment in firm-specific human capital.[87] If firms cannot credibly commit to rewarding employees for these types of human-capital investments, then employees will underinvest in these skills, ***1413** leading to an efficiency loss.[88] Bringing labor into the boardroom keeps management (and shareholders) from expropriating these investments and, thus, overcomes the commitment issues that led to the inefficiency.

A different channel involves overcoming information asymmetries. Furubotn and Wiggins (1984) argue that labor representation on the board facilitates credible exchange of information between labor and management.[89] This exchange can occur in either direction. For example, feedback from labor directly to senior management can improve operational efficiency. Alternatively, improved visibility of a company's condition during times of stress could expedite concessions from labor. Information can also flow from labor to shareholders regarding management, such as through monitoring. Examining data on German firms, Fauver and Fuerst (2006) provide evidence that labor representation on boards can protect against expropriation of surplus by management or large shareholders, to the benefit of shareholders more broadly.[90] Overall, representation within the boardroom facilitates transparency, communication, and monitoring that is otherwise difficult to maintain.

Importantly, however, the incentives of labor differ significantly from those of shareholders. Labor's future wages and pension benefits amount to fixed claims on the firm, and labor is likely to be more risk averse than shareholders, given an inability to diversify.[91] The overall effects of including such interests in decision-making are, from a social-welfare perspective, ambiguous. As an example of possible social benefit, Lin, Schmid, and Xuan (2018) examine German firms and suggest a role for labor akin to that of banks.[92] Employees are likely to have preferences that are closely aligned with those of bank lenders or other creditors, such as high levels of risk aversion.[93] Employees also have access to information that outside monitors do not, and therefore can play that role efficiently. They find that firms with employee representation have lower borrowing costs as a result.

***1414** However, increased risk aversion can lead to negative effects of labor control. The classic theoretical argument is made by Jensen and Meckling (1979), who identify a number of reasons why a firm owned and managed by employees would be less efficient than one managed exclusively to maximize shareholder value.[94] In particular, investment decisions could be constrained because the claims of employee-owners are not tradeable.[95] For example, utility-maximizing employees may reject investment projects that value-maximizing shareholders would choose to pursue, if a significant enough fraction of employees' wealth was tied up in the firm and would be at risk if the project failed.[96] Similarly, because current employees have a short horizon, they only consider cash flows that occur during their careers. Such a firm would not make a positive NPV investment where much of the value is generated after most of the current employees would have retired.[97]

These examples show how awarding board seats to labor can also introduce new constraints to bargaining. While, on the one hand, better commitment and information flow represent reductions to the costs of bargaining, the non-tradability of labor's claims introduces new costs. If the surplus transferred to labor is meaningful vis-à-vis employees' wealth, then the efficient outcome--that which maximizes joint welfare--becomes increasingly risk averse.

The empirical literature contains evidence in support of both the pros and cons of labor control. The richest literature examines the experience of labor representation in Germany. Under this system, known (in English) as ***1415** codetermination, large German companies are required by law to have labor representation on their boards.[98] This law has existed in one form or another since 1952.[99] The specifics have varied over time, and the exact proportion of board seats that must be allocated to employees has varied. Currently, it is between one-third and one-half of seats, with the latter requirement binding for firms with greater than 2,000 employees.[100] This has provided ample fodder for analysis of labor representation, but other studies have looked at the U.S. and other countries as well.

Some studies have found that codetermination decreases firm value. For example, Gorton and Schmid (2000) find codetermination results in a notable decrease in Tobin's Q, utilizing the reunification of East and West Germany as a natural experiment.[101] Gorton and Schmid (2004) find a similar result in comparing firms with one-third versus one-half of board seats allocated to labor.[102] Others find the opposite effect. Fauver and Fuerst (2006) find that small increases in labor representation increase Tobin's Q.[103] Using French data, Ginglinger, Megginson, and Waxin (2011) also find that small increases in employee ownership increase firm value.[104] However, this study also finds that the effect is nonlinear--larger increases in labor control detract from firm value.[105] Fauver and Fuerst suggest that possibly both of the effects discussed above are at play.[106] Small amounts of labor control help overcome ***1416** transaction costs associated with efficient contracting, particularly in industries that require coordination with labor, such as manufacturing.[107] However, higher levels of labor control lead to lower valuation, which they attribute to the heightened risk aversion of labor and the associated constraints on investing.[108]

Viewed again through the Coasian lens, the results that shareholder value eventually declines as labor representation increases may be consistent with improving social welfare. The Coase theorem applies only to the efficiency of outcomes, not the division of surplus. An efficiently run corporation with increased labor control should have reduced shareholder value: if board seats are indeed a type of property right, then labor should use its rights to extract value from shareholders. These gains for labor could come in the form of increased pensions, better working conditions, or higher wages, any of which may detract from shareholder value. In fact, it is exactly this transfer of value that many of the proponents of codetermination in the U.S. seek to achieve.[109]

The more pertinent question is if awarding labor some degree of control changes the behavior of a corporation in some consistent way. There is strong evidence of this from studies that look beyond shareholder value. Looking again at German data, Lin, Schmid, and Xuan (2018) find that companies with labor board representation have less volatile cash flows, engage in fewer (and more profitable) M&A transactions, reduce idiosyncratic risk, have lower borrowing costs, and deploy higher leverage.[110] Using U.S. data, Faleye, Mehrotra, and Morck (2006) find that companies with higher employee ownership may have lower investment, lower R&D, reduced operating risk, and consequently lower growth.[111] More recently, Rapp and Wolf (2019) find evidence that German firms weathered the global financial ***1417** crisis more easily than firms based in other countries and laid off fewer employees.[112]

It is possible that financing the riskiest projects imposed externalities on workers or other stakeholders, such that abandoning them after the addition of labor to the board enhances efficiency. Possibly, labor's interests were not otherwise being appropriately internalized, or including labor on the board reduces some principal-agent problems between shareholders and management that encouraged value-destroying M&A.

Alternatively, it could be that awarding control rights to labor induces excessive conservatism, and the resulting decline in growth and innovation is costly to society in the long term. The existing literature is largely silent on this distinction, in part because the empirical work is typically constrained to cross-sectional analysis within individual economies. While this is understandable from an econometric standpoint--tests of cross-economy differences are subject to numerous confounders, compared to the sorts of quasi-natural experiments done within countries--it does limit the ability to derive insights about the U.S. economy from the international evidence.

However, a few very basic statistics suggest some possibilities.[113] For example, as of January 2021, the P/E multiple of the S&P 500 (based on 2021 consensus earnings) is nearly 22; at the same time, the P/E multiple of the DAX (the main German stock index) is 15.[114] This implies that either the cost of equity in Germany is higher than that in the U.S., or the expected growth rate of corporate earnings is lower, or both. Of course, this comparison ignores obvious sectoral differences between the two economies. The Information Technology sector, which has a particularly high multiple, is more heavily represented in the U.S., for example.[115] But that fact itself is ***1418** informative--the increased concentration of high-growth, innovative sectors in the U.S. is very likely to be endogenous to the structure of the U.S. economy, which could include factors like board representation.

An example in the Autos sector is worth noting. Dammann and Eidenmueller (2020) point to better employee relations at Daimler-Benz versus Tesla after the onset of COVID-19 as evidence of the beneficial effect of codetermination.[116] Better relations between labor and management may indeed be a benefit. But this example makes the potential costs quite clear as well. Tesla stock traded in a relatively narrow range from 2014 to the middle of 2019 while the viability of the company's ambitious plans remained in question.[117] The stock has subsequently generated a return of over 1,000% as it has proven a path to profitability and has gone from being worth less than Daimler-Benz to being worth over eleven times more.[118] Despite the obvious autos-related IP that exists within Germany, it is possible that Tesla was only viable in the U.S.--the German structure may not be hospitable to a company that would make long-term, money-losing investments over many years on ***1419** an unproven idea, even if it had the potential to become one of the world's most valuable companies.

Another area of potential exploration is the relationship between labor board representation and corporate malfeasance. As discussed above, “skin in the game” maintains appropriate incentives to limit bad corporate behavior. However, the German system limits the extent to which labor is held accountable for corporate malfeasance.[119] In the event of a restructuring, labor would retain seats on the new board, so long as the restructured company was large enough to qualify for codetermination. In this sense, labor's share of the corporate surplus in Germany is senior, at least to that of shareholders; we predict that one consequence of this structure is a limited incentive for monitoring and reporting on malfeasance. The relationship of this structure to some high-profile corporate scandals in Germany cannot be ignored. For example, some commentators have argued that the relationship between senior management and labor fostered by codetermination played a role in the emission scandal at VW.[120] At the same time, the material fines and penalties paid by VW across the globe have been paid by shareholders.

V. A Recipe for Pro-Social Inclusion Mandates and Some Brief Observations on the Proposals

A. Summing up the Coasian Framework

These economic insights lead to an understanding of what might make an inclusion mandate deliver corporate behavior that is beneficial to overall social welfare. The corporation is faced with an array of potential projects, among which may be some that generate large business profits at the expense of external harm. What would lead the corporate board to internalize those externalities to a greater extent and, thus, make better social choices?

In order to alter corporate behavior, the inclusion mandate must bring inside the Coasian bubble of the boardroom a person or group with significantly different incentives. To avoid external harms, these different preferences must include a greater regard for those external harms. Because ***1420** the magnitude of corporate profits is large for large entities, those preferences must be of a large magnitude themselves to not be overwhelmed by a share of corporate lucre. This likely entails accountability of the board representative to some population that stands under the shadow of potential corporate externalities; constituency mandates have the potential to do well on this front. Traditional *ex post* liability is, further, complementary with such constituency mandates. Individuals, while they may have different preferences, have relatively little variation in their preferences compared to corporate resources; rather, only aggregated preferences of large numbers of like-minded persons will rival corporate-sized incentives. This is likely to be an innate failing of diversity mandates, at least with regard to their effectiveness at altering corporate purpose in a more pro-social direction.

Last, but certainly not least, depending on the structure and other particulars, an inclusion mandate does have the capacity to make things worse. This would occur where the included constituency's claims on the corporation are not residual ones; if they are not, then they put the constituency in the position of being able to expropriate other interests.

B. Recommendations on U.S. Inclusion Mandates

Turning to the inclusion mandates that are currently enacted or proposed in the United States, some recommendations come to mind. A main and obvious distinction is between diversity and constituency mandates. Diversity mandates may well improve the effectiveness with which corporations maximize shareholder value. We can easily imagine that a diverse board is less likely to function like an "old boys' club" and more likely to challenge management, thus remediating a principal-agent problem between shareholders and board members. The California diversity mandate specifically cites evidence that diverse boards pay CEOs less than non-diverse boards, which is possible evidence of stricter oversight of management.[121] In keeping with this line of reasoning, the California and Nasdaq diversity mandates both cite better value creation as justification for diverse boards.[122] For example, the California statute cites improvements to earnings, return on equity, and price-to-book ratio, all obviously linked to long-term shareholder value.[123] Both mandates also cite reduced fraud and ***1421** better financial reporting.[124] To the extent that fraud and misreporting destroy long-term shareholder value (which would be the case if they are the product of managerial short-termism, for example), then the same logic regarding the benefits of diverse boards applies.

However, the Coasian analysis would imply skepticism of the claim that diverse boards would systematically engage in less corporate malfeasance that risked the realization of a negative externality but did maximize shareholder value *ex ante*. Similarly, it seems unlikely that diverse boards would be more risk-averse and use less leverage, as claimed by the California statute (leaving aside the issue that, unlike avoiding fraud and other forms of malfeasance, which is at least pro-social, it is unclear that a more risk-averse corporate sector is a positive change for society).[125] Our analysis highlights that many of the characteristics of board representation necessary to effect these changes in corporate behavior are lacking in diversity mandates, as currently construed. They create no accountability of the directors to anyone other than the rest of the board (which nominates them) and the shareholders at large (who elect them). It seems likely that extant boards would nominate diverse directors who are otherwise just like them, and shareholders would elect and incentivize directors so as to maximize shareholder profits, just as before. To the extent diverse directors have different preferences, the typical large corporation will have plenty of resources to overcome even significant differences in individual preferences. Though it seems unlikely that these diversity mandates will change corporate behavior significantly (other than perhaps to make the company run even more efficiently and/or ruthlessly than before), they do not worsen incentives either: diverse directors have interests that are residual in nature, being accountable, ultimately, to the firm's residual claimants.

The Accountable Capitalism Act, as a constituency statute, would award 40% of the board seats of large business entities to representatives of labor.[126] This seems certain to effect a significant change in the preferences represented in the Coasian bubble of the board room: labor has interests in wages, working conditions, and pensions, all of which differ significantly from equity interests. Because labor's claims are ones that may otherwise be expropriated through risk-taking or restructuring, the Act has the potential to improve incentives by bringing otherwise externalized harms into the boardroom. The main drawback, however, of the Act is the lack of accountability of labor: as written, labor retains its representative interest no ***1422** matter what happens, apart from the relatively unlikely event that the entity simply ceases to exist.[127] If corporate malfeasance forces the entity through Chapter 11, labor emerges on the other side with its board representation (and at least its funded pensions) intact; this effectively reduces the capitalization of the company and creates opportunities for expropriating others that did not exist before. An improvement would be to give labor additional skin in the game through either a different structuring of its claims or by making labor's assets subject to *ex post* liability for corporate malfeasance.

Footnotes

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1 This Article sometimes uses the term "corporate" in the loose sense of a business entity and "corporate governance" to apply to the governance of such entities. Such usage is not technically correct in a legal context, as applied to increasingly-common forms of

business associations such as the limited liability company and limited partnership, some of which are quite large and even publicly traded. However, such a use is etymologically defensible, as "corporate" derives from the Latin "corporare," meaning to form into a body, which is a concept that is applicable to business entities generally. This happens also to be the way in which the Accountable Capitalism Act uses the term, including, as it does, "bod[ies] corporate," LLCs, and actual corporations in the new category of U.S. corporations. Accountable Capitalism Act, S. 3215, 116th Cong. § 2(4)(A)(i) (2020). The same caveat applies, *mutatis mutandis*, for this Article's usage of terms such as "corporate board room."

2 *See, e.g.*, Press Release, Elizabeth Warren, Senator, U.S. Senate, Senator Warren to Business Roundtable: Your 2019 Commitment to 'Promote an Economy that Serves All Americans' Was an Empty Publicity Stunt (Sept. 17, 2020), https://www.warren.senate.gov/newsroom/press-releases/senator-warren-to-business-roundtable-your-2019-commitment-to-promote-an-economy-that-serves-all-americans-was-an-empty-publicity-stunt [https://perma.cc/2H8M-7MKS] (discussing the purpose of the Accountable Capitalism Act to reverse "harmful corporate trends" that have arisen because of the drive for corporate profits); Jillian Ambrose, *Major Global Firms Accused of Concealing Their Environmental Impact*, Guardian (June 16, 2019, 1:13 PM), https://www.theguardian.com/environment/2019/jun/16/major-global-firms-accused-of-concealing-their-environmental-impact [https://perma.cc/AL9Z-ZUDZ] (alleging a lack of transparency from major corporations regarding their effect on the environment); Siva Vaidhyanathan, *Making Sense of the Facebook Menace: Can the Largest Media Platform in the World Ever Be Made Safe for Democracy?*, New Republic (Jan. 5, 2021), https://newrepublic.com/article/160661/facebook-menace-making-platform-safe-democracy [https://perma.cc/YCA2-H54R] (asserting the lack of incentives for corporations to shift their focus from gaining profit to preserving democracy).

3 *See, e.g.*, Gretchen Morgenson, *A Bank Too Big to Jail*, N.Y. Times (July 15, 2016), https://www.nytimes.com/2016/07/17/business/a-bank-too-big-to-jail.html [https://perma.cc/26NM-4HJE] (analyzing Justice Department reluctance to prosecute large financial institutions that are capable of causing global financial crises).

4 *See* M. Todd Henderson & James C. Spindler, *Taking Systemic Risk Seriously in Financial Regulation*, 92 Ind. L.J. 1559, 1560, 1594-95 (2017) (discussing how bank regulation may include both *ex post* regulation and *ex ante* (command-and-control) regulation).

5 *See* James C. Spindler, *Why Shareholders Want Their CEOs to Lie More After* Dura Pharmaceuticals, 95 Geo. L.J. 653, 667-68 (2007) (describing damages requirements under both the tort of fraud and federal statutory securities fraud claims).

6 *See* Henderson & Spindler, *supra* note 4, at 1594-95 (discussing the prevalence of command-and-control regulations in stable industries, such as energy production); Daniel H. Cole & Peter Z. Grossman, *When Is Command-and-Control Efficient? Institutions, Technology, and the Comparative Efficiency of Alternative Regulatory Regimes for Environmental Protection*, 1999 Wis. L.Rev. 887, 914 (arguing that command-and-control regulation can be efficient given certain conditions). Other aspects of financial services such as insurance (largely regulated at the state level) and asset management (by the SEC) are treated similarly. Utilities and healthcare are other obvious examples with significant command-and-control regulation. *See* Omar Al-Ubaydli & Patrick McLaughlin, *RegData: A Numerical Database on Industry-Specific Regulations for All United States Industries and Federal Regulations, 1997-2012*, 11 Reg. &GovernanceE 109, 119 (2017) (quantifying the degree to which various industries are regulated). The methodology is based on a count of binding constraints in the Code of Federal Regulations, aggregated at the industry level. Various aspects of financial services, utilities, and resource extraction make up four of the top five most heavily regulated industries. *See* Patrick McLaughlin & Oliver Sherouse, *The McLaughlin-Sherouse List: The 10 Most-Regulated Industries of 2014*, Mercatus (Jan. 21, 2016), https://www.mercatus.org/publications/regulation/mclaughlin-sherouse-list-10-most-regulated-industries-2014 [https://perma.cc/6J72-ER9N] (listing petroleum and coal products manufacturing, electric power generation, nondepository credit intermediation, and depository credit intermediation as four of the top five most-regulated industries in 2014).

7 *See* Accountable Capitalism Act, S. 3215, 116th Cong. § 6(b)(1) (2020) ("Not less than 2/5 of the directors of a United States corporation shall be elected by the employees of the United States corporation"); Elizabeth Warren, *Accountable Capitalism Act*, Elizabeth Warren, https://www.warren.senate.gov/imo/media/doc/Accountable%20Capitalism%C20Act%20One-Pager.pdf [https://perma.cc/42SY-5PLR] (requiring a United States corporation to ensure that at least 40% of the corporation's directors are selected by the corporation's employees). According to Senator Warren's description of the Act, the Act is motivated by a desire to "balance the interests of all of [American corporations'] stakeholders, including employees, customers, business partners, and shareholders," by encouraging corporate long-term reinvestment (as opposed to shareholder distributions) to produce "broad-based growth." *Id.*

8 *See* A.B. 979, 2019-2020 Cal. Assemb., Reg. Sess. (Cal. 2020), http://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201920200AB979 [https://perma.cc/B8QM-JREW] (requiring a minimum number of corporate directors to be from underrepresented communities depending on the size of the corporation's board).

9 *See* Press Release, Nasdaq, Nasdaq to Advance Diversity through New Proposed Listing Requirements (Dec. 1, 2020), https://www.nasdaq.com/press-release/nasdaq-to-advance-diversity-through-new-proposed-listing-requirements-2020-12-01 [https://perma.cc/L2AF-5YMF] (requiring most Nasdaq-listed companies to have diverse directors with at least one identifying as female and at least one other identifying as an underrepresented minority); The Nasdaq Stock Mkt. LLC, Self-Regulatory Organization Filing of Proposed Rule Changes (Form 19b-4) 3 (Dec. 1, 2020), https://listingcenter.nasdaq.com/assets/RuleBook/Nasdaq/filings/SR-NASDAQ-2020-081.pdf [https://perma.cc/PLB3-P487] [hereinafter Nasdaq (Form 19b-4)] (proposing the adoption of a diverse-board-representation rule to require Nasdaq companies to have at least one director who self-identifies as female and at least one director who self-identifies as an underrepresented minority or to explain why the board does not meet this diversity rule). Board diversity also typically counts toward ESG ratings, which are increasingly of concern to companies as ESG investing grows in prominence. *See* Neesha-ann Longdon, Dimitri Henry & Caitlin Harris, *Diversity and Inclusion as a Social Imperative*, S&P Global Ratings (Aug. 3, 2020), https://www.spglobal.com/ratings/en/research/articles/200803-environmental-social-and-governance-diversity-and-inclusion-as-a-social-imperative-11573860 [https://perma.cc/23CE-LVYY] (stating that a decline in ESG performance--which may come from failing to develop an inclusive workforce--can result in a loss of both customers and profit); *Making Sense of ESG*, PwC: In the Loop (Oct. 29, 2020), https://www.pwc.com/us/en/cfodirect/publications/in-the-loop/esg-reporting-controls.html [https://perma.cc/5QYC-PLDJ] (articulating how investment strategies increasingly involve ESG, which leads to investors calling on companies to promote enhanced diversity and inclusion practices).

10 *See* A.B. 979 § 1(r), 2019-2020 Cal. Assemb., Reg. Sess. (Cal. 2020), http://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201920200AB979 [https://perma.cc/7SDB-AGLD] ("More racially and gender diverse boards further the goals of the Sarbanes-Oxley Act of 2002, which pushed for more independent boards that decrease the likelihood of corporate fraud.").

11 Accountability to rank-and-file shareholders is not a given. Technology companies such as Google and Facebook have gone public with voting structures that entrench control in the hands of founders or important executives. *See* Lucian A. Bebchuk & Kobi Kastiel, *The Perils of Small-Minority Controllers*, 107 Geo. L.J. 1453, 1457 (2019) ("Companies have increasingly gone public with dual-class structures, including well-known names such as Alphabet (formerly Google), Berkshire Hathaway, Facebook, Ford, News Corp, Nike, and Viacom."). Prior to such developments, there has been a long-running debate over whether shareholders can and do exercise meaningful control over public companies. *See, e.g.*, Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 Univ. Chi. L. Rev. 751, 754 (2002) (putting forth the "managerial power approach" to account for the design of executive compensation, in which executives have the ability to "influence their own compensation schemes").

12 *See* R. H. Coase, *The Problem of Social Cost*, 3 J. L. & Econ. 1, 1 (1960) (examining the "actions of business firms which have harmful effects on others"). As discussed more fully below in Part III, a primary insight of Coase's work was that, absent transactions costs, private parties would be able to contract to a socially optimal result. *See id.* at 5-6 (explaining how contracting would optimize the allocation of resources between a hypothetical rancher and farmer). Also, while there is some difference of opinion on the spelling of the term "Coasian," we use the spelling used by Ronald Coase himself. *See* Peter Klein, *Coasian or Coasean?*, Orgs. and Mkts. (Mar. 20, 2011), https://organizationsandmarkets.com/2011/03/20/coasian-or-coasean/ [https://perma.cc/9PKJ-4QXN] (expressing that Coase used the spelling "Coasian" to refer to his own theory).

13 For a different and contrasting model of board inclusion, see Jens Dammann & Horst Eidenmueller, *Taming the Corporate Leviathan: Codetermination and the Democratic State* 41 (European Corp. Governance Inst., Working Paper No. 536/2020, 2020), which argues that including labor on the board prevents the corporation from effectively profit-maximizing.

14 *See, e.g.*, Howard H. Preston, *The Banking Act of 1933*, 23 Am. Econ. Rev. 585, 585-87 (1933) (regarding the passage of the Banking Act of 1933 as a response to the Great Depression); Barack Obama, U.S. President, Remarks by the President on 21st Century Financial Regulatory Reform (June 17, 2009) (transcript available at https://obamawhitehouse.archives.gov/the-press-office/remarks-president-regulatory-reform/) [https://perma.cc/JD5S-B7CQ]) (containing the speech of President Obama announcing reform initiatives in response to the financial crisis of 2007-2008, which ultimately led to the Dodd-Frank legislation). *See also infra* note 25.

15 This relies on the ability to contract within the Coasian bubble. If suitable contracts cannot be written, then factors such as risk aversion of the included constituency could lead to changes in corporate decisions, such as increased conservatism, which we discuss in more detail in Part V. For a detailed discussion of the theoretical constraints that would face a firm entirely owned by labor, see Michael C. Jensen & William H. Meckling, *Rights and Production Functions: An Application to Labor-Managed Firms and Codetermination*, 52 J. Bus. 469, 493 (1979).

16 An example, discussed in more detail below, is when including labor representation on a board overcomes contracting issues that keep employees from making efficient investments in firm-specific human capital. For a theoretical model and associated empirical tests, see Eirik G. Furubotn & Steven N. Wiggins, *Plant Closings, Worker Reallocation Costs and Efficiency Gains to Labor Representation on Boards of Directors*, 140 J. Institutional & Theoretical Econ. 176, 187 (1984).

17 An emerging body of empirical literature addresses the potential benefits of more diverse boards, and this line of reasoning is behind many of the efforts to mandate a minimum level of board diversity. Much of the literature in support of this position is done by advocacy groups or consultants. *See, e.g.*, Vivian Hunt, Sara Prince, Sundiatu Dixon-Fyle & Kevin Dolan, *Diversity Wins: How Inclusion Matters*, McKinsey &Company 3 (2020), https://www.mckinsey.com/~/media/McKinsey/Featured%20Insights/Diversity%20and%20Inclusion/Diversity%20wins%C20How%C20inclusion%20matters/Diversity-wins-How-inclusion-matters-vF.pdf [https://perma.cc/HP63-5HF4] ("This report shows not only that the business case remains robust, but also that the relationship between diversity on executive teams and the likelihood of financial outperformance is now even stronger than before."). The academic literature is more circumspect regarding the benefits of increased diversity. See Corinne Post & Kris Byron, *Women on Boards and Firm Financial Performance: A Meta-Analysis*, 58 Acad. Mgmt. J. 1546, 1557-58 (2015), who perform a meta-analysis and find limited effects on accounting variables and no effect on financial performance from greater board diversity. *See also* Jenny M. Hoobler, Courtney R. Masterson, Stella M. Nkomo & Eric J. Michel, *The Business Case for Women Leaders: Meta-Analysis, Research Critique, and Path Forward*, 44 J. Mgmt. 2473, 2481 (2018) (examining female corporate leaders more generally and finding mixed results). For a recent academic treatment supporting the benefits of diversity, see Daehyun Kim & Laura T. Starks, *Gender Diversity on Corporate Boards: Do Women Contribute Unique Skills?*, 106 Am. Econ. Rev. 267, 268-69 (2016).

18 *See infra* notes 22-24 and accompanying text.

19 *See, e.g.*, Milton Friedman, *A Friedman Doctrine - The Social Responsibility of Business Is to Increase Its Profits*, N.Y. Times (Sept. 13, 1970), https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html [https://perma.cc/J55N-Q3EP] ("[The corporate executive's] responsibility is to conduct the business in accordance with [the owners'] desires, which generally will be to make as much money as possible while conforming to the basic rules of the society ....").

20 *See id.* Friedman explained:

Many a reader who has followed the argument this far may be tempted to remonstrate that it is all well and good to speak of government's having the responsibility to impose taxes and determine expenditures for such "social" purposes as controlling pollution or training the hard-core unemployed, but that the problems are too urgent to wait on the slow course of political processes, that the exercise of social responsibility by businessmen is a quicker and surer way to solve pressing current problems.

Aside from the question of fact--I share Adam Smith's skepticism about the benefits that can be expected from "those who affected to trade for the public good"--this argument must be rejected on grounds of principle. What it amounts to is an assertion that those who favor the taxes and expenditures in question have failed to persuade a majority of their fellow citizens to be of like mind and that they are seeking to attain by undemocratic procedures what they cannot attain by democratic procedures.

Id. But see Paul Krugman, *Why Libertarianism Doesn't Work, Part N*, N.Y. Times: Paul Krugman (May 14, 2010, 1:40 PM), https://krugman.blogs.nytimes.com/2010/05/14/why-libertarianism-doesnt-work-part-n/ [https://perma.cc/7KHX-JHEC] (criticizing the effectiveness of letting lawsuits inspire social responsibility given liability limits).

21 *See* McLaughlin & Sherouse, *supra* note 6 (listing the ten industries with the most regulatory restrictions, including: nondepository credit intermediation; depository credit intermediation; electric power generation, transmission, and distribution; petroleum and coal products manufacturing; and oil and gas extraction).

22 *See* Ivan Penn, *PG&E's Bankruptcy Filing Creates a 'Real Mess' for Rival Interests*, N.Y. Times (Jan. 29, 2019), https://www.nytimes.com/2019/01/29/business/energy-environment/pge-file-bankruptcy.html [https://perma.cc/R6R3-SGVJ] (explaining that PG&E's bankruptcy would likely prevent payouts for some of the wildfire damage it caused).

23 *See* Richard Squire, *Shareholder Opportunism in a World of Risky Debt*, 123 Harv. L. Rev. 1151, 1153 (2010) (noting that the losses on troubled financial assets assumed by Fannie Mae and Freddie Mac were borne by taxpayers); Daisy Maxey, *Expense Tally for Reserve Primary Since 'Breaking Buck': $16.6 Million*, Wall St. J. (June 13, 2009, 11:59 PM), https://www.wsj.com/articles/SB124485814552011899 [https://perma.cc/6A6A-ULK2] (explaining how news of Lehman's failure "sent panic through the money-market fund industry and prompted the Treasury Department to offer a temporary guaranty program for money-market funds, set to expire in September").

24 Eric Beech, *U.S. Government Says It Lost $11.2 Billion on GM Bailout*, Reuters (Apr. 30, 2014, 10:03 AM), https://www.reuters.com/article/us-autos-gm-treasury/u-s-government-says-it-lost-11-2-billion-on-gm-bailout-idUSBREA3T0MR20140430 [https://perma.cc/9WCY-DVM6].

25 Financial regulation passed in the wake of the Great Depression included the Banking Act of 1933 (which created the FDIC and instituted the Glass-Steagall separations of commercial and investment banking), the Securities Act of 1933, and the Securities Exchange Act of 1934 (which established the SEC). The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) was passed in 1989 during the savings and loan crisis. For a discussion of the historical context behind the major advances in financial regulation in the U.S., see generally Alejandro Komai & Gary Richardson, *A Brief History of Regulations Regarding Financial Markets in the United States: 1789 to 2009* (Nat'l Bureau of Econ. Research, Working Paper No. 17443, 2011), http://www.nber.org/papers/w17443 [https://perma.cc/84DR-UF7G].

26 Jeff Meli, Jonathan Millar & Adam Kelleher, *Increased Corporate Concentration and the Influence of Market Power*, 5 Barclays Impact Series 4, 31 (2019), https://www.investmentbank.barclays.com/content/dam/barclaysmicrosites/ibpublic/documents/our-insights/MarketPower/Barclays-ImpactSeries5-MarketPower_final_2.4MB.pdf [https://perma.cc/DX4G-P6R8].

27 Simcha Barkai, *Declining Labor and Capital Shares*, 75 J. Fin. 2421, 2449 (2020) finds a link between lower labor share of output and increased concentration and corporate profits. One possible interpretation of this phenomenon is that increased concentration has reduced competition. Germán Gutiérrez & Thomas Philippon, *Declining Competition and Investment in the U.S.* 3 (Nat'l Bureau of Econ. Research, Working Paper No. 23583, 2017), https://www.nber.org/papers/w23583 [https://perma.cc/GB7A-FP8C] associate increased concentration with a decline in competition in the U.S., and a corresponding reduction in investment in the corporate sector. An alternative explanation is that competition has actually increased, and as a result the most successful firms aggregate market share, but that this represents increased efficiency, not a rise in market power. *See* David Autor, David Dorn, Lawrence F. Katz, Christina Patterson & John Van Reenen, *The Fall of the Labor Share and the Rise of Superstar Firms*, 135 Q.J. Econ. 645, 648 (2020) (arguing that market concentration may be due to highly productive firms responding efficiently to changing market conditions).

28 *See* Mitchell Hartman, *What Did America Buy with the Auto Bailout, and Was It Worth It?*, Marketplace (Nov. 13, 2018), https://www.marketplace.org/2018/11/13/what-did-america-buy-auto-bailout-and-was-it-worth-it/ [https://perma.cc/MQX3-V749] (citing a researcher's statement that the bailout prevented catastrophe for auto-dependent communities across the Upper Midwest).

29 Kate Conger, *Uber and Lyft Drivers in California Will Remain Contractors*, N.Y. Times (Nov. 4, 2020), https://www.nytimes.com/2020/11/04/technology/california-uber-lyft-prop-22.html [https://perma.cc/PZE5-HP4P].

30 For example, despite repeated whistleblower complaints made to the SEC, the Bernie Madoff Ponzi scheme was allowed to persist for sixteen years due to SEC inexperience, incompetence, and poor incentive structures. *See* Office of Inspector Gen., U.S. Sec. & Exch. Comm'n, Case No. OIG-509, Report of Investigation: Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme (2009), https://www.sec.gov/files/oig-509-exec-summary.pdf [https://perma.cc/R2PW-CNGS] (cataloging the various complaints, investigations, and news articles about Madoff's fraud that the SEC inexplicably failed to act on).

31 *See* Scott Shane, *The Fake Americans Russia Created to Influence the Election*, N.Y. Times (Sept. 7, 2017), https://www.nytimes.com/2017/09/07/us/politics/russia-facebook-twitter-election.html [https://perma.cc/84SK-N4VU] (noting that Facebook and Twitter did not stop their platforms "from being turned into engines of deception and propaganda" prior to the 2016 election).

32 Georgia Wells, Jeff Horwitz & Deepa Seetharaman, *Twitter, Facebook Lock Trump Out of His Accounts*, Wall St. J. (Jan. 6, 2021, 9:56 PM), https://www.wsj.com/articles/facebook-and-twitter-take-steps-to-remove-calls-for-violence-as-protesters-storm-u-s-capitol-11609971394 [https://perma.cc/N3U6-BTM6].

33 *See, e.g.*, Dammann & Eidenmueller, *supra* note 13, at 18 ("[C]oncentrations of corporate power that are so extreme as to undermine the functioning of our democratic institutions are incompatible with democratic processes and principles.").

34 *See, e.g.*, Dorothy S. Lund & Elizabeth Pollman, *The Corporate Governance Machine*, Colum. L. Rev. (forthcoming 2021) (manuscript at 10), http://ssrn.com/abstract_id=3775846 [https://perma.cc/38XA-MDCU] (asserting that modern corporate governance has converged on ensuring faithful representation of shareholder interests).

35 *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305, 312 (1976) (explaining the inherent agency costs in the typical corporate form, which separates ownership and control). Legal attempts to address the problems of remote ownership and potentially disloyal agents date back to ancient times. Roman patriarchs, for example, could entrust family members (in the *pater familias*) or his slaves (in the *peculium*) with a business or property, and enjoyed agency-like protections; some commentators believe these prefigure modern organizational entities. *See* Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 Harv. L. Rev. 1333, 1357-60 (2006) (explaining how Roman families transacted business as a family unit or through its slaves, thus enjoying collective property ownership, credit cost shielding and other agency-like privileges). *See also* Oliver Wendell Holmes, Collected Legal Papers 51, 56-58 (Peter Smith 1952) (1920) (recognizing that agency principles were applied in the master and slave dynamic in ancient Roman culture). The idea of fiduciary duties as a stand-alone has been traced back to medieval English courts, in the context of feoffments or other property held in trust for the owner/grantor or his heirs. *See* David J. Seipp, *Trust and Fiduciary Duty in the Early Common Law*, 91 B.U. L. Rev. 1011, 1034-36 (2011) (examining English judicial remedies' inherent characteristics of bestowing fiduciary duties on those who held temporary control over the property of another).

36 *See, e.g.*, Tex. Bus.Orgs. Code Ann. § 21.359 (West 2006) ("[D]irectors of a corporation shall be elected by ... holders of shares.").

37 *See* Seipp, *supra* note 35, at 1034 (explaining that the creation of fiduciary duties owed by tenants to landlords required a reasonable accounting of money owed).

38 *See, e.g.*, Recent Case, *In re* Smurfit-Stone Container Corp. Shareholder Litigation, *No. 6164-VCP, 2011 WL 2028076 (Del. Ch. May 24, 2011)*, 125 Harv. L.Rev. 1256, 1260 (2012) (detailing doctrinal treatment of merger consideration in the application of fiduciary duties).

39 *See* Proxy Disclosure Enhancements, Securities Act Release No. 9089, Exchange Act Release No. 61,175, Investment Company Act Release No. 29,092, 74 Fed. Reg. 68,333, 68,354 (Dec. 23, 2009), https://www.govinfo.gov/content/pkg/FR-2009-12-23/pdf/E9-30327.pdf [https://perma.cc/RJ7P-AE65] (describing enhanced mandatory disclosures about executive compensation); James C. Spindler, *Hidden Costs of Mandatory Long-Term Compensation*, 13 Theoretical Inquiries in L. 623, 626-27 (2012) (analyzing the effect of mandatory long-term compensation reforms and arguing that they are likely counterproductive).

40 *See* Facilitating Shareholder Director Nominations, Securities Act Release No. 9136, Exchange Act Release No. 62,764, Investment Company Act Release No. 29,384, 75 Fed. Reg. 56,667, 56,669 (Sept. 16, 2020), https://www.govinfo.gov/content/pkg/FR-2010-09-16/pdf/2010-22218.pdf [https://perma.cc/9TM4-MZ6Y] (discussing a change in federal proxy rules in order to give shareholders greater insight and control into and over company management).

41 For examples of the relatively few treatments of the bad shareholder problem, see generally Squire, *supra* note 23; William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. Pa. L. Rev. 653 (2010); James C. Spindler, *Optimal Deterrence When Shareholders Desire Fraud*, 107 Geo. L.J. 1071 (2019); and James Cameron Spindler, *Vicarious Liability for Managerial Myopia*, 46 J. Legal Stud. 161 (2017).

42 *See* Stephen M.Bainbridge &M.ToddHenderson, Limited Liability:ALegal and Economic Analysis 9 (2016) (describing the general rule (and exceptions thereto) that corporate creditors can satisfy their claims only against assets of the firm, not its shareholders).

43 *See, e.g.*, John Mulford, *Corporate Distributions to Shareholders and Other Amendments to the Pennsylvania Business Corporation Law*, 106 U. Pa. L. Rev. 536, 536-37 (1958) (outlining the prohibition on shareholder distributions from anything other than surplus in the Business Corporation Law of Pennsylvania); Richard A. Booth, *Capital Requirements in United States Corporation Law* 15 (2005) (unpublished manuscript) (on file with Villanova University Charles Widger School of Law) (explaining that rules involving capital surplus offer a small amount of protection for creditors).

44 *See* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101-02 (Del. 2007) (explaining that "[w]hen a corporation is insolvent ... creditors take the place of the shareholders" as derivative beneficiaries of fiduciary duties) (emphasis omitted).

45 *See* David Rosenberg, *Delaware's "Expanding Duty of Loyalty" and Illegal Conduct: A Step Towards Corporate Social Responsibility*, 52 Santa Clara L. Rev. 81, 86-87 (2012) (highlighting that although it is not exactly disloyal, approval of profit-motivated illegal activity is a breach of a director's fiduciary duty); Elizabeth S. Miller & Robert A. Ragazzo, 20A Texas Practice Series, Business Organizations (3d ed. November 2020) § 36:11 ("[D]irectors have a duty to observe the law" and "they stand to be liable for taking illegal action.").

46 For potential damages problems as well, see Rosenberg, *supra* note 45, at 87-88, which highlights the unique challenge of imposing damages in the context of an illegal, but shareholder value-maximizing, action, resulting in a morality-based duty of loyalty toward outsiders. Receivership plays an important role in cases where the firm was solvent at the time of the conduct, but was subsequently rendered insolvent, since combined action by the receiver or trustee (who accedes to claims of the corporation and the equity holders) and creditors eliminates standing issues that might otherwise arise. *See In re* Bernard L. Madoff Inv. Sec. LLC, 721 F.3d 54 (2d. Cir. 2013).

47 *See* Bainbridge &Henderson, *supra* note 42, at 3 (recognizing that the law surrounding veil piercing theory is "not at all clear"); William H. Widen, *Report to the American Bankruptcy Institute: Prevalence of Substantive Consolidation in Large Public Company Bankruptcies from 2000 to 2005*, 16 Am. Bankr. Inst. L. Rev. 1, 1-2 (2008) (highlighting the limited court treatment of substantive consolidation).

48 *See, e.g.*, Jacqueline Palank, *Fairfield Investors, Citco Settle Madoff-Related Lawsuit*, Wall St. J. (Aug. 13, 2015, 11:47 AM), https://www.wsj.com/articles/fairfield-investors-citco-settle-madoff-related-lawsuit-1439480840 [https://perma.cc/TB6T-AR84] (describing settlements and lawsuits involving a Madoff feeder fund, the fund administrator, and the feeder fund's auditor).

49 *See* Booth, *supra* note 43, at 25-31 (discussing multiple doctrines, including fraudulent transfer statutes, piercing the corporate veil, and others); Kenneth C. Johnston, Kellie M. Johnson & Joseph A. Hummel, *Ponzi Schemes and Litigation Risks: What Every Financial Services Company Should Know*, 14 N.C. Banking Inst. 29, 29, 34-35 (2010) (discussing how financial institutions are one party that faces claims like "breach of fiduciary duty, negligence, negligent misrepresentation, fraudulent transfers, aiding and abetting fraud, and aiding and abetting breach of fiduciary duty"); Sarah Schiferl, *Aiding and Abetting Breach of Fiduciary Duty: Lawyer Beware*, Am. Bar Ass'n (May 23, 2017), https://www.americanbar.org/groups/litigation/committees/business-torts-unfair-competition/practice/2017/aiding-and-abetting-breach-of-fiduciary-duty-lawyer-beware/ [https://perma.cc/KNJ2-PZHS] (discussing aiding and abetting breach of fiduciary duties).

50 Accountable Capitalism Act, S. 3215, 116th Cong. §§ 2(4)(A), 4(a) (2020).

51 *Id.* § 3.

52 *Id.* § 5(b)-(c).

53 *Id.* § 9(c)(2)(A).

54 *Id.* § 8(b)(1).

55 *Id.* § 7(b)(1).

56 *Id.* § 6(b)(1).

57 S.B. 826, 2017-2018 Cal. S., Reg. Sess. § 2 (Cal. 2018), https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201720180SB826 [https://perma.cc/N4FJ-DHJL].

58 *Id.* § 1.

59 A.B. 979, 2019-2020 Cal. Assemb., Reg. Sess. § 3 (Cal. 2020), https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201920200AB979 [https://perma.cc/B8EE-7MYJ].

60 *Id.* § 1.

61 Nasdaq (Form 19b-4), *supra* note 9, at 1.

62 *Id.* at 6.

63 *Id.* at 6.

64 *Id.* at 9.

65 *Id.* at 9-10.

66 *See* Coase, *supra* note 12, at 6 (noting that the Coase theorem predicts that when an economic actor engages in activity that harms another, the actors will bargain for a situation that maximizes the value of their combined production).

67 *See id.* (using the cattle-raiser-farmer hypothetical to illustrate that production will be maximized regardless of the initial property entitlement).

68 *Id.* at 6-8.

69 *See id.* at 16 (noting that "[o]ne arrangement of rights may bring about a greater value of production than any other" but that the costs to change rights distribution "may be so great that this optimal arrangement of rights, and the greater value of production which it would bring, may never be achieved").

70 Lee Anne Fennell, *The Problem of Resource Access*, 126 Harv. L. Rev. 1471, 1478-79 (2013) ("[C]osts [from bargaining] are not zero, and indeed are routinely large.").

71 *See* William T. Allen, Reinier Kraakman &Guhan Subramanian, Commentaries and Cases on the Law of Business Organization 101-02, 105-08 (3d ed. 2009) (discussing the powers to direct corporate behavior given to board members).

72 *See* Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. Davis L. Rev. 407, 412 (2006) (arguing that "corporate law has never given shareholders very much power").

73 Coase, *supra* note 12, at 2-3.

74 *Id.*

75 For studies proposing such a channel, see *infra* Part IV.

76 It may be that the gains from efficient contracting do not scale linearly with the degree of constituent representation, suggesting that an ideal balance from the shareholders' perspective is a positive but low level of constituent representation. For example, if awarding board seats to labor improves the credibility of information exchange between management and employees, then even a solitary board representative may be sufficient to capture those gains. This would come with less sacrifice of corporate surplus and potentially represent an overall gain to shareholders. As discussed in Part IV below, several studies have found a nonlinear relationship between labor board representation and shareholder value, where value initially increases and then decreases. *See, e.g.*, Larry Fauver & Michael Fuerst, *Does Good Corporate Governance Include Employee Representation? Evidence from German Corporate Boards*, 82 J. Fin. Econ. 673, 675, 677 (2006) (noting that a previous study concluded that the inclusion of employee representation on the board of a firm may sacrifice shareholder value in favor of payroll and that the present study confirms that conclusion).

77 *See supra* text accompanying notes 50-56.

78 We differentiate here between decisions that appear values based but maximize long-term profitability versus those that explicitly sacrifice profits in pursuit of other ends. For example, a company with a substantial carbon footprint faced with rising costs of capital due to an increase in ESG-focused stakeholders or regulators may find that profit maximization requires reducing its carbon footprint. This change would not be dependent on a constituency mandate, whereas a proactive reduction of fossil-fuel use at the expense of profitability would.

79 Accountable Capitalism Act, S. 3215, 116th Cong. § 6 (2020).

80 *See* Henderson & Spindler, *supra* note 4, at 1591 (explaining the benefits of *ex post* liability as a regulatory option).

81 *See id.* at 1565, 1592 (describing the problem of judgment proofness in effective regulation through *ex post* liability).

82 *See* S. 3215 § 6 (requiring 40% employee representation on the board but making no provision for terminating that representation in the event of a restructuring). This is also the case with labor representation in Germany. *See infra* Part IV.

83 A risk-averse constituency with deep pockets would reject a negative NPV project but not a positive NPV project that has negative cash flows in some states of the world, so long as that constituency is able to hedge its downside risk (such as by selling off some of the positive NPV), which implicitly assumes that its claims on the firm are at least partially tradeable. We discuss in Part IV below the potential for wealth effects arising from untradeable claims to constrain positive NPV investments.

84 *See* Fiona Stewart, *Benefit Protection: Priority Creditor Rights for Pension Funds* 24-25 (Org. for Econ. Co-Operation and Dev., Working Paper on Insurance and Private Pensions No. 6, 2007), https://dx.doi.org/10.1787/267415864801 [https://perma.cc/X3V7-B7G7] (explaining that the Pension Benefit Guarantee Corporation cannot attach assets of bankrupt companies to protect pensioners).

85 It is well established that firms reduce employment following bankruptcy (while this is obvious for firms that liquidate, it is true in restructurings as well). *See, e.g.*, Edith Shwalb Hotchkiss, *Postbankruptcy Performance and Management Turnover*, 50 J. Fin. 3, 11 n.13 (1995) ("The median declines in revenues, assets, and employees from the fiscal year end preceding bankruptcy to the first full fiscal year following bankruptcy are each close to 50 percent."). More relevant for this discussion is the observation that employees of firms that file for bankruptcy have reduced future lifetime earnings, regardless of whether or not they remain at the firm post-bankruptcy. *See* John R. Graham, Hyunseob Kim, Si Li & Jiaping Qiu, *Employee Costs of Corporate Bankruptcy* 2 (Nat'l Bureau of Econ. Research, Working Paper No. 25922, 2019) ("The present value (PV) of [employees'] earnings losses from the year of bankruptcy to six years afterward is 67% of pre-bankruptcy annual earnings.").

86 *See, e.g.*, Richard Freeman & Edward Lazear, *An Economic Analysis of Works Councils*, *in* Works Councils: Consultation, Representation, and Cooperation in Industrial Relations 27, 29 (Joel Rogers & Wolfgang Streeck eds., 1995) ("Most Western European countries mandate elected works councils in enterprises above some size and give the councils rights to information and consultation about labor and personnel decisions. Germany gives councils co-determination over some decisions as well.").

87 *Id.* at 28. Such capital is considered important given the relevance of tenure at a firm to wage regressions in the labor-economics literature. *See, e.g.*, Robert Topel, *Specific Capital, Mobility, and Wages: Wages Rise with Job Seniority*, 99 J. Pol. Econ. 145, 149 tbl.1 (1991) (finding that the relative negative wage impact of a termination increases with tenure of the employee).

88 *See* Freeman & Lazear, *supra* note 86, at 49 ("[O]ne would expect workers in enterprises with strong councils to have greater loyalty to their firm and to be more eager to invest in firm-specific skills than workers in other firms.").

89 Eirik G. Furubotn & Steven N. Wiggins, *Plant Closings, Worker Reallocation Costs and Efficiency Gains to Labor Representation on Boards of Directors*, 140 J. Institutional & Theoretical Econ. 176, 187 (1984).

90 Fauver & Fuerst, *supra* note 76, at 691.

91 Jensen & Meckling, *supra* note 15, at 485-86.

92 *See* Chen Lin, Thomas Schmid & Yuhai Xuan, *Employee Representation and Financial Leverage*, 127 J. Fin. Econ. 303, 304 (2018) (arguing that employees and lenders share a lower risk appetite than equity owners).

93 These channels are often linked. For example, employees are likely to prefer stability in order to protect any quasi-rents they earn, for example, through returns to firm-specific human capital, which they may only be willing to develop because of their ability to influence management.

94 *See* Jensen & Meckling, *supra* note 15, at 480-81 (identifying the impossibility of pure rental, a time-horizon problem, a common-property problem, a non-transferability problem, and a control problem).

95 *See id.* at 481 ("[W]orkers' claims on firm cash flows are contingent on employment with the firm and are nonmarketable.").

96 Consider the following simple one-period example. Assume a firm is worth 10, split between shareholders, who retain 90% of the surplus, and employees, who extract 10% of the surplus in the form of a bonus at the end of the period if the firm survives. Shareholders maximize wealth and employees maximize utility, which is given by the utility function $U = \sqrt{(W)}$. Employees are paid a wage of 1 up-front, which is equivalent to a riskless wealth endowment. The firm can invest in a new project that generates net cash flows of -10 if it fails (wiping out all the surplus) or x if it succeeds. Assuming a 10% chance of failure, shareholders would choose to pursue this project if $x > 1.11$, the level above which pursuing the project increases expected wealth (of both shareholders and employees). However, the expected utility of the employees must be greater than $\sqrt{(2)}$ for them to agree to the project--this is only true if $x > 1.32$; at that level, 10% of the upside is worth the chance of losing half of their current wealth. Of course, if employees could sell their claim on the firm, this problem would disappear. But employee claims are naturally difficult to trade, and then the risk aversion of the employees can result in underinvestment. In some cases, shareholders may be able to make side payments to labor--but there will be a range of projects whose NPV, while positive, is not high enough to compensate employees for risk of lost utility. That range is wider if employees are more risk averse and if they have more wealth tied up in the firm.

97 Such a firm may also reject projects that involved hiring more employees, which is a form of dilution.

98 For a summary of the legislative history of both codetermination and workers' councils in Germany and Sweden, see generally Julian Constain, Note, *A New Standard for Governance: Reflections on Worker Representation in the United States*, 24 Fordham J. Corp. & Fin. L. 408 (2019).

99 *See id.* at 414 ("The Works Constitution Act of 1952 (the '1952 Act') introduced the current conception of German codetermination."). The law was originally limited to industries outside of the coal-mining and steel industries, and companies with 500-2,000 employees were required to give one-third of their board seats to employees. *Id.* at 414-15. In 1976 it was expanded to include companies with more than 2,000 employees and require 50% labor representation for companies outside of the coal-mining and steel industries. *Id.* at 415.

100 *See id.* at 414-15 (noting that one-third representation is required for firms between 500 and 2,000 employees in size and one-half representation is required for firms greater than 2,000 employees in size).

101 Gary Gorton & Frank Schmid, *Class Struggle Inside the Firm: A Study of German Codetermination* 5-6 (Nat'l Bureau of Econ. Research, Working Paper No. 7945, 2000), https://www.nber.org/papers/w7945 [https://perma.cc/9TKB-KDQY].

102 Gary Gorton & Frank A. Schmid, *Capital, Labor, and the Firm: A Study of German Codetermination*, 2 J. Euro. Econ. Ass'n 863, 879 (2004).

103 *See* Fauver & Fuerst *supra* note 76, at 686 ("[F]irms with employee representation have a significantly higher median value for Tobin's Q than do firms without employee representation ....").

104 Edith Ginglinger, William Megginson & Timothée Waxin, *Employee Ownership, Board Representation, and Corporate Financial Policies*, 17 J. Corp. Fin. 868, 878 (2011).

105 *Id.*; *see also* Fauver & Fuerst, *supra* note 76, at 698 (while not finding that larger increases *detract* from firm value, concluding that labor representation in excess of one-half has a "generally positive but statistically insignificant" effect on firm value).

106 *See* Fauver & Fuerst, *supra* note 76, at 703 (noting the likely positive effects of information flows and the likely negative effects--on stock price--of prioritization of wages).

107 *See id.* at 674, 701 (finding the effect of the interaction of employee representation and industry classification on firm value to be statistically significant and positive).

108 *See id.* at 703 (explaining how excessive employee representation on the board may cause labor itself to cause increased agency costs).

109 Senator Warren's campaign website makes clear that the motivation for her proposed ACA is to redirect corporate surplus towards workers: "Elizabeth has a plan to empower workers and transform corporate America so it produces broad-based growth that gets workers the wages they deserve." *Empowering Workers Through Accountable Capitalism*, Warren Democrats, https://elizabethwarren.com/plans/accountable-capitalism [https://perma.cc/9AHW-HW78].

110 Lin, Schmid & Xuan, *supra* note 92, at 321 (attributing the higher leverage to a supply-side effect, namely that banks are willing to lend more, and at lower rates, as a consequence of labor's influence on the company).

111 Olubunmi Faleye, Vikas Mehrotra & Randall Morck, *When Labor Has a Voice in Corporate Governance*, 41 J. Fin. &QuantitativeAnalysis 489, 493 (2006). They also find that companies with higher employee ownership exhibit lower growth in employees, indicating that existing employees are wary of diluting their claims by expanding headcount. *Id*. at 506, 509.

112 Marc Steffen Rapp & Michael Wolff, Strong Codetermination - Stable Companies: An Empirical Analysis in Lights of the Recent Financial Crisis 4 (I.M.U., Mitbestimmungsreport No. 51, 2019), https://www.econstor.eu/bitstream/10419/204837/1/1679444662.pdf [https://perma.cc/E3PT-PXDU].

113 We make the following comparisons for illustrative purposes only-- the headlines themselves are enough to suggest that these issues warrant deeper exploration. A serious comparison across economies would need to account for a large number of factors, including (but not limited to) demographics, the role of government, the level of unionization, and other (non-board) labor protections, etc.

114 For the S&P 500, see S&P Dow Jones Indices, Market Attributes: U.S. Equities January 2021, at 5 (2021), https://www.spglobal.com/spdji/en/documents/commentary/market-attributes-us-equities-202101.pdf [https://perma.cc/SAK6-WZN9] (estimates of S&P 2021 P/E ratio expected to be 21.9, as of January 2021). For the DAX, see *DAX Index (Germany): P/E Ratio & Yield*, Global Financial Database by Siblis Research, https://siblisresearch.com/data/dax-pe-ratio-yield/ [https://perma.cc/889J-55Y6] (estimates of 15.06 as of December 31, 2020).

115 *Compare* Craig Israelsen, *Sector by Sector in the S&P 500 with ETFs*, ETF.com (Feb. 9, 2021), https://www.etf.com/sections/etf-strategist-corner/sector-sector-sp-500?nopaging=1 [https://perma.cc/H2LV-HQ8F] (showing that the information technology sector is 27.6% of the S&P 500 index, as of December 31, 2020), *with DAX 30 Index Sector Weightings*, Global Financial Database by Siblis Research, https://siblisresearch.com/data/dax-30-sector-weights/ [https://perma.cc/2ZX4-Q6GC] (showing that the weight of the information technology sector in the DAX is only 13.99%, as of December 31, 2020). *See also* S&P Dow Jones Indices, *supra* note 114, at 15 (reflecting that the P/E multiple of information technology was 26.5x as of January 2021).

116 Dammann & Eidenmueller, *supra* note 13, at 54-55.

117 *See, e.g.*, Jason Aten, *Elon Musk Has a Plan to Make Tesla Profitable by Raising Prices and Making It Harder to Change Your Mind*, Inc. (Oct. 18, 2019), https://www.inc.com/jason-aten/elon-musk-has-a-plan-to-make-tesla-profitable-by-raising-prices-making-it-harder-to-change-your-mind.html [https://perma.cc/6B4D-8W2N] ("Te[sl]a has a problem--it makes amazing cars, but it doesn't make any money."). On February 28, 2014, Tesla closed with a share price of $48.96 and on October 7, 2019, it closed at $47.54 (effectively unchanged over a period in excess of five and a half years); over that period, the price reached a high of $77.92 on September 18, 2017, and a low of $28.21 on February 9, 2016. *Tesla, Inc. (TSLA)*, Yahoo Finance (Apr. 1, 2021), https://finance.yahoo.com/quote/TSLA [https://perma.cc/A4LP-ASV8].

118 Tesla stock began increasing in late 2019 and reached an all-time high (closing price) of $729.77 on January 4, 2021 (and has since increased even more). *Tesla, Inc. (TSLA)*, *supra* note 117. Based on an estimation from shares outstanding as of April 6, 2021 (959.85 million), that high translated into a market capitalization of approximately $747 billion. *Id*. On January 4, 2021, the market capitalization of Daimler AG was approximately €61 billion on the same date (based on a closing share price of €56.9 and 1.07 billion shares outstanding). *Daimler AG (DAI.DE)*, Yahoo Finance (Apr. 1, 2021), https://finance.yahoo.com/quote/DAI.DE [https://perma.cc/PJP8-T5J9]. Based on the dollar-to-euro FX rate on that day (0.8163), TSLA was worth over 10 times Daimler on that day. *USD/EUR (USDEUR=X)*, Yahoo Finance (Apr. 1, 2021), https://finance.yahoo.com/quote/USDEUR=X/ [https://perma.cc/UZ5J-E9DA]. For a popular press discussion of the drivers of the sharp increase in TSLA price over this time, see Charley Grant, *Tesla's Stock Is the Original GameStop*, Wall St. J. (Jan. 27, 2021), https://www.wsj.com/articles/tesla-stock-is-the-original-gamestop-11611798484 [https://perma.cc/8KY8-H8KY]. The ratio was clearly lower before the sharp increase in TSLA. For example, on October 7, 2019, the ratio was 0.92 (i.e., TSLA was worth less than Daimler). *See Tesla Inc. (TSLA)*, *supra* note 117 (displaying a closing price of $47.54); *Daimler AG (DAI.DE)*, *supra* (displaying a closing price of €43.81, or $51.48).

119 Although labor would retain its representation on a restructured firm post-bankruptcy, the structure of the German bankruptcy process does typically involve the appointment of a trustee, who makes decisions on behalf of the various stakeholders. Thus, the influence of labor is interrupted, in a sense, during bankruptcy itself. *See* Jens Dammann & Horst Eidenmüller, *Codetermination: A Poor Fit*

for U.S. Corporations, 2020 Colum. Bus. L. Rev. 870, 917-18 (explaining that codetermination is "practically irrelevant in German corporate restructurings" because of the appointment of an administrator to manage the firm's assets during bankruptcy).

120 *See generally* Jack Ewing, Faster, Higher, Farther: How One of the World's Largest Automakers Committed a Massive and Stunning Fraud (2017) (arguing that due to its particular structure, VW labor had substantial power over the choice of the Chief Executive, and was potentially willing to look the other way on malfeasance so long as employment, wages, and benefits continued to rise, ultimately contributing to the corporate scandal).

121 *See* A.B. 979 § 1(p), 2019-2020 Cal. Assemb., Reg. Sess. (Cal. 2020) ("Studies have shown that culturally homogenous boards pay chief executive officers more than a culturally diverse board.").

122 *See supra* note 65 and accompanying text; A.B. 979 § 1(m)-(n) (citing consulting reports concluding that with diversity comes correlative increases in earnings and revenue); S.B. 826 § 1(c), (g), 2018 Cal. S., Reg. Sess. (Cal. 2018) (citing independent studies concluding that companies and their boards perform better when women serve on their boards of directors).

123 S.B. 826 § 1(c)(1)-(2).

124 *See* A.B. 979 § 1(r) (postulating that diverse boards would work to decrease corporate fraud); S.B. 826 § 1(c)(3) (citing a study concluding that boards with more women have a high level of transparency).

125 *See* S.B. 826 § 1(c)(5)(C) (claiming that "[c]ompanies with women on their boards tend to be somewhat risk averse and carry less debt, on average").

126 *See supra* note 56 and accompanying text.

127 *See supra* note 82 and accompanying text.

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Ponzi Schemes and Litigation Risks: What Every Financial Services Company Should Know

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PONZI SCHEMES AND LITIGATION RISKS: WHAT EVERY FINANCIAL SERVICES COMPANY SHOULD KNOW

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I. INTRODUCTION

As the current economic recession continues, the financial community continues to learn about many Ponzi schemes and other frauds that proliferated during recent years. Ponzi scheme investigations now make up twenty-one percent of the SEC's enforcement workload, compared with seventeen percent in 2008 and nine percent in 2005.[1] This article focuses on the litigation risks that financial institutions may encounter in the wake of a collapsed Ponzi scheme.

Part II of this article reviews the history of Ponzi schemes perpetrated in the twenty-first century.[2] Part III analyzes potential claims against financial institutions in Ponzi scheme suits, which generally include breach of fiduciary duty, negligence, negligent misrepresentation, fraudulent transfers, as well as aiding and abetting fraud, breach of fiduciary duty, and Blue Sky violations.[3] To provide a meaningful overview from a national perspective, Part III of this article identifies and discusses state and federal laws and court decisions without attempting to reconcile any splits in authority. In Part IV, the authors survey recent trends in Ponzi scheme and investment fraud litigation against financial

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1. Curt Anderson, *Ponzi Schemes' Collapses Nearly Quadrupled in '09*, LAW.COM, Dec. 29, 2009, http://www.law.com/jsp/article.jsp?id=1202437299784.
2. *See infra* Part II, pp. 30-34.
3. *See infra* Part III, pp. 34-42.

institutions and examine these trends in the context of financial institutions that knowingly participate in or facilitate Ponzi schemes, as well as those that unwittingly conducted business with businesses that later proved to be Ponzi schemes.[4] Part IV also includes a discussion of fraudulent transfer litigation activity in the fraudulent transfer context.[5] Finally, Part V identifies proposed federal legislation that could abrogate the Supreme Court's holding in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*,[6] which severely restricted aiding and abetting claims in the context of Ponzi scheme liability.[7] If enacted, the legislation could reopen the door to litigation against financial institutions and others who may unwittingly participate in such a scheme.

II. HISTORY OF PONZI SCHEMES

A Ponzi scheme is generally a fraudulent investment scheme whereby an operator makes payments to early investors with money received from new investors.[8] Ponzi scheme operators promise original investors abnormally high or fast returns, often by suggesting that they use a unique strategy or investment mechanism.[9] The Ponzi scheme operators repay the original investors with later investments creating the illusion that they have fulfilled their promise of rapid success.[10] This attracts new investors.[11] Inevitably, the Ponzi scheme operator is unable to recruit new investors to fund the original investors' payment

4. *See infra* Part IV, pp. 43-53; *see also* Wayne E. Baker & Robert R. Faulkner, *Diffusion of Fraud: Intermediate Economic Crime and Investor Dynamics*, 41 CRIMINOLOGY 1173, 1174 (2003) (explaining that, while many Ponzi schemes are planned, created, and designed from inception to defraud investors, other business enterprises only become fraudulent after years of legitimate operation. Unlike the traditional "pre-planned [Ponzi] frauds," "intermediate frauds" occur when fraudulent acts are committed by or as part of a legitimate business).

5. *See infra* pp. 48-51.

6. 552 U.S. 148 (2008).

7. *See infra* Part V, pp. 53-56.

8. *In re* United Energy Corp., 944 F.2d 589, 590 n.1 (9th Cir. 1991). *See generally* Cunningham v. Brown, 265 U.S. 1, 7-8 (1924) (describing Charles Ponzi's original pyramid scheme).

9. *In re United Energy Corp.*, 944 F.2d at 590 n.1.

10. *Id.*

11. *Id.*

returns, and the Ponzi scheme collapses leaving all current investors' investments mired in the Ponzi scheme.[12]

A. *The Origin of Ponzi Schemes*

Ponzi schemes are named after an early twentieth century scam orchestrated by Charles Ponzi.[13] Between 1919 and 1921, Ponzi pretended to buy and sell international postal reply coupons in different markets and solicited thousands of Bostonians to invest in his fraudulent operation.[14] He accumulated 40,000 investors by promising fifty-percent returns in forty-five days.[15] But rather than paying the investors from actual profits, Ponzi paid them from new investors' investments.[16] Eventually the well of new investors ran dry and the scam failed, but not before Ponzi made millions of dollars.[17] Today, Charles Ponzi's legacy lives on, and the label "Ponzi" attaches to any scheme that involves a fraudster who uses money from later investors to repay earlier investors in whole or in part.

B. *Recent High Profile Ponzi Schemes*

Fraudsters have used Ponzi schemes to defraud innocent investors for decades, but in recent years, Ponzi scheme operators have orchestrated larger and more sophisticated schemes.[18] In 2008, authorities uncovered the largest Ponzi scheme in history orchestrated by Bernard L. Madoff.[19] A former chairman of the

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12. *See Cunningham*, 265 U.S. at 8-9.
13. *See id.* at 7-8.
14. *Id.*
15. *Id.* at 7-9.
16. *Id.* at 8.
17. *Id.* at 9.
18. Del Quentin Wilber, *Economic Downturn Accelerates Collapse of Ponzi Schemes*, WASH. POST, Jun. 12, 2009, at B1, *available at* http://www.washington post.com/wp-dyn/content/article/2009/06/11/AR20090611039 93.html ("As recently as a few decades ago, most Ponzi schemes were relatively small, relying on word of mouth, direct mail and advertisements in magazines. They generally burned out after two or three years. But through the Internet and modern communications, Ponzi schemes have grown in size, scope and sophistication.").
19. Joshua Brockman, *Q&A: Madoff Case Puts Spotlight on SEC*, NAT'L PUB. RADIO, Dec. 17, 2008, http://www.npr.org/templates/story/story.php?storyId=98272 825.

NASDAQ exchange, he founded Bernard L. Madoff Investment Securities, LLC (Madoff Investments) to facilitate his Ponzi scheme.[20] Despite many years of success, the precipitous downturn in the economy and the stock market collapse caused Madoff's scheme to unravel in December 2008.[21] The authorities arrested Madoff on December 11, 2008, for operating a $65 billion Ponzi scheme since at least the 1990s and possibly for more than thirty years.[22]

Robert Allen Stanford allegedly operated another high-profile Ponzi scheme through his company, the Stanford Financial Group.[23] Stanford solicited investments totaling as much as $8 billion based on high-yield certificates of deposit issued by the Stanford Financial Group's bank in Antigua.[24] Each month, along with his former college roommate, James Davis, Stanford allegedly set a predetermined rate of return for the certificates.[25] Then, Stanford's accountants "reverse-engineered financial statements" to reflect non-existent investment income earned by the bank.[26] The SEC also alleged that Stanford and Davis "misappropriated" at least $1.6 billion worth of investors' money through "bogus personal loans" to Stanford for "speculative, unprofitable private businesses controlled by Stanford."[27] He consequently enjoyed many years of prosperity before his scheme collapsed.[28] He

20. *See* Diana B. Henriques, *New Description of Timing on Madoff's Confession*, N.Y. TIMES, Jan. 10, 2009, at B1, *available at* http://www.nytimes.com/2009/01/10/business/10madoff.html?_r=1.

21. *See* Robert Frank, *Madoff Jailed After Admitting Epic Scam*, WALL ST. J., Mar. 13, 2009, at A1, *available at* http://online.wsj.com/article/SB123685693449906551.html?mod=djemalertNEWS.

22. *See id.*

23. *See* Clifford Kraus et al., *Texas Firm Accused of $8 Billion Fraud*, N.Y. TIMES, Feb. 18, 2009, at A1, *available at* http://www.nytimes.com/2009/02/18/business/18stanford.html?_r=1&ref=business.

24. Anna Driver, *U.S. Charges Stanford With Massive Ponzi Scheme*, REUTERS, Feb. 27, 2009, http://www.reuters.com/article/idUSTRE51Q66G20090228.

25. *Id.*

26. *Id.*

27. *Id.*

28. *See generally* Kraus, *supra* note 23 ("In Texas, Robert Allen Stanford was just another wealthy financier. But in the breezy money haven of Antigua, he was lord of an influential financial fief, decorated with a knighthood, courted by government officials and basking in the spotlight of sports and charity events on which he so generously showered his fortune.").

surrendered to the FBI on June 18, 2009, and was indicted that same day for operating a multi-billion dollar Ponzi scheme.[29]

While Madoff and Stanford may have perpetrated the two largest Ponzi schemes in U.S. history, they were certainly not the first to rob innocent investors. Before Madoff and Stanford, Bradford Bleidt facilitated "a slow-motion Ponzi scheme in Massachusetts that lasted 20 years."[30] Bleidt promised investors that he would manage and invest their funds, but instead, he used the funds to fuel a lavish lifestyle.[31] In the end, he cheated 125 clients out of $32.6 million.[32] Bleidt has since been sentenced to eleven years in prison.[33]

Likewise, Summit Accommodators Inc. (Summit) allegedly orchestrated a Ponzi scheme with funds that it received from investors in short-term real estate transactions for Section 1031 tax benefits.[34] Instead of investing the money in real estate, Summit's owners allegedly transferred the investment funds to its affiliate, Inland Capital Corp. (Inland Capital), which made loans, including to Summit's owners.[35] When Summit's investors demanded the return of their funds before the loan from Inland Capital had come due, Summit financed the return of the funds with new

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29. Zachary A. Goldfarb & Anita Kumar, *Stanford, 5 Associates Charged with Running a $7 Billion Ponzi Scheme*, WASH. POST, June 20, 2009, at A11, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2009/06/19/AR20090619000 78.html.

30. *See Investors Relive Bradford Bleidt Ponzi Case*, PatrickPretty.com, (Jan. 20, 2009, 5:17 AM), http://patrickpretty.com/2009/01/20/investors-relive-bradford-bleidt-ponzi-case/.

31. Robert Weisman, *An Earlier Ponzi Pain Lingers*, BOSTON GLOBE, at 1, Jan. 20, 2009, *available at* http://www.boston.com/business/articles/2009/01/20/an_earlier_pon zi_pain_lingers/.

32. *Id.*

33. *Id.*

34. Courtney Sherwood, *Summit Accommodators Case Draws Umpqua's Ire*, PORTLAND BUS. J., Jan. 22, 2010, *available at* http://portland.bizjournals.com/port land/stories/2010/01/25/story8.html?b=1264395600%5E2769061&s=industry&i=bankr uptcies. It appears that Summit and Inland Capital were initially legitimate business operations but later turned fraudulent. *Id.*; *see also* Karina Brown, *Trustee Claims Bank Abetted Ponzi Scam,* COURTHOUSE NEWS SERVICE, Jun. 23, 2009, http:// www.courthousenews.com/2009/06/23/Trustee_Caims_Bank_Abetted_Ponzi_Scam.ht m ("Inevitably, the owners' embezzlement caused liquidity problems, and when the company was unable to pay its bills, the owners started a Ponzi scheme, bringing in new investors in order to pay the old ones, the receiver says.").

35. Brown, *supra* note 34.

investments it received until 2008 when it filed for bankruptcy.[36] The bankruptcy trustee claims that Summit was perpetrating a Ponzi scheme, while Summit's owners maintain that they simply lacked liquidity.[37]

These Ponzi schemes are just a few of the many that have been recently discovered in the wake of the financial downturn. Whether designed from inception to defraud investors or becoming fraudulent after a period of legitimate business operations, these Ponzi schemes left many innocent investors in financial ruin.

III. CLAIMS AGAINST FINANCIAL INSTITUTIONS

The inevitable insolvency of a Ponzi scheme operator, coupled with the almost overnight evaporation of fictitious investments, prompts bankruptcy trustees, receivers, and aggrieved investors to aggressively pursue recovery efforts against all solvent parties–however innocently and unwittingly involved in the Ponzi scheme operator's activities. Targets often include the financial institutions that unknowingly played even remote roles in Ponzi schemes. Financial institutions that invested in Ponzi schemes for their own accounts or on behalf of their investor clients, and certainly those financial institutions that knowingly facilitated the business operations of a Ponzi scheme, face the greatest litigation risks. Even those financial institutions that unwittingly participated in Ponzi schemes encounter many claims relating to their involvement. Because creative attorneys are filing suits based on an increasing number of grounds, Ponzi scheme litigation against financial institutions is increasing.[38]

Financial institutions face claims including common law claims for breach of fiduciary duty, negligence, negligent misrepresentation, fraudulent transfers, aiding and abetting fraud,

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36. *Id.*

37. Sherwood, *supra* note 34.

38. *See* Stephanie Plancich & Svetlana Starykh, *Recent Trends in Class Action Litigation: 2009 Mid-Year Update*, NERA ECONOMIC CONSULTING (July 2009), at 11, http://www.nera.com/image/Recent_Trends_Report_0709.pdf (finding that between January 1, 2007 and June 30, 2009, Ponzi scheme filings comprised 3.5% of all federal class action filings, up from 0.2% in the previous two years).

and aiding and abetting breach of fiduciary duty.[39] In addition, aggrieved plaintiffs are increasingly bringing claims for violations of state Blue Sky laws.[40] The following list of potential claims, while not exhaustive, provides a practitioner with a primer on the strengths and limits of these claims.

A. *Breach of Fiduciary Duty*

To prevail on a breach of a fiduciary duty claim, a plaintiff must establish both a fiduciary relationship between the parties and a breach of the fiduciary duty.[41] Generally, a bank does not owe fiduciary duties to a customer in a deposit or lending relationship or to third parties that might be affected by that relationship.[42] Instead, the relationship between a bank and a depositor is typically a debtor-creditor relationship.[43] In an effort to overcome this obstacle, claimants often seek to prove that a fiduciary relationship existed as a result of a specific trust implied from the case-specific evidence.[44] While a plaintiff may contend that it "reposed trust and confidence" in a financial institution–for example, one that acted as the "bank of record" for an investment program–such "unilateral trust or confidence does not automatically create a fiduciary relationship; the trust or confidence must be accepted [by the financial institution] as well."[45]

39. *See, e.g.*, Class Action Complaint ¶¶ 58-90, Inversiones Mar Octava Limitada v. Banco Santander, S.A., No. 09-20215 (S.D. Fla. filed Jan. 26, 2009) (alleging violation of securities laws, breach of fiduciary duty, gross negligence, negligent misrepresentation, unjust enrichment, and professional malpractice); Amended Complaint ¶¶ 35-84, Fine v. Sovereign Bank, No. 06-11450-NG (D. Mass. filed Dec. 7, 2006) (alleging, among other claims, aiding and abetting breach of fiduciary duty and negligence).

40. *See* Class Action Complaint & Jury Demand ¶¶ 47-57, Grossbard v. Sec. Am., Inc., No. 8:09-cv-00350-JFB-TDT (D. Neb. filed Oct. 1, 2009); Complaint ¶¶ 54-55, Purdue Ave. Investors LP v. Morgan Keegan & Co., No. DC-09-14448 (N.D. Tex filed Oct. 9, 2009).

41. *See* Musalli Factory for Gold & Jewellry v. JP Morgan Chase Bank, N.A., 261 F.R.D. 13 (S.D.N.Y. 2009) (holding that a lender is not a fiduciary of a debtor and therefore owes no fiduciary duties, not even reaching the question of whether a fiduciary duty had been breached).

42. *See id.* at 26.

43. *Id.*

44. *See id.*

45. *See id.*

The case of *Mazzaro de Abreu v. Bank of America Corp.*[46] provides insight into how a fiduciary duty might be created.[47] In considering a claim for aiding and abetting breach of fiduciary duty, the *Mazzaro* court found that the Bank of Europe created a fiduciary duty when it solicited investments "with the written promise of a profitable return."[48] The court went on to find that the Bank of Europe breached its fiduciary duties by stealing and spending the plaintiffs' money.[49]

B. *Negligence*

In order to prevail on a negligence claim against a financial institution, the plaintiff, in this case the defrauded investor, must prove two things. First, a plaintiff must prove that the Ponzi scheme operator's use of a financial institution created a duty between the defrauded investor and the financial institution. Second, a plaintiff must prove that the financial institution breached that duty.[50] As a threshold matter, a court must decide as a matter of law whether such a legal duty exists between the parties.[51] Courts consider the foreseeability and likelihood of injury, the social utility of the financial institution's conduct, the gravity of the burden placed on the financial institution to guard against injury, and the consequences of imposing such a burden.[52]

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46. 525 F. Supp. 2d 381 (S.D.N.Y. 2007).

47. *Id.* at 385-86. The plaintiffs sued defendants Bank of America Corporation, Bank of America, N.A., and Standard Chartered Bank for allegedly participating in and substantially assisting in a fraud and money laundering scheme perpetrated by Bank of Europe. The defendants were correspondent banks employed by Bank of Europe to "perform basic banking operations" and to "process transactions on its behalf." *Id.* at 384. The plaintiffs alleged that the defendants improperly transferred funds in numerous instances to offshore companies controlled by Bank of Europe and its owner. As alleged, the Court found no aiding and abetting liability and granted the defendants' motion to dismiss. *Id.*

48. *See id.* at 394 (citing Pension Comm. of Univ. of Montreal Pension Plan v. Banc of Am. Sec., LLC, 446 F. Supp. 2d 163, 195-96 (2006)).

49. *See id.*

50. *See, e.g.,* Rozsa v. May Davis Group, 187 F. Supp. 2d 123, 131 (S.D.N.Y. 2002); Trautenberg v. Paul, Weiss, Rifkind, Whartong & Garrison LLP, 629 F. Supp. 2d 259, 262 (S.D.N.Y. 2007).

51. *See, e.g.,* Calbillo v. Cavender Oldsmobile, Inc., 288 F.3d 721, 728 (5th Cir. 2002).

52. *See* Graff v. Beard, 858 S.W.2d 918, 920 (Tex. 1993); *see also* Harrison v. Dean Witter Reynolds, Inc., 715 F. Supp. 1425, 1435 (N.D. Ill. 1989), *rev'd on other*

A special relationship may create a legal duty where the financial institution is vested with a right of control over the proceeds of the investor's investment.[53] Absent finding that legal duty exists, there cannot be liability for negligence.[54]

C. *Negligent Misrepresentation*

For negligent misrepresentation, a plaintiff must generally prove that the defendant owed a duty, that the defendant made a false representation, and that the plaintiff reasonably relied on that misrepresentation.[55] Similar to the requirements for a negligence claim, a plaintiff must also prove that a special relationship giving rise to a duty to disclose existed between the investor and the financial institution. The failure to prove such a relationship will likely prove fatal to a negligent misrepresentation claim.[56] Therefore, in order to successfully defend against a negligent misrepresentation claim, a financial institution should focus on negating the existence of a legal duty. A special relationship of trust or confidence between the parties is evidence that the plaintiff reasonably relied on the false representation. Therefore, by negating the existence of such relationship that often times may give rise to a legal duty, the financial institution can successfully argue that the investor did not reasonably rely upon the financial institution's representation.

Courts generally consider three factors when determining whether an investor reasonably and justifiably relied on a financial

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grounds, 974 F.2d 873 (7th Cir. 1992) (describing the four factors used to evaluate whether there is a legal duty); Greater Houston Transp. Co. v. Phillips, 801 S.W.2d 523, 525 (Tex. 1990) ("In determining whether the defendant was under a duty, the court will consider several interrelated factors, including the risk, foreseeability, and likelihood of injury weighed against the social utility of the actor's conduct, the magnitude of the burden of guarding against the injury, and the consequences of placing the burden on the defendant.").

53. *See Graff*, 858 S.W.2d at 920 ("Under 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.").

54. *See id.*

55. Musalli Factory for Gold & Jewellry v. J.P. Morgan Chase Bank, N.A., 261 F.R.D. 13 (S.D.N.Y. 2009) (quoting Hydro Investors, Inc. v. Trafalgar Power, Inc., 227 F.3d 8, 20 (2d Cir. 2000)).

56. *See id.*

institution's representation: "[(1)] whether the person making the representation held or appeared to hold unique or special expertise; [(2)] whether a special relationship of trust or confidence existed between the parties; and [(3)] whether the speaker was aware of the use to which the information would be put."[57]

D. *Fraudulent Transfer*

The Uniform Fraudulent Transfer Act (UFTA),[58] adopted in all but a handful of states,[59] is often used as a tool to recover funds paid out or distributed by a Ponzi scheme operator.[60] In the fraudulent transfer context, a Ponzi scheme operator is considered a "debtor" and each defrauded investor is a "tort creditor."[61] The fraudulent transfer may be a payment to an investor,[62] but it might also be a collateral pledge to a secured lender.[63]

Fraudulent transfer liability requires the claimant to establish the "actual intent to hinder, delay, or defraud any creditor of the debtor."[64] Establishing this in the Ponzi scheme context is relatively easy because the existence of a Ponzi scheme operated by the debtor serves as conclusive proof of "actual intent to hinder, delay, or defraud" a creditor.[65] This presumption exists because "actual intent" is defined under the UFTA to include transfers by insolvent debtors or debtors nearing insolvency.[66]

57. *See id.*

58. Unif. Fraudulent Transfer Act §§ 1-14, 7A Pt. II ULA 13-556 (2006).

59. Nat'l Conference of Comm'r of Unif. State Laws, *A Few Facts About the Uniform Fraudulent Transfer Act*, UNIFORM LAW COMMISSIONERS (2002), http:// www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-ufta.asp. *Id.* As of June 5, 2005, forty-four states have adopted the UFTA, according to the National Conference of Commissioners on Uniform State Laws. Texas has adopted its version of the Uniform Fraudulent Transfer Act under Chapter 24 of the Tex. Bus & Comm. Code. California adopted its version under Cal. Civ. Code Section 3439, *et seq.*

60. *E.g.* Scholes v. Lehmann, 56 F.3d 750, 757 (7th Cir. (Ill.) 1995).

61. *Id.* at 755

62. *Id.*

63. SEC v. Madison Real Estate Group, LLC, 647 F. Supp. 1271, 1279 (D. Utah 2009).

64. Unif. Fraudulent Transfer Act § 4(a)(1) (1984).

65. *Madison Real Estate Group, LLC*, 647 F. Supp. 2d at 1279.

66. Unif. Fraudulent Transfer Act § 4(b)(9); *see also In re* Evergreen Security, Ltd., 319 B.R. 245, 253 (Bankr. M.D. Fla. 2003) ("When the existence of a Ponzi

Because courts have found as a matter of law that Ponzi schemes are insolvent from their inception, all transfers from a Ponzi scheme are presumptively made during insolvency.[67]

Essentially, those who invest before a Ponzi scheme's collapse are "entities to whom the [Ponzi scheme operator] became indebted when the investors entrusted their money."[68] When Ponzi scheme operators make transfers to earlier investors with the presumed[69] actual intent to defraud later investors, such transfers may qualify as fraudulent under the UFTA.[70]

E. Aiding and Abetting Liability

1. Aiding and Abetting Fraud and Breach of Fiduciary Duty

In order to recover losses based upon a claim of aiding and abetting fraud or breach of fiduciary duty, a plaintiff must prove: (1) fraud or breach of fiduciary duty by the Ponzi scheme operator, and (2) that the financial institution had actual knowledge of the violation.[71] Additionally, with regard to a claim for aiding and abetting fraud, a plaintiff must prove that the financial institution provided substantial assistance in order to further the violation.[72] Similarly, to prevail on a claim for aiding and abetting a breach of fiduciary duty, a plaintiff must prove that a financial institution knowingly participated in the breach.[73] For example, under New York law, "an entity 'knowingly participates

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scheme is proven by the evidence a presumption of actual fraudulent intent is presumed.").

67. Scholes v. Lehmann, 56 F.3d 750, 755; *In re* Randy, 189 B.R. 425, 441 (N.D. Ill. 1995); *see also* Quilling v. Schonsky, 247 F. App'x 583, 586 (5th Cir. 2007) (finding that under the UFTA Ponzi schemes are insolvent by definition from the time of their inception).

68. *Madison Real Estate Group, LLC,* 647 F. Supp. 2d at 1279 (quoting Floyd v. Dunson (*In re* Rodriguez), 209 B.R. 424, 433 (Bankr. S.D. Tex. 1997)).

69. *See In re Evergreen Security,* 319 B.R. at 253.

70. *See Madison Real Estate Group, LLC,* 647 F. Supp. 2d at 1279.

71. *See* Mazzaro de Abreu v. Bank of Am. Corp., 525 F. Supp. 2d 381, 387 (S.D.N.Y. 2007); Musalli Factory for Gold & Jewellry v. JP Morgan Chase Bank, N.A., 261 F.R.D. 13, 24 (S.D.N.Y. 2009).

72. *See Mazzaro,* 525 F. Supp. 2d at 387.

73. *Id.* at 392.

in a breach of fiduciary duty only when it provides substantial assistance to the primary violator.'"[74]

Actual knowledge cannot generally be established solely through allegations about the failure to investigate or discover warning signs of Ponzi scheme fraud.[75] While inaction alone is not enough, the Second Circuit has suggested that facts which give rise to a "strong inference" that the financial institution had knowledge of the Ponzi scheme may be enough to satisfy the actual knowledge requirement.[76] This inference "may be established by either: (a) alleging facts to show that [the financial institution] had both motive and opportunity to commit fraud; or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness."[77] Hence, "actual knowledge may be implied from a strong inference of fraudulent intent,"[78] but a "plaintiff must allege more than [an] interest in bank fees . . . to create a reasonable inference of fraudulent intent."[79]

A failure to act does not constitute an affirmative or overt act sufficient to meet the substantial assistance requirement.[80] Furthermore, a simple allegation that a financial institution held funds from a Ponzi scheme in a customer's deposit account is insufficient, without more, to constitute an affirmative act that would subject a bank to liability.[81] Furthermore, "ignored advice is

74. *Id.* at 393.

75. *See* Pension Comm. of the Univ. of Montreal Pension Plan v. Banc of Am. Sec., LLC, 446 F. Supp. 2d 163, 202-03 (S.D.N.Y. 2006).

76. *See generally* Lerner v. Fleet Bank, N.A., 459 F.3d 273, 293 (2d Cir. 2006) ("The plaintiffs allege in detail that the banks knew that Schick engaged in improper conduct that would warrant discipline by the Appellate Division, but those alleged facts do not give rise to the 'strong inference' required by the Federal Rule of Civil Procedure 9(b), of actual knowledge of his outright looting of client funds.").

77. Dominic J. Campisi, *The Black Swans (and Other Cliches) Have Come Home to Roost: Trustee Liability in a Sigma Seven World*, *in* LESSONS FROM THE "SIGMA SEVEN" MELT-DOWN AND THE LITIGATION LANDSCAPE 25 (ALI-ABA 2009) (*citing* Lerner, 459 F.3d 273).

78. *Mazzaro*, 525 F. Supp. 2d at 388-89 (finding that a bank's alleged profit motive is insufficient to infer the fraudulent intent necessary to support a finding of actual knowledge).

79. *Id.* (citing Renner v. Chase Manhattan Bank, No. 98 Civ. 926 (CSH), 2000 U.S. Dist. LEXIS 8552, 2000 WL 781081 at 13 (S.D.N.Y. June 16, 2000)).

80. *See* Ontario Ltd. v. Zurich Capital Markets, Inc., 249 F. Supp. 2d 974, 990 (N.D. Ill. 2003).

81. *See id.*

not substantial assistance in the achievement of an underlying fraud."[82]

At least one case suggests that actual knowledge coupled with continued participation is not always sufficient to establish liability.[83] In *Mazzaro,* the court declined to impose liability on Bank of America for aiding and abetting fraud.[84] In that case, the court concluded that the bank had actual knowledge because it advised the Ponzi scheme operator how to conceal its fraudulent activities more effectively.[85] The court determined, however, that because the Ponzi scheme operator did not take this advice, the conduct did not amount to substantial assistance, and therefore liability for such advice under an aiding and abetting fraud theory was improper.[86] *Mazzaro* reinforces the idea that proof of actual knowledge and fraudulent conduct is not enough to prevail under an aiding and abetting fraud theory. Therefore, plaintiffs also must prove that the actual knowledge and fraudulent conduct amounted to substantial assistance.

2. Aiding and Abetting Fraud Under Blue Sky Laws

Plaintiffs are increasingly seeking relief under state Blue Sky laws,[87] many of which contain the same elements of and defenses to aiding and abetting liability as do state common law claims.[88] With the exception of New York, most states, including

82. *Mazzaro,* 525 F. Supp. 2d at 392 (holding that because the bank's suggestion to the Ponzi scheme operator to "open a separate bank account to 'conceal the fraud more effectively'" was ignored, such conduct did not rise to substantial assistance in the achievement of the underlying fraud).

83. *Id.*

84. *Id.* at 398.

85. *Id.* at 390-92, 394. This case came before the court on a motion to dismiss. *Id.* at 383 n.4. Pursuant to FED. R. CIV. P. 12, the court took all factual allegations in the plaintiffs' petition as true. *Id.* The authors make no presumption that the facts in the plaintiffs' complaint are true.

86. *Id.* at 392.

87. Richard I. Alvarez & Mark J. Astarita, *Introduction to the Blue Sky Laws*, SECLAW.COM, ("While the SEC directly, and through its oversight of the NASD and the various Exchanges, is the main enforcer of the nation's securities laws, each individual state has its own securities laws and rules. These state rules are known as 'Blue Sky Laws.'").

88. *E.g.,* TEX REV. CIV. STAT. ANN. art. 581, § 33 (Vernon Supp. 2010); CAL. CORP. CODE § 25504 (West 2010).

Texas and California, allow a private plaintiff to sue a financial institution that materially aided the fraudulent sale of securities issued and sold in connection with a Ponzi scheme.[89] Further, the common defenses to aiding and abetting liability under state common law and Blue Sky laws include the financial institution's lack of knowledge or awareness and the lack of privity between the investor and the financial institution.[90]

In *Sterling Trust Co. v. Adderley*,[91] investors sued Sterling Trust Co., the custodian of Ponzi scheme funds, for aiding and abetting fraud under the Texas Securities Act (TSA). The TSA, like other states' Blue Sky laws, provides for secondary liability for both intentional and reckless conduct.[92] Namely, one "who directly or indirectly with intent to deceive or defraud or with reckless disregard for the truth or the law materially aids a seller, buyer, or issuer of a security" may be liable.[93]

In *Sterling*, the Texas Supreme Court placed limits on the reckless-conduct standard. Specifically, the court held that an aiding party is subject to secondary liability "only if it rendered assistance to the seller in the face of a perceived risk that its assistance would facilitate untruthful or illegal activity by the primary violator."[94] Although the aiding party need not know of the exact misrepresentation or omission made by the seller, the court held an aiding party "must be subjectively aware of the primary violator's improper activity."[95] This requirement is similar to the actual knowledge required to impose secondary liability under common law.

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89. *Compare* TEX. REV. CIV. STAT. ANN. art. 581, § 33 (Vernon Supp. 2010), *and* CAL. CORP. CODE § 25504, *with* N.Y. GEN. BUS. § 352 (McKinney 2010). The New York statute does not provide for a private right of action. Therefore, only the Attorney General, not individual plaintiffs, can sue for fraudulent sales of securities. Individual plaintiffs must pursue common law claims.

90. *E.g.* TEX. REV. CIV. STAT. ANN. art. 581, § 33F; CAL. CORP. CODE § 25504; N.Y. GEN. BUS. 352.

91. 168 S.W.3d 835 (Tex. 2005).

92. *Sterling Trust Co.* 168 S.W. 2d at 839.

93. *Id.* (quoting TEX. REV. CIV. STAT. ANN. art. 581, § 33F(1)-(2)).

94. *Id.* at 842 (internal quotation marks omitted).

95. *Id.* at 837.

IV. RECENT LITIGATION TRENDS

In recent Ponzi scheme litigation, plaintiffs have most frequently filed suit based on the defendant financial institutions' knowing participation in the schemes or, conversely, the financial institutions' indirect and unwitting participation in the frauds. Claims against financial institutions for fee disgorgement and unjust enrichment have also been brought under the UFTA.

A. *Allegations of Knowing Participation in a Ponzi Scheme*

Plaintiffs have filed numerous civil complaints against financial institutions that allegedly knowingly played roles in Ponzi schemes. While many of the claims and allegations may be considered specious at best, certain common underpinnings exist. Most claims against these financial institutions are couched as either securities law violations or common law claims, such as breach of fiduciary duty, negligence, aiding and abetting fraud, or aiding and abetting breach of fiduciary duty. Often, the financial institution's liability hinges on whether the plaintiff can prove the institution's actual knowledge of the underlying Ponzi scheme.

1. *MLSMK Investments Co. v. JP Morgan Chase & Co.*[96]

MLSMK Investments Co. (MLSMK) sued JP Morgan Chase & Co. and JP Morgan Chase Bank, N.A. (together, Chase) for "knowingly [participating] in Madoff's continuing scheme to defraud investors."[97] The complaint alleges claims for racketeering under 18 U.S.C. § 1962(d), aiding and abetting breach of fiduciary duty, commercial bad faith, and two counts of negligence.[98]

According to the complaint, Madoff directed all money received in his investment advisory business to Chase.[99] The alleged wrongful activity began in 2006, when Chase developed a derivative product specifically for use with Madoff-related

96. Complaint, No. 1:09-cv-04049-swk (S.D.N.Y. filed Apr. 23, 2009).
97. *See id.* ¶ 42.
98. *See id.* ¶¶ 48-133.
99. *See generally id.* ¶¶ 24-27 (explaining how Madoff's business relationship with Chase resulted in billions of dollars in working capital for Chase).

investments.[100] Ultimately, Chase's mid-2008 investment into a Madoff fund prompted a due diligence investigation, which raised concerns regarding Madoff's reported gains during a period of substantial market losses.[101] The plaintiffs alleged that, during the course of this due diligence investigation, Chase learned that Madoff's returns were implausible and quietly began liquidating its holdings in Madoff's funds.[102] Despite this alleged actual knowledge of the fraud, Chase "knowingly [participated] in Madoff's continuing scheme to defraud investors" when it continued to provide Madoff with banking services and to trade with him, allegedly creating "the volume of trading necessary to create the illusion that [Madoff Investments] was generating a trading volume consistent with having $7.2 billion under management."[103] This alleged ongoing cooperation by Chase allowed Madoff and Madoff Investments to continue operations through the end of 2008.[104] MLSMK invested $12.8 million with Madoff Investments during the fall of 2008.[105]

MLSMK's racketeering claim is based on the trades and ongoing banking operations Chase provided to Madoff from September 2008 to December 2008.[106] MLSMK alleges that, given this knowledge, Chase "knowingly and purposefully conspired to violate 18 U.S.C. § 1962(c) by providing Madoff with banking services that were integral to the functioning of the racketeering enterprise."[107] This assistance also forms the basis of MLSMK's aiding and abetting breach of fiduciary duty claim.[108]

100. *See generally id.* ¶ 33 (explaining how the derivative product was linked to the performance of the funds that an asset management group in Connecticut owned and managed).

101. *See generally id.* ¶¶ 33-42 (detailing the extensive due diligence that Chase carried out on Madoff's portfolio strategy, and how Chase realized that Madoff's reported returns were false and illegitimate).

102. *See* Complaint ¶¶ 40-41, *MLSMK Inv. Co.*

103. *Id.* ¶ 42.

104. *See id.* ¶ 43.

105. *Id.*

106. *See generally id.* ¶¶ 49-85 (outlining the pattern of racketeering activity that Madoff executed with BMIS and DePasquale).

107. *See id.* ¶ 67.

108. *See generally* Complaint ¶¶ 87-97, *MLSMK Inv. Co.* (explaining the extent to which Chase had knowledge of Madoff's fraudulent behavior and how Chase played a necessary role necessary in helping Madoff execute his operations).

The commercial bad faith and negligence claims arise out of the same operative allegations–Chase continued to provide Madoff with banking and financial services after it knew Madoff was operating a Ponzi scheme.[109] By failing to act on this information, MLSMK contends, Chase was negligent.[110]

2. *Padrick v. Umpqua Bank*[111]

Much like the MLSMK plaintiffs, bankruptcy trustee Kevin Padrick brought claims for civil conspiracy and aiding and abetting breach of fiduciary duty based on Umpqua Bank's actual knowledge or awareness of the alleged wrongdoing.[112]

Padrick alleged that four Summit shareholders operated a Ponzi scheme in connection with Summit's Section 1031 exchange business.[113] By 2006, Umpqua was the primary depository institution for Summit's client deposits.[114] In early 2007, the Summit shareholders, in face-to-face meetings and in telephone conferences, "described in great detail all relevant aspects of their Ponzi scheme and embezzlement," including their business model and the diversion of funds to an affiliate company and to Umpqua.[115] The complaint alleged that, despite being informed of this fraud, Umpqua officials continued to assist Summit and its shareholders by allowing them to use Umpqua bank accounts and encouraging them to transfer additional funds to Umpqua.[116]

109. *See generally id.* ¶¶ 99-133 (outlining the different ways in which Chase continued to act as Madoff's bank even after Chase discovered the illegitimacy of Madoff's investment returns).

110. *See id.* ¶ 130.

111. Complaint, No. 0906-08488 (Cir. Ct. Or. 2009).

112. *See id.* ¶ 1; *see also* Complaint, *MLSMK Inv. Co.* (alleging that Chase was liable for racketeering, aiding and abetting breach of fiduciary duty, commercial bad faith, and negligence against defendants).

113. Complaint ¶ 4, *Padrick*; *see supra* pp. 33-34.

114. Complaint ¶ 10, *Padrick*.

115. *Id.* ¶ 12.

116. *Id.* ¶¶ 13-14.

B. *Allegations of Unwitting or Indirect Participation in a Ponzi Scheme*

In addition to being subjected to liability for what they actually knew, financial institutions are increasingly facing litigation for indirectly participating in Ponzi schemes. The cases below demonstrate that financial institutions often face substantial litigation risk due to their unwitting involvement in fraudulent activity about which the financial institutions allegedly should have known.

1. *Fine v. Sovereign Bank*[117]

David J. Fine brought suit on behalf of an investor class against Sovereign Bank (Sovereign) for allegedly accepting funds deposited by a Ponzi scheme operator, Bradford C. Bleidt.[118] The complaint alleged that Sovereign knew or should have known that the Allocation Plus Asset Management Company, Inc. (APAM) account was being used for fraudulent or improper activities.[119] Notably, the plaintiffs alleged that Sovereign knew or should have known that the APAM account was not being used for legitimate investor deposits because: (1) statements for the APAM account were being sent to Bleidt's home and not the business's address; (2) the account was a personal account as opposed to a commercial account, as required by the SEC; (3) Bleidt was the only person authorized to do anything with the APAM account; (4) there was a second, "legitimate" APAM account at Fleet Bank that Sovereign knew about; and (5) there were many indicators that Bleidt was not using the investors' money for legitimate purposes.[120]

The claims against Sovereign included: (1) aiding and abetting breach of fiduciary duty; (2) taking instruments with notice of breach of fiduciary duty; (3) negligence in permitting Bleidt to act beyond the scope of his authority; (4) negligence in

117. Amended Complaint, No. 06-cv-11450-NG (Mass. Dist. Ct. filed Dec. 7, 2006).
118. *See id.* ¶ 24.
119. *See id.*
120. *Id.*

permitting Bleidt to shield his fraudulent conduct from the SEC; (5) violations of the consumer protection laws of Massachusetts; and (6) conversion.[121]

The court denied summary judgment because an issue of fact existed regarding actual knowledge. In December 2008, a jury found in favor of Sovereign on all claims.[122] Thereafter, Fine filed a motion for new trial, which the court granted in part as to the conversion claim and denied as to the other claims.[123]

2. *Inversiones Mar Octava Limitada v. Banco Santander S.A.*[124]

In *Inversiones Mar Octava Limitada v. Banco Santander S.A.*, a class action case, investors sued Banco Santander (Santander) alleging liability based on Santander's "indirect" investments in Madoff Investments.[125] Santander, the complaint alleged, marketed two funds to investors after allegedly conducting "intensive due diligence."[126] The investors claimed that proper due diligence by the defendants would have revealed that Madoff was a fraud.[127] Accordingly, the plaintiffs alleged that Santander should have known that it was participating in a massive Ponzi scheme and thus should be liable.[128]

The plaintiffs based their suit on alleged violations of the Securities Exchange Act of 1934.[129] Plaintiffs also asserted claims for breach of fiduciary duty, gross negligence, negligent misrepresentation, unjust enrichment, and professional malpractice.[130]

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121. *See id.* ¶ 1.
122. *Id.*
123. *See* Fine v. Sovereign Bank, No. 06cv11450-NG, 2009 WL 4250076 *1 (D. Mass. Nov. 27, 2009).
124. Complaint, No. 1:09-cv-20215-PCH (S.D. Fla. filed Jan. 26, 2009).
125. *See id.* ¶¶ 1-2.
126. *Id.* ¶ 34 (quotation omitted).
127. *Id.* ¶¶ 44-52.
128. *See generally id.* (describing the many "red flags" that should have signaled that Madoff's investment operation was a Ponzi scheme).
129. *Id.* ¶¶ 6, 58-90; *see* 15 U.S.C. § 78a (2009).
130. Complaint ¶¶ 58-90, Inversiones Mar Octava Limitada v. Banco Santander S.A., No. 1:09-cv-20215-PCH (S.D. Fla. filed Jan. 26, 2009).

3. *Grossbard v. Securities America, Inc.*[131]

In *Grossbard v. Securities America Inc.*, a class led by Ilene Grossbard sued Securities America, Inc., Securities America Financial Corporation, and Ameriprise Financial, Inc. for allegedly participating in a Ponzi scheme when the financial institutions should have known it was a massive fraud.[132] Specifically, Grossbard alleged that the financial institutions

> failed to perform due diligence that would have revealed that [the fund] was a fraud; or . . . performed due diligence and recklessly and/or negligently failed to discover . . . [the] fraud; or . . . performed due diligence and came to appreciate . . . [it] likely was a Ponzi scheme.[133]

Grossbard and the class brought claims for negligence, violations of the Nebraska Blue Sky law, negligent misrepresentation, and fraudulent misrepresentation.[134]

C. *Fraudulent Transfer Claims*

1. *Rotstain v. Trustmark National Bank*[135]

In the aftermath of the SEC's case against Allen Stanford and Stanford Financial Group,[136] a putative class of aggrieved investors filed suit against five banks for their alleged roles in facilitating Stanford's sale of fraudulent certificates of deposit.[137]

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131. Complaint, No. 8:09-cv-00350-JFB-TDT (D. Neb. Filed Oct. 10, 2009).

132. *See id.* ¶ 1. The defendants allegedly sold millions of dollars worth of notes for a medical services company that turned out to be running a $2 billion Ponzi scheme. *Id.*

133. *Id.* ¶ 20.

134. *Id.* ¶¶ 47-74.

135. Complaint, No. 3:09-cv-023484-N (N.D. Tex. filed Nov. 13, 2009) (removed from the 129th Judicial District Court of Harris County, Texas to the District Court for the Southern District of Texas, No. 4:09-cv-03673, and transferred to the Northern District of Texas).

136. *See supra* pp. 32-33.

137. *See* Complaint, *Rotstain* at 1-2.

The plaintiffs alleged that the banks, while not directly involved in the sale of the certificates of deposit, acted as "willing and essential conduits for the flow of money from Stanford's unsuspecting victims to Stanford's criminal enterprise."[138] The plaintiffs contended that each bank either knew or should have known that Stanford's operation was illegitimate. Despite this alleged knowledge, the banks continued to conduct business for Stanford and earned significant fees in the process.[139]

In an effort to force the banks to disgorge their fees, the plaintiffs filed claims under the Texas Uniform Fraudulent Transfer Act for conspiracy to commit fraud and aiding and abetting fraud.[140] According to the complaint, the banks were paid with funds stolen from the plaintiffs.[141] Furthermore, the plaintiffs alleged that these funds were paid to the banks pursuant to a scheme and with the actual intent to hinder, delay, and defraud the plaintiffs and other members of the class without having paid reasonably equivalent value, and at a time when Stanford was insolvent or nearing insolvency.[142]

2. *SEC v. Madison Real Estate Group, LLC*[143]

In *SEC v. Madison Real Estate Group, LLC*, the SEC sought to invalidate real estate loan transactions with Fannie Mae, Midland Loan Services, Inc., and Crown NorthCorp., Inc., under the UFTA.[144] The SEC complained that Madison Real Estate Group and three individuals wrongfully solicited and obtained investments from the fraudulent sale of limited partnership interests in a number of apartment complexes.[145] The complaint alleged that the returns paid to investors came from newly-invested funds from other investors.[146] The court appointed a

138. *See id.* at 2.
139. *See id.* at 3-4.
140. *See id.* at 23-26.
141. *See id.* at 4.
142. *See id.*
143. 647 F. Supp. 2d 1271 (D. Utah 2009).
144. *See id.* at 1279 n.33 (noting that the fraudulent transfer claims were brought under the UFTA, as adopted by both Texas and Utah).
145. *Id.* at 1275-1279
146. *Id.*

receiver to take control of and marshal the defendants' assets, including the apartment complexes.[147]

Both the SEC and the receiver moved to invalidate the loan transactions under the UFTA because the collateral was pledged, or transferred, from a Ponzi scheme.[148] The court, however, found that the lenders acted in good faith and gave reasonably equivalent value in exchange for their security interests.[149] The court held that contracts arising from a Ponzi scheme are "unenforceable to the extent they purport to give persons a right to payments in excess of their initial undertaking," but these lenders acquired the loans from other lenders and gave reasonably equivalent value for the notes and trust deeds they held.[150] Thus the loan transactions were not voidable.[151]

3. *Janvey v. Alguire*[152]

In a companion case to the SEC's case against Allen Stanford and Stanford International Bank (SIB), Ralph Janvey, the court-appointed receiver for SIB brought disgorgement claims against a number of relief defendants in *Janvey v. Alguire*.[153] The receiver sued to recover proceeds, including interest and principal redemptions, from the relief defendants, who benefited from the sale of fraudulent SIB certificates of deposit (CDs).[154] Among the

147. *See id.*

148. *See id.* at 1275.

149. *See Madison Real Estate Group, LLC*, at 1281-82.

150. *Id.* at 1280.

151. *See id.* at 1279.

152. Receiver's First Amended Complaint Against Certain Stanford Investors, Janvey v. Alguire, No. 03:09-CV-0724-N (N.D. Tex. Dec. 7, 2009).

153. *Id.* "Relief defendants" are not defendants or even real parties in interest in the traditional sense. *See* SEC v. Cherif, 933 F.2d 403, 414 (7th Cir. 1991). Often they are custodial banks or innocent investors who merely received or are holding payments distributed under a Ponzi scheme. *See generally* SEC v. Cavanagh, 155 F.3d 129, 136 (2d Cir. 1998) (explaining how federal courts can order equitable relief against an individual in a securities enforcement where the person has received "ill-gotten" funds and "does not have a legitimate claim to those funds"). A finding that a relief defendant has received funds to which he has no legitimate claim, even if it only served as custodian, may subject the relief defendant to a disgorgement order. *See* SEC *v.* Colello, 139 F.3d 674, 678 (9th Cir. 1998).

154. Receiver's First Amended Complaint Against Certain Stanford Investors, Janvey v. Alguire, ¶ 42, No. 03:09-CV-0724-N (N.D. Tex. Dec. 7, 2009).

named relief defendants were investors, but also certain "Custodian Relief Defendants" and financial institutions that held CD proceeds in a trust capacity for SIB investors.[155] The receiver later amended his complaint to allege claims for fraudulent transfers.[156]

Through his amended complaint, the receiver seeks disgorgement of CD proceeds from certain Stanford investors, as well as from former Stanford employees, on fraudulent transfer and unjust enrichment theories.[157] To defeat the receiver's fraudulent transfer claims, the defendants must establish the affirmative defense of both objective good faith and reasonably equivalent value.[158] As the case is ongoing, only time will tell whether the receiver will actually recover CD proceeds under these or any other theories.

D. *Defending Against Ponzi Scheme Litigation*

A financial institution's liability generally hinges on whether the plaintiffs can prove that the financial institution had actual knowledge of the Ponzi scheme. Therefore, a financial institution's defense to Ponzi scheme litigation should intensively focus on establishing that the financial institution did not have actual knowledge of the underlying fraud.[159] At least one court has

155. *See id.*

156. *See generally id.* (explaining how the Stanford Investors were unjustly enriched from fraudulent CD proceeds).

157. *Id.* ¶ 42 (showing how the Receiver is entitled to disgorgement because payments to Stanford Investors were fraudulent or, in the alternative, because Stanford Investors was unjustly enriched); Receiver's Second Amended Complaint Against Certain Stanford Employees, ¶¶ 34, 42, Janvey v. Alguire, No. 3:09-CV-00724-N (D. Tex. filed Dec. 12, 2009) (showing how the Receiver is entitled to disgorgement because payments to Stanford Investors were fraudulent or, in the alternative, because Stanford Investors was unjustly enriched).

158. *See generally* Receiver's First Amended Complaint Against Certain Stanford Investors ¶¶ 34-35, Janvey v. Alguire, No. 03:09-CV-0724-N (outlining the defenses available to the defendant); Receiver's Second Amended Complaint Against Certain Stanford Employees ¶¶ 36-37, Janvey v. Alguire, No. 03:09-CV-0724-N (outlining the defenses available to the defendant).

159. Amended Complaint ¶ 41, Fine v. Sovereign Bank, No. 06CV1450-NG (D. Mass. Aug. 8, 2008) (order denying Plaintiffs' Motion for summary judgment) ("To prove that Sovereign aided and abetted Bleidt's actions, the receiver must show that it knew of the breach of fiduciary duty. . . . Similarly, to succeed on the negligence claim, the receiver must demonstrate 'actual knowledge' of the misappropriation.").

held that actual knowledge is an issue of fact, suggesting that a financial institution cannot dispose of claims at the summary judgment stage of scheme litigation.[160]

Defending against fraudulent transfer claims may also prove difficult. Once the existence of a Ponzi scheme is proven, a presumption of actual intent to hinder, delay, or defraud attendant to any transfer from the Ponzi scheme is established.[161] Therefore, to successfully defend against a fraudulent transfer claim, a financial institution must prove that it acted in good faith and gave reasonably equivalent value in exchange for the transfer.[162] With regard to investors, several courts have held that in the context of a Ponzi scheme, "a debtor does not receive reasonably equivalent value for any payments made to investors that represent 'false profits.'"[163] This rule could arguably apply to a financial institution that holds funds from a trustee or similar custodian. One court has defined "reasonably equivalent value" in this context as follows:

> up to the amount that "profit" payments return the innocent investor's initial outlay, these payments are settlements against the defrauded investor's restitution claim. Up to this amount, therefore, there is an exchange of "reasonably equivalent value" for the defrauded investor's outlay.[164]

Moreover, courts do not treat "false profits" as "profits" in the traditional sense of the word, but consider "false profits" to be the monies paid out by a Ponzi scheme to old investors to encourage further investment and sustain the fraudulent scheme.[165] Thus, a financial institution should focus its defense on establishing that it acted in good faith and gave reasonably equivalent value for the transactions at issue.

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160. *Id.* ¶ 42.
161. *See* SEC v. Madison Real Estate Group, LLC, 647 F. Supp. 2d 1271, 1279-80 (D. Utah 2009).
162. *See id.* at 1279-81.
163. *Id.* at 1279–80.
164. *See* Donell v. Kawell, 533 F.3d 762, 777 (9th Cir. 2008).
165. Drenis v. Haligiannis, 452 F. Supp. 2d 418, 422 (S.D.N.Y. 2008).

V. PROPOSED LEGISLATION THAT MIGHT AFFECT SCHEME LIABILITY[166]

In a recent effort to increase corporate responsibility, Congressional leaders introduced a bill known as the Investors' Rights and Corporate Accountability Act of 2009 (Bill).[167] Among other things, the Bill seeks to expand aiding and abetting liability by adding to the Securities Exchange Act of 1934 a substantial assistance standard of care.[168] Specifically, the Bill provides:

> [A]ny person that provides substantial assistance to another person, with reckless disregard for whether the substantial assistance is in violation of this title, or of any rule or regulation issued under this title, shall be liable in a private action brought under this title, to the same extent as the person to whom the substantial assistance is provided.[169]

In the economic context of a Ponzi scheme, the language of "scheme liability" refers to claims based on deceptive conduct and manipulative acts and practices rather than on material misrepresentations or omissions.[170] As of the publication date of this Article, the Bill had been referred to the Senate Committee on Banking, Housing, and Urban Affairs[171] and may emerge with similar provisions or in some form of a compromise. Nonetheless, Congress appears clearly interested in expanding liability to, among others, third parties and licensed professionals who are involved in the economic transactions that are later determined to have been a "scheme." This legislation could abrogate the Supreme Court's holding in *Stoneridge Inves. Partners, LLC v. Scientific-Atlanta, Inc.*, which severely restricted aiding and abetting liability.[172]

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166. Scheme liability refers to claims based on deceptive conduct and manipulative acts and practices rather than on material misrepresentations or omissions. *See, e.g., In re* Enron Corp. Securities, Derivative & "ERISA" Litigation, 439 F. Supp. 2d 692, 723 (S.D. Tex. 2006).

167. *See* S. 2813, 111th Cong. (2009).

168. *Id.* § 7 (emphasis added).

169. *Id.*

170. *See, e.g., In re Enron Corp.* 423 F. Supp. 2d at 723.

171. Investors Rights and Corporate Accountability Act, S. 2813, 111th Cong. (2009), *available at* http://thomas.loc.gov/cgi-bin/query/z?c111:s.2813:.

172. Stoneridge Inv. Partners, LLC v. Scientific-Atlantic, Inc., 552 U.S. 148, 148 (2008) ("Although *Central Bank* prompted calls for creation of an express cause of

In *Stoneridge*, the Court upheld the principle enunciated in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*[173] that claimants may pursue actions under Section 10(b) of the Securities Exchange Act of 1934 against "secondary actors who commit primary violations" of the securities laws.[174] To resolve a circuit-court split over whether Section 10(b) applied to secondary actors such as accountants, lawyers, or banks, the *Central Bank* Court held that it was not Congress's intent to extend the "directly or indirectly" language of Section 10(b) to aiding and abetting claims.[175] The Court reasoned that doing so would improperly extend aiding and abetting liability to persons who did not actually engage in a deceptive act or practice.[176] The *Stoneridge* Court once again refused to find a private right of action for aiding and abetting, holding that Congress must decide whether to extend a private cause of action for aiding and abetting.[177] Thus, both cases

action for aiding and abetting, Congress did not follow this course. Instead, in § 104 of the Private Securities Litigation Reform Act of 1995 (PSLRA), it directed the SEC to prosecute aiders and abettors. Thus, the § 10(b) private right of action does not extend to aider and abettors.").

173. 511 U.S. 164 (1994).

174. *See Stoneridge*, 552 U.S. at 166; *see also Central Bank of Denver*, 511 U.S. at 191 (holding that "[b]ecause the text of § 10(b) does not prohibit aiding and abetting . . . a private plaintiff may not maintain an aiding and abetting suit under § 10(b). The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities laws. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met.").

175. *See Central Bank of Denver*, 511 U.S. at 175-76.

176. *See id.* at 176-177.

177. *See Stoneridge*, 552 U.S. at 164-65.

found that it was the exclusive right of the SEC—and not private litigants—to enforce aiding and abetting liability.[178]

The proposed Bill, as well as a similar bill proposed by Sen. Arlen Specter, could effectively abrogate the Court's holdings in *Central Bank* and *Stoneridge* by allowing private actions under aiding and abetting liability.[179] As proposed, the Bill would potentially expand liability to the lawyers, accountants, and banks that would otherwise be beyond reach of private aiding and abetting claims. The Bill also proposes a "reckless disregard" standard, which could be easier to prove than the "actual knowledge" standard required under a Section 10(b) claim.[180]

As proposed, the Bill could effectively remedy what some commentators have argued is, after *Stoneridge*, a toothless secondary liability statute. In the eyes of one commentator, the Court's decision in *Stoneridge* effectively thwarted the basic tenet of securities laws, which is to protect the investing public from manipulations and frauds whose sole purpose is to enhance stock prices to the detriment of investors.[181] In holding that secondary actors–who themselves do not make fraudulent statements–cannot be held liable for assisting a securities issuer in committing a fraud, the Court "essentially provided an incentive for companies to assist one another in developing complex fraudulent business transactions."[182]

While the Bill may widen the scope of scheme liability and deter the incentive for developing fraudulent business transactions, it may also increase litigation against lawyers,

178. *See id.*; *see also Central Bank of Denver*, 511 U.S. at 191 (holding respondents could not maintain a private action against petitioner for aiding and abetting another's use of a manipulative device).

179. *Compare* S. 1551, 111th Cong. (2009) ("For purposes of any private civil action implied under this title, any person that knowingly and recklessly provides substantial assistance to another person in violation of this title, or of any rule or regulation issued under this title, shall be deemed to be in violation of this title to the same extent as the person to whom such assistance is provided.") *with* S. 2813, 111th Cong. (2009) (proposing a "reckless disregard" standard).

180. *See Central Bank of Denver*, 511 U.S. at 190 (standard of actual knowledge). S. 1551, as proposed, would institute a "knowingly and recklessly" standard for aider and abettor liability. S. 1551, 111th Cong.

181. *See* Stefan A. Dann, *The Supreme Court Narrows Secondary Actor Liability By Abrogating Scheme Liability: Stoneridge Investment Partners, LLC v. Scientific-Atlanta*, 47 DUQ. L. REV. 391, 406 (2009).

182. *Id.*

accountants, banks, and others who unwittingly provide assistance to Ponzi schemes or to other securities law violators. In theory, the Bill's proposed, less stringent "reckless disregard" standard could subject actors like those in *Banco Santander* and *Grossbard* to liability in common commercial transactions where they "should have known" of a fraud. Given recent calls for greater oversight and accountability from financial institutions following the credit crisis and revelations of gross misconduct by investment managers who became Ponzi scheme operators, such as Madoff and Stanford, the passage of the Bill or some variation thereof seems increasingly likely.[183]

VI. CONCLUSION

This article offers insight into the types of claims that financial institutions may face when a Ponzi scheme collapses. In the current economic climate, claims against financial institutions will no doubt increase. And, in the aftermath of a Ponzi scheme's collapse, financial institutions, whether direct or indirect participants, will almost certainly face litigation risks for even the most remote involvement in financial frauds. Recent litigation shows that aggrieved investors are becoming increasingly creative, and they are pursuing any solvent entity—especially financial institutions—that may have played a role. With a stagnant economy and growing public outrage over the lack of oversight and accountability within the financial industry, these trends may become a pattern.

Financial institutions would be well advised to take steps to review and evaluate their potential exposure to scheme liability as best they can. A thorough due diligence review of business practices could help to defend against a claim that a financial institution "knew or should have known" they were dealing with a Ponzi scheme. In the event that the Bill or similar aiding and abetting legislation is passed, such due diligence may be useful in defending against claims that a financial institution acted with

183. *See generally SEC Officials Promise Changes After Madoff Failure*, CRAIN'S N. Y. BUS., Sept. 10, 2009, http://www.crainsnewyork.com/article/20090910/FREE/ 90 9109995 (showing how the Madoff scandal has led to calls for change and revamped enforcement efforts at the SEC).

"reckless disregard." In either respect, financial institutions and learned professionals should be increasingly vigilant about knowing their customers and those with whom they are doing business.

THE LIMITS OF LIMITED LIABILITY: VEIL PIERCING AND OTHER BASES OF PERSONAL LIABILITY OF OWNERS, GOVERNING PERSONS, AND AGENTS OF TEXAS BUSINESS ENTITIES

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CHAPTER 3

Table of Contents

I. Introduction

Sole proprietors and partners in a traditional general partnership enjoy no protection from the debts and liabilities of the business. The various business entities that provide some type of liability protection do so under slightly varying approaches. These variations are discussed below.

II. Corporations

A. Limited Liability of Shareholders, Directors, and Officers

A corporation is well-recognized for its complete liability shield. Unless a shareholder, director, or officer is liable on some independent legal basis (e.g., is personally a tortfeasor or guarantor), such parties ordinarily have no liability for corporate debts and obligations. "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 liable individually." *Castleberry v. Branscum*, 721 S.W.2d 270, 271 (Tex. 1986). Disregard of the corporate fiction in this manner is also referred to as "piercing the corporate veil."

B. Piercing the Corporate Veil

A short discussion cannot do justice to the developments in the area of corporate veil piercing in Texas over the last 35 years; however, a brief summary is provided below.

1. <u>Alter-Ego Theory</u>

Traditionally, most veil-piercing cases were premised on the alter-ego theory. The Texas Supreme Court has described this basis for piercing the corporate veil as follows: "Under the alter ego theory, courts disregard the corporate entity when there exists such unity between the corporation and individual that the corporation ceases to be separate and when holding only the corporation liable would promote injustice." *Mancorp, Inc. v. Culpepper*, 802 S.W.2d 226, 228 (Tex. 1990), citing *Castleberry v. Branscum*, 721 S.W.2d 270, 272 (Tex. 1986). The total dealings between the shareholder and the corporation are relevant in determining whether there is an alter-ego relationship. *Id.*; *see also Gentry v. Credit Plan Corp. of Houston*, 528 S.W.2d 571 (Tex. 1975). The supreme court has stated that the evidence may include "'the degree to which corporate formalities have been followed and corporate and individual property have been kept separately, the amount of financial interest, ownership and control the individual maintains over the corporation, and whether the corporation has been used for personal purposes.'" *Mancorp, Inc. v. Culpepper*, 802 S.W.2d at 228, citing *Castleberry v. Branscum*, 721 S.W.2d 270, 272 (Tex. 1986). The alter-ego theory has been affected by legislative developments described below. In a case in which a claimant seeks to impose liability on a shareholder for a corporate obligation arising out of a contract, the claimant must show that the shareholder caused the corporation to be used to perpetrate "actual fraud" on the claimant "primarily for the direct personal benefit" of the shareholder, as further discussed below. Additionally, as discussed below, the role of corporate formalities in a veil-piercing analysis is now addressed by statute.

The Texas Supreme Court has distinguished between "jurisdictional veil piercing" (i.e, piercing for purposes of exercising personal jurisdiction) and "substantive veil piercing" (i.e., piercing for purposes of imposing liability) and stated that they involve different elements of proof. *PHC-Minden, L.P. v. Kimberly-Clark Corp.*, 235 S.W.3d 163 (Tex. 2007). Specifically, the court has stated that "fraud—which is vital to piercing the corporate veil under Section 21.223 of the Business Organizations Code—has no place in assessing contacts to determine personal jurisdiction." *Id.* at 175. The relevant factors for jurisdictional veil piercing were described by the court as follows:

> To 'fuse' the parent company and its subsidiary for jurisdictional purposes, the plaintiffs must prove the parent controls the internal business operations and affairs of the subsidiary. But the degree of control the parent exercises must be greater than that normally associated with common ownership and directorship; the evidence must show that the two entities cease to be separate so that the corporate fiction should be disregarded to prevent fraud or injustice.

Id. at 175 (citing *BMC Software*, 83 S.W.3d at 799).

2. <u>The Emergence of "Sham to Perpetrate a Fraud" and the Legislative Response (Statutory Requirement of Actual Fraud in Cases Arising Out of a Contract)</u>

The Texas Supreme Court articulated what many believed was an unprecedented and unduly broad approach to veil piercing in *Castleberry v. Branscum*, 721 S.W.2d 270 (1986). In that case, the court recognized the "sham to perpetrate a fraud" basis for piercing the corporate veil.[1] This theory was distinct from alter ego, explained the court, and was a basis to pierce the corporate veil if "recognizing the separate corporate existence would bring about an inequitable result." To prove there has been a sham to perpetrate a fraud, the court stated that tort claimants or contract creditors need only show constructive fraud. The court described constructive fraud as "the breach of some legal or equitable duty which, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive others, to violate confidence, or to injure public interests."

The Texas legislature reacted to the *Castleberry* opinion by amending the Texas Business Corporation Act (TBCA). As a result of amendments to Article 2.21 of the TBCA in 1989 and several subsequent legislative sessions, veil piercing is now addressed by statute in Texas in such a way that piercing the corporate veil to impose personal liability for a contractual, or contractually related, obligation of a corporation is quite difficult. The post-*Castleberry* amendments to Article 2.21 of the TBCA provided that a shareholder or affiliate may not be held liable for a contractual obligation of the corporation, or any matter relating to or arising from the contractual obligation, unless the shareholder or affiliate caused the corporation to be used to perpetrate "an actual fraud . . . primarily for the direct personal benefit" of the shareholder or affiliate. Tex. Bus. Corp. Act art. 2.21A(2) (expired eff. Jan. 1, 2010). This provision has been carried forward in the corporate provisions of the Texas Business Organizations Code (BOC). Tex. Bus. Orgs. Code § 21.223(a)(2) and (b). By protecting "affiliates" (of the shareholders and of the corporation) as well as shareholders, the statute protects affiliated entities and non-shareholder directors and officers of the corporation to the extent a veil-piercing theory might be relied upon to impose liability on such persons for a contractually related obligation of the corporation. *Phillips v. United Heritage Corp.*, 319 S.W.3d 156 (Tex. App.—Waco 2010, no pet.).

A 1998 court of appeals case illustrates the difficulty plaintiffs may have in meeting these standards to pierce the veil. In *Menetti v. Chavers*, 974 S.W.2d 168 (Tex. App.—San Antonio 1998, no pet.), the plaintiffs sued their builder alleging breach of contract and various tort and DTPA claims. The court determined that all the claims arose from or related to the construction contract and required a showing of actual fraud to pierce the corporate veil. The court acknowledged that the evidence indicated the defendants were poor bookkeepers and took little effort to preserve the corporate fiction; however, there was no evidence that the defendants made any fraudulent misrepresentations (the theory of actual fraud pursued by the plaintiffs). Thus, the plaintiffs were unable to impose liability based upon the alter-ego theory. In addition, the court held that, since Article 2.21 required actual fraud to pierce the veil on the basis of "alter ego, . . . sham to perpetrate a fraud, or other similar theory," the lack of actual fraud precluded liability under all of the other theories pleaded by the plaintiffs, including sham to perpetrate a fraud, denuding, trust fund doctrine, and illegal purposes.

There has been some disagreement among litigants as to how "actual fraud" should be defined when a veil-piercing issue is submitted to the jury. In *Castleberry*, the Texas Supreme Court described actual fraud in the veil-piercing context to involve "dishonesty of purpose or intent to deceive," and most courts have concluded that "actual fraud" for purposes of Article 2.21 of the TBCA or Section 21.223 of the BOC is not the same as the common-law tort of fraud. *See, e.g., Latham v. Burgher*, 320 S.W.3d 602, 606-07 (Tex. App.—Dallas 2010, no pet.) (holding "dishonesty of purpose or intent to deceive" was sufficient definition of "actual fraud" for veil-piercing purposes and trial court did not err in refusing to submit instruction based on common law fraud); *Dick's Last Resort of the West End, Inc. v.*

[1]The court listed six "bases" to disregard the separate corporate existence: (1) when the fiction is used as a means of perpetrating fraud (i.e., sham to perpetrate a fraud); (2) where a corporation is organized and operated as a mere tool or conduit of another (i.e., alter ego); (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 a wrong. The court then noted in a footnote that "[i]nadequate capitalization is another basis for disregarding the corporate fiction," thus raising the possibility that inadequate capitalization was itself enough to disregard a corporation's separate existence. In previous cases, the court had referred to inadequate capitalization as a factor to be considered in a veil-piercing analysis but not as an independent basis to pierce the veil. In *SSP Partners v. Gladstrong Investments (USA) Corporation*, 275 S.W.3d 444 (Tex. 2008), the supreme court listed the six bases set forth above without mentioning inadequate capitalization.

Market/Ross, Ltd., 273 S.W.3d 905, 909-10 (Tex. App.—Dallas 2008, pet. denied) (rejecting argument that actual fraud instruction should include elements of tort of common-law fraud); *McCarthy v. Wani Venture, A.S.*, 251 S.W.3d 573, 584-85 (Tex. App.—Houston [1st Dist.] 2007, pet. denied) (stating that actual fraud can be concealment or failure to disclose material facts and holding trial court did not abuse its discretion in defining actual fraud based on such theory rather than requiring finding of material misrepresentation); *In re Arnette (Ward Family Found. v. Arnette)*, 2011 WL 2292314 (Bankr. N.D. Tex. 2011) (discussing actual fraud under Section 21.223 of BOC and stating that actual fraud for purposes of statute is not the same as common-law tort of fraud and simply requires proof of dishonesty of purpose or intent to deceive).

Assuming a veil-piercing claimant is able to show the requisite "actual fraud," the claimant must additionally establish that the actual fraud was perpetrated "primarily for the direct personal benefit" of the shareholder or affiliate. In *Bates Energy Oil & Gas v. Complete Oilfield Services*, 361 F. Supp. 3d 633 (W.D. Tex. 2019), the court explained that most cases in which this requirement was found to have been met had evidence showing that "'funds derived from the corporations' allegedly fraudulent conduct were pocketed by or diverted to the individual defendant.'" According to the court, "[w]hen the funds were used for the corporation's benefit, that has been held insufficient, even where it indirectly benefits the corporate officers and agents because the corporation is 'able to live another day due to its ability to satisfy some demands' or because their ownership interest retains its value, and this appears true even where the individual is the sole shareholder and where corporate formalities are disregarded."

The Texas Supreme Court has discussed the "narrowly prescribed . . . circumstances under which a shareholder can be held liable for corporate debts" under TBCA Article 2.21 and BOC Sections 21.223-21.226. *Willis v. Donnelly*, 199 S.W.3d 262, 271-73 (Tex. 2006). Donnelly argued that Willis and his wife were personally liable for the breach of a letter agreement under which two corporations formed by Willis were obligated to issue stock to Donnelly. After describing the circumstances leading to the amendment of Article 2.21 (i.e., the business community's displeasure with the flexible approach to veil piercing embraced in *Castleberry*), the court relied upon BOC Sections 21.223-21.225 to reject Donnelly's claim that the Willises were liable for breach of the agreement based on an implied ratification of the agreement. The court pointed out that the statute precludes holding a shareholder liable for any contractual obligation of the corporation on the basis of alter ego, actual or constructive fraud, sham to perpetrate a fraud, or *other similar theory* unless the shareholder causes the corporation to be used to perpetrate an actual fraud on the obligee for the shareholder's direct personal benefit or the shareholder expressly agrees to be personally liable for the obligation. The jury rejected Donnelly's fraud claim, and the court concluded that the Willises did not expressly agree to assume personal liability under the contract. According to the court, "[t]o impose liability against the Willises under a common law theory of implied ratification because they accepted the benefits of the letter agreement would contravene the statutory imperative that, absent actual fraud or an express agreement to assume personal liability, a shareholder may not be held liable for contractual obligations of the corporation." The court held that Donnelly's characterization of his theory as "ratification" rather than "alter ego" was simply asserting another "similar theory" of derivative liability that is covered by the statute.

BOC Section 21.223, like its predecessor (Article 2.21 of the TBCA), does not specify that liability based upon alter ego, sham to perpetrate a fraud, or other veil-piercing theories must be accompanied by actual fraud if the underlying claim is based upon a tort or statutory liability that does not arise out of a contract of the corporation. *See Love v. State*, 972 S.W.2d 114, 117-18 (Tex. App.—Austin 1998, pet. denied); *Farr v. Sun World Savings Ass'n*, 810 S.W.2d 294, 296 (Tex. App.—El Paso 1991, no writ); *Western Horizontal Drilling, Inc. v. Jonnet Energy Corp.*, 11 F.3d 65, 68 n. 4 (5th Cir. 1994); *Nordar Holdings, Inc. v. Western Sec. (USA) Ltd.*, 969 F.Supp. 420, 422 and 423 n. 2 (N.D.Tex.1997). Bar committee commentary, however, characterizes the constructive fraud standard as "questionable" in the context of tort claims and suggests that the amendments should be considered by analogy in the context of tort claims, in particular contractually based tort claims. Tex. Bus. Corp. Act art. 2.21, Comment of Bar Committee–1996. The statute was amended in 1997 to make clear that the corporate veil may not be pierced to hold a shareholder or affiliate liable on a claim "relating to or arising from" a contractual obligation of the corporation absent actual fraud on the part of the shareholder or affiliate.

Although actual fraud may not be required to pierce the corporate veil in the context of a non-contractual obligation, veil piercing has traditionally been predicated on notions of justice and fairness. Thus, the plaintiff should nevertheless be required to establish that injustice or inequity will result if the separate corporate existence is recognized. *See SSP Partners v. Gladstrong Invs. (USA) Corp.*, 275 S.W.3d 444 (Tex. 2008) (stating that there must be evidence of abuse or injustice to disregard the corporate form and rejecting the single business enterprise theory because the factors do not reflect illegitimate use of limited laibility); *Matthews Constr. Co., Inc. v. Rosen,* 796 S.W.2d 692 (Tex. 1990) (stating that "[w]hen the corporate form is used as an essentially unfair device—when it is used as a sham—courts may act in equity to disregard the usual rules of law in order to avoid an inequitable result"); *Mancorp, Inc. v. Culpepper,* 802 S.W.2d 226 (Tex. 1990) (stating that courts may disregard the corporate entity under the alter-ego theory "when there exists such unity between the corporation and individual that the corporation ceases to be separate and when holding only the corporation liable would promote injustice"); *Lucas v. Texas Indus., Inc.,* 696 S.W.2d 372 (Tex. 1984) (noting policy reasons that courts are less reluctant to pierce the veil in tort cases than breach of contract cases but refusing to pierce the corporate veil in the tort case in question in the absence of evidence that the corporate form caused the plaintiff to fall victim to a "basically unfair device by which . . . [the] corporate entity was used to achieve an inequitable result").

Most courts have held that the statutory actual-fraud standard applicable in a veil-piercing case does not protect corporate shareholders/officers from liability for their own torts, even though such torts may have occurred while acting on behalf of the corporation in the context of a contractual transaction between the corporation and the plaintiff. *See Bates Energy Oil & Gas v. Complete Oilfield Servs.,* 361 F. Supp. 3d 633 (W.D. Tex. 2019) and cases cited therein; *Gore v. Scotland Golf, Inc.*, 136 S.W.3d 26, 32 (Tex. App.—San Antonio 2003, pet. denied); *Kingston v. Helm*, 825 S.W.3d 755, 764-67 (Tex. App.—Corpus Christi 2002, pet. denied); *but see TecLogistics, Inc. v. Dresser-Rand Group, Inc.,* 527 S.W.3d 589 (Tex. App.—Houston [14th Dist.] 2017, no pet.); *Hong v. Havey*, 551 S.W.3d 875 (Tex. App.—Houston [14th Dist.] 2018, no pet.); Glenn D. West and Adam D. Nelson, Corporations, 57 SMU L. REV. 799, 805-08 (2004) (disagreeing with application of agency law to impose liability on corporate officer in *Gore v. Scotland Golf, Inc.*); Glenn D. West and Susan Y. Chao, Corporations, 56 SMU L. REV. 1395, 1403-08 (2003) (disagreeing with application of agency law to impose liability on corporate officer in *Kingston v. Helm*).

3. <u>De-Emphasis of Corporate Formalities</u>

The Texas legislature has also addressed the relevance of failure to follow corporate formalities in the veil-piercing context. Traditionally, the failure to follow corporate formalities has been a factor in alter-ego cases; however, Section 21.223(a)(3) of the BOC, like its predecessor (Article 2.21A(3) of the TBCA), provides that failure to follow corporate formalities is not a "basis" to hold a shareholder or affiliate liable for any obligation of the corporation.[2] Courts have generally interpreted this provision to mean that failure to follow corporate formalities is no longer a "factor" in veil piercing. *See, e.g., Durham v. Accardi,* 587 S.W.3d 179 (Tex. App.—Houston [14th Dist.] 2019, no pet.); *TransPecos Banks v. Strobach*, 487 S.W.3d 722 (Tex. App.—El Paso 2016, no pet.); *TMX Fin. Holdings, Inc. v. Wellshire Fin. Services, LLC*, 2016 WL 5920776 (Tex. App.—Houston [1st Dist.] 2016, no pet.); *Gurganus v. Furniss*,

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[2]In addition to the veil-piercing provisions contained in BOC Section 21.231, which are applicable generally to Texas corporations, there are special provisions in Subchapter C (Sections 21.101-21.109) and Subchapter O (Sections 21.701-21.732) of Chapter 21 of the BOC. These provisions permit closely held corporations to operate pursuant to a shareholders' agreement that dispenses with traditional corporate features if certain requirements are met.

BOC Section 21.101allows shareholders of a closely held corporation to structure the corporation to alter or dispense with traditional corporate rules and norms if certain conditions and requirements set forth in the statute are met. BOC Section 21.107 states that the existence or performance of a shareholders' agreement shall not be grounds for imposing personal liability on a shareholder for the obligations of the corporation by disregarding the separate corporate entity even if, pursuant to the agreement, the corporation operates as if it were a partnership or fails to observe corporate formalities otherwise applicable.

The requirements under BOC Sections 21.101-21.109 are somewhat simpler than those imposed under the close corporation provisions found in Subchapter O (Sections 21.701-21.732) of the BOC. In order to be a "close corporation" governed by Subchapter O, the certificate of formation of the corporation must contain the following statement: "This corporation is a close corporation." Additionally, a close corporation that operates pursuant to a shareholders' agreement under Subchapter O must file a statement of operation as a close corporation with the Secretary of State. Subchapter O of Chapter 21 of the BOC also contains a provision that protects shareholders of these special statutory "close corporations" against veil piercing. This protective provision states that neither the failure of a close corporation to observe usual formalities or the statutory requirements prescribed for an ordinary corporation, nor the performance of a shareholders' agreement that treats the close corporation as if it were a partnership or in a manner that otherwise is appropriate only among partners, is a factor in determining whether to impose personal liability on the shareholders for an obligation of the close corporation by disregarding the separate corporate existence or otherwise. Tex. Bus. Orgs. Code § 21.730.

2016 WL 3745684 (N.D. Tex. 2016); *Sparling v. Doyle*, 2014 WL 12489990 (W.D. Tex. 2014); *In re Abraham*, 2014 WL 3406513 (S.D. Tex. 2014); *In re Atlas Fin. Mortg., Inc.*, 2014 WL 172283 (Bankr. N.D. Tex. 2014); *Hernandez v. Frazier*, 2012 WL 12895761 (W.D. Tex. 2012), report and recommendation adopted, 2013 WL 12142682 (W.D. Tex. 2013); *In re Gregg*, 2012 WL 4506776 (Bankr. E.D. Tex. 2012); *Lonrho PLC v. Starlight Invs., LLC*, 2012 WL 4215754 (S.D. Tex. 2012); *Doyle v. Kontemporary Builders, Inc.*, 370 S.W.3d 448, 458 (Tex. App.—Dallas 2012, pet. denied); *Burchinal v. PJ Trailers-Seminole Mgmt. Co., LLC*, 372 S.W.3d 200, 217 (Tex. App.—Texarkana 2012, no pet.); *Penhollow Custom Homes, LLC v. Kim,* 320 S.W.3d 366 (Tex. App.—El Paso 2010, no pet.); *Country Village Homes, Inc. v. Patterson*, 236 S.W.3d 413, 428 (Tex. App.—Houston [1st Dist.] 2007, pet. granted, judgm't vacated w.r.m.); *Sparks v. Booth,* 232 S.W.3d 853, 868-69 (Tex. App.—Dallas 2007, no pet.); *Hoffman v. Dandurand*, 180 S.W.3d 340, 347 (Tex. App.—Dallas 2005, no pet.); *Carone v. Retamco Operating, Inc.*, 138 S.W.3d 1, 13 (Tex. App.—San Antonio 2004, pet. denied); *Hall v. Timmons*, 987 S.W.2d 248, 250 n. 2 (Tex. App.—Beaumont 1999, no pet.); *In re Ryan (Bale v. Ryan)*, 443 B.R. 395, 407 (Bankr. N.D. Tex. 2010); *Hunt v. Stephens*, 2002 WL 32341814 *5 (Tex. App.—Eastland 2002, no pet.)(not designated for publication); *Eckhardt v. Hardeman*, 1999 WL 33226 * 4 n. 4 (Tex. App.—Austin 1999, pet. denied)(not designated for publication); *In re Arnette (Ward Family Found. v. Arnette)*, 2011 WL 2292314 (Bankr. N.D. Tex. 2011); *see also Mancorp, Inc. v. Culpepper*, 802 S.W.2d 226, 233 (Tex. 1990)(Hecht, J., dissenting); *but see Schlueter v. Carey*, 112 S.W.3d 164, 170 (Tex. App.—Fort Worth 2003, pet. denied) (considering failure to follow corporate formalities along with other evidence of alter ego and interpreting TBCA article 2.21 as providing individual may not be held liable under alter-ego theory "based simply" on corporation's failure to follow corporate formalities). The suggested instruction for defining the alter-ego basis of holding a shareholder liable in *Texas Pattern Jury Charges* conspicuously omits any reference to "failure to follow corporate formalities." *See* PJC 108.2.

In *PHC-Minden, L.P. v. Kimberly-Clark Corp.*, 235 S.W.3d 163 (Tex. 2007), the Texas Supreme Court distinguished between "jurisdictional veil piercing" and "substantive veil piercing" and stated that they involve different elements of proof. In that case, the court suggested that failure to follow corporate formalities would be relevant in determining if a parent and subsidiary were "fused" for purposes of jurisdictional piercing.

4. The Rise and Fall of the Single Business Enterprise Theory

In the mid 1980s, the "single business enterprise" veil-piercing theory emerged in Texas. As described in *Paramount Petroleum Corp. v. Taylor Rental Center*, 712 S.W.2d 534, 536 (Tex. App.—Houston [14th Dist.] 1986, writ ref'd n.r.e.), the single business enterprise theory allowed a claimant to reach the assets of one or more affiliates of a corporation to satisfy the liability of the corporation on the basis that the corporation and its affiliates "integrated their assets to achieve a common business purpose." The court in *Paramount Petroleum* identified a number of factors that would support a finding that separate corporations should be treated as a single business enterprise. Over the next couple of decades, the formulation of the single business enterprise theory articulated in *Paramount Petroleum* made its way into the mainstream of Texas veil-piercing jurisprudence. For example, in *Superior Derrick Services, Inc. v. Anderson*, 831 S.W.2d 868 (Tex. App.—Houston [14th Dist.] 1992, writ denied), the court, in addressing whether the evidence was sufficient to hold one corporation ("Superior") jointly and severally liable for the debt of another corporation ("Champion") on the basis that they operated as a single business enterprise, stated:

> The "single business enterprise" theory involves corporations that "integrate their resources to achieve a common business purpose . . . ." *Paramount Petroleum Corp. v. Taylor Rental Center*, 712 S.W.2d 534, 536 (Tex. App.—Houston [14th Dist.] 1986, writ ref'd n.r.e.). In determining whether two corporations had not been maintained as separate entities, the court may consider the following factors: (1) common employees; (2) common offices; (3) centralized accounting; (4) payment of wages by one corporation to another corporation's employees; (5) common business name; (6) services rendered by the employees of one corporation on behalf of another corporation; (7) undocumented transfers of funds between corporations; and (8) unclear allocation of profits and losses between corporations. *Id.*

831 S.W.2d at 874.

Though some of the factors were absent, the court found the evidence sufficient to uphold the finding that the two corporations in question operated as a single business enterprise.

> The evidence showed that a Superior stockholder formed Champion, Superior provided office space for Champion in the same building as Superior's offices, Superior provided Champion with all forms necessary for business, performed services for Champion, and that Superior paid all of Champion's bills, expenses, and employee salaries. In our opinion, this is sufficient to show that the two corporations did not operate as "separate entities but rather integrate[d] their resources to achieve a common business purpose . . . ."

831 S.W.2d at 875.

After the single business enterprise theory was set forth in *Paramount Petroleum* in 1986, Texas courts of appeals applied the theory in a significant number of cases; however, the Texas Supreme Court did not directly address the validity of the theory until 2008. In *SSP Partners v. Gladstrong Investments (USA) Corporation*, 275 S.W.3d 444 (Tex. 2008), the Texas Supreme Court rejected the single business enterprise theory as inconsistent with veil-piercing principles under Texas law. Prior to its opinion in *SSP Partners*, the Texas Supreme Court had expressly refrained from endorsing or rejecting the single business enterprise theory as a means of imposing liability. *Southern Union Co. v. City of Edinburg*, 129 S.W.3d 74, 87 (Tex. 2003) ("We need not decide today whether a theory of 'single business enterprise' is a necessary addition to the theory of alter ego for disregarding corporate structure or the theories of joint venture, joint enterprise, or partnership for imposing joint and several liability."); *see also Nat'l Plan Administrators, Inc. v. Nat'l Health Ins. Co.*, 235 S.W.3d 695, 704 (Tex. 2007) ("We do not reach the question of, and express no opinion on, whether the single-business enterprise theory is a viable doctrine to pierce the veil of an entity such as [the parent corporation of an entity that had allegedly breached a fiduciary duty to the plaintiff]."). In *Southern Union*, the court stated that it need not address the parameters of the single business enterprise theory because, whatever label was applied, the plaintiff's attempt to treat various entities as a single entity was encompassed within Article 2.21 of the TBCA, and the plaintiff failed to satisfy the actual-fraud standard imposed by the statute.

In *SSP Partners v. Gladstrong Investments (USA) Corporation*, 275 S.W.3d 444 (Tex. 2008), the Texas Supreme Court pointed out that abuse and injustice are not components of the single business enterprise theory as set forth in *Paramount Petroleum*, and the court stated that there must be evidence of "inequity" or "injustice" (something beyond a subjective perception of unfairness by an individual judge or juror) to disregard the corporate structure. The court stated that there was nothing abusive or unjust about the single business enterprise factors identified in *Paramount Petroleum*, such as sharing of names, offices, accounting, employees, services, and finances. "Creation of affiliated corporations to limit liability while pursuing common goals lies firmly within the law and is commonplace," according to the Texas Supreme Court in *SSP Partners*. Citing Article 2.21 of the TBCA, which employs a strict approach to veil piercing and requires actual fraud to disregard the corporate structure in certain cases, the court concluded that the single business enterprise theory is fundamentally inconsistent with the approach taken by the legislature in Article 2.21. The court thus held that the theory as set forth in *Paramount Petroleum* will not support the imposition of one corporation's liability on another.

The court's opinion in *SSP Partners* raises a number of potential questions. Is the single business enterprise theory a basis to hold an affiliate liable for a corporation's liability if the claimant establishes actual fraud (in a case arising out of a contract) or "inequity" or "injustice" (in a tort or other non-contract case) in addition to the single business enterprise factors? Is the sham to perpetrate a fraud basis for piercing the veil available to reach the assets of a corporation's non-shareholder affiliate (such that the single business enterprise factors may be superfluous) if the claimant establishes actual fraud (in a contract case) or constructive fraud (in a tort or other non-contract case)? Is it possible to reach the assets of a non-shareholder affiliate pursuant to the alter-ego basis for piercing the veil? Though the issue has not often been discussed by Texas courts, some cases indicate that the alter-ego doctrine is not available to impose liability on a party other than a shareholder of the corporation. *See Bollore S.A. v. Import Warehouse, Inc.*, 448 F.3d 317, 325-26 (5th Cir. 2006) (stating that "[t]he great weight of Texas precedent indicates that, for the alter ego doctrine to apply against an individual . . . , the individual must own stock in the corporation"). Other cases seem to suggest that veil piercing may extend to persons in management roles even if they are not shareholders. While making the point that courts have never indiscriminately applied the alter-ego doctrine to "arguably responsible bystanders," a Texas court recently described the alter-ego doctrine as applying to "owners and operators of the firm, including 'shareholders, officers, and directors' who would ordinarily be insulated from liability for corporate obligations." *Peterson Grp., Inc. v. PLTQ Lotus Grp., L.P.*, 417 S.W.3d 46 (Tex. App.—Houston [1st Dist.] 2013, pet. denied), citing *Castleberry v. Branscum*, 721 S.W.2d 270, 271 (1986).

Some plaintiffs have tried to resuscitate their single business enterprise claims by arguing that the factors are accompanied by evidence of actual fraud. In *Big Easy Cajun Corp. v. Dallas Galleria Ltd.*, 293 S.W.3d 345 (Tex. App.—Dallas 2009, pet. denied), a lessor obtained a judgment against a lessee for breach of the lease after the lessee defaulted on the lease and abandoned the premises. The lessor then brought suit against various corporations seeking to hold the corporations liable under the single business enterprise theory for the judgment obtained against the lessee. The jury found for the plaintiff on the single business enterprise claim, and the trial court entered judgment in favor of the plaintiff on the claim. During the pendency of the appeal, the Texas Supreme Court issued its opinion in *SSP Partners v. Gladstrong Investments (USA) Corporation*, and the plaintiff argued that it proved more than the single business enterprise theory discussed in *SSP Partners*, i.e., that it obtained an implicit finding of actual fraud. The court of appeals concluded that the trial court's judgment in favor of the plaintiff must be reversed, however, because the supreme court rejected the fundamental theory of liability the plaintiff submitted to the jury.

In the bankruptcy case of *In re HRM Holdings, LLC (Seidel v. Hosp. Res. Mgmt. LLC)*, 421 B.R. 244 (Bankr. N.D. Tex. 2009), the trustee sought to pierce the debtor LLC's veil and hold several affiliated LLCs liable as a single business enterprise based on actual fraud consisting of the debtor LLC's failure to notify creditors that it was terminating its business operations. (The bankruptcy court applied corporate veil-piercing principles in the LLC context, noting that "Texas courts and other jurisdictions have applied the same state law principles for veil-piercing that they have applied to corporations.") The trustee's original complaint had simply asserted the single business enterprise theory as a basis of liability without specifying fraud, but the court found the complaint deficient based on *SSP Partners* and gave the trustee the opportunity to specify actual fraud as a basis to hold the affiliated defendants liable to the debtor's creditors.

In a more recent decision of the Houston First Court of Appeals, the court appeared to somewhat equate the concept of a single business enterprise to that of an alter-ego relationship when analyzing "the first consideration in piercing the corporate veil [under an alter-ego theory]– whether the persons or entities sought to be charged with liability are the alter egos of the primary debtor." *Tryco Enters., Inc. v. Robinson*, 390 S.W.3d 497 (Tex. App.—Houston [1st Dist.] 2012, pet. dism'd). Relying on *SSP Partners*, the court of appeals stated that piercing the corporate veil to impose liability under the alter-ego theory requires a two-prong showing: (i) that the persons or entities upon whom a claimant seeks to impose liability are alter egos of the debtor, and (ii) that the corporate fiction was used for illegitimate purposes, i.e., to perpetrate fraud. The court stated that whether the persons or entities sought to be charged are alter egos of the primary debtor can be assessed using the single business enterprise factors. The court concluded that the parties sought to be charged were part of a single business enterprise and were alter egos of each other. With respect to the second prong, the court characterized the separate bases for piercing the corporate veil identified in *Castleberry* as "criteria" for meeting the second prong and concluded that the second prong was met based on evidence of five of the six criteria.

In *Clapper v. American Realty Investors, Inc.*, 2016 WL 302313 (N.D. Tex. 2016), the plaintiffs brought suit against various defendants seeking to hold them liable under the single business enterprise theory. The plaintiffs argued that *SSP Partners* did not completely eliminate the single business enterprise theory, but instead held that there must be a showing of actual fraud. The court rejected the plaintiffs' reliance on *Tryco Enters., Inc. v. Robinson* because that case sought to pierce the veil on the basis of alter ego. The court dismissed the plaintiffs' single business enterprise claims against multiple entities as to which the defendants did not also plead alter ego or any other veil-piercing theory.

In *Shoop v. Devon Energy Production Company, L.P.*, 2013 WL 12251353 (N.D. Tex. 2013), the court held that there was a material fact issue as to whether the defendant limited partnership and an affiliated limited partnership should be treated as the same entity on the basis that they entered into a "sham transaction" to deprive the plaintiff of higher royalties. The court explained that "alleging a sham transaction is a vehicle to disregard the lines between legally distinct entities in an effort to avoid a transaction without imputing liability." In other words, the plaintiffs were not attempting to impute liability but rather were alleging that the sale between the defendant and its affiliate should be disregarded because the defendant and its affiliate should be treated as one and the same. The defendant relied on the Texas Supreme Court's holding in *SSP Partners v. Gladstrong Investments (USA) Corp.*, 275 S.W.3d 444, 447 (Tex. 2008), that affiliates cannot be liable for each other's actions under the single business enterprise doctrine, but the court distinguished the case as follows: "[W]hile the Texas Supreme Court noted that it has never 'approved of imposing joint liability on separate entities merely because they were a part of a single business enterprise,' the issue in *that case* did not involve a theory espousing that the corporate structure was abused to 'perpetuate fraud.' *SSP Partners*, 275 S.W.3d at 451. Rather than hitting a brick wall by merely alleging corporate affinity, this claim positively breaks through with evidence supporting the notion a corporate structure was 'used as part of a basically unfair device to achieve an inequitable result." *Id.* (quoting *Castleberry v. Branscum*, 721 S.W.2d 270, 271 (Tex. 1986)).'"

Prior to the *SSP Partners* opinion, numerous courts had concluded that the single business enterprise theory fell within the scope of TBCA Article 2.21A(2), which required a showing of actual fraud in order to hold a shareholder or affiliate liable for a corporation's contractual or contractually related obligation on the basis of alter ego, actual fraud, constructive fraud, sham to perpetrate a fraud, "or other similar theory." *Southern Union Co. v. City of Edinburg*, 129 S.W.3d 74, 87-89 (Tex. 2003); *Olympic Fin. Ltd. v. Consumer Credit Corp.*, 9 F.Supp.2d 726 (S.D. Tex. 1998); *Nordar Holdings, Inc. v. W. Sec. (USA) Ltd.*, 969 F.Supp. 420 (N.D. Tex. 1997). These cases illustrate the difficulty a plaintiff faces in a veil-piercing case when the statutory actual-fraud standard is applicable. In each of these cases, the plaintiff's veil-piercing claim failed for lack of a showing of actual fraud. *But see Country Village Homes, Inc. v. Patterson*, 236 S.W.3d 413 (Tex. App.—Houston [1st Dist.] 2007, pet. granted, judgm't vacated w.r.m.)(holding actual fraud is required to impose liability in a case arising out of a contract under the single business enterprise theory; while defendant failed to preserve error regarding single business enterprise instruction that omitted actual fraud element, evidence was sufficient to sustain jury's finding of actual fraud in connection with alter-ego liability). In the tort context, where the corporate statutes do not require actual fraud in order to pierce the veil, the single business enterprise theory proved a potent weapon. *See, e.g., N. Am. Van Lines v. Emmons*, 50 S.W.3d 103 (Tex. App.—Beaumont 2001, no pet.);[3] *Hall v. Timmons*, 987 S.W.2d 248 (Tex. App.—Beaumont 1999, no pet.); *Nichols v. Pabtex, Inc.*, 151 F.Supp.2d 772 (E.D. Tex. 2001). If the single business enterprise theory has any continuing application in the tort context, however, it appears clear that the single business enterprise factors would have to be accompanied by some type of inequity or injustice.

In addition to relying upon the single business enterprise theory to impose liability, courts of appeals relied upon the theory to impute the contacts of a related party for purposes of imposing personal jurisdiction. *See, e.g., Bridgestone Corp. v. Lopez*, 131 S.W.3d 670 (Tex. App.—Corpus Christi 2004, pet. granted, judgm't vacated w.r.m.); *El Puerto De Liverpool, S.A. de C.V. v. Servi Mundo Llantero S.A. de C.V.*, 82 S.W.3d 622 (Tex. App.—Corpus Christi 2002, pet. dism'd w.o.j.). In *PHC-Minden, L.P. v. Kimberly-Clark Corp.*, 235 S.W.3d 163 (Tex. 2007), however, the Texas Supreme Court rejected the single business enterprise theory as a basis for piercing in the personal jurisdiction context. *See also Munro v. Lucy Activewear, Inc.*, 2016 WL 4257750 (W.D. Tex. 2016); *Fisher v. Blue Cross & Blue Shield of Texas, Inc.*, 2015 WL 5603711 (N.D. Tex. 2015).

5. Reverse Corporate Veil Piercing

Occasionally, a party will attempt to use the alter-ego doctrine to characterize the assets of a corporation as the assets of its shareholder. Such "reverse piercing" may be sought in order to hold a corporation liable for the controlling shareholder's debt. *See Chao v. Occupational Safety and Health Review Comm'n*, 401F.3d 355, 364-66 (5th Cir. 2005); *Zahra Spiritual Trust v. United States*, 910 F.2d 240, 243-44 (5th Cir. 1990); *Seghers v. Bizri*, 513 F. Supp. 2d 694 (N.D. Tex. 2007); *In re Boyd (Rodriguez v. Four Dominion Drive, LLC)*, 2012 WL 5199141 (Bankr. W.D. Tex. 2012); *In re Bass (Roberts v. J. Howard Bass & Assocs., Inc.)*, 2011 WL 560418 (Bankr. W.D. Tex. 2011); *In re Moore (Cadle Co. v. Brunswick Homes, LLC)*, 379 B.R. 284 (Bankr. N.D. Tex. 2007); *Wilson v. Davis*, 305 S.W.3d 57 (Tex. App.—Houston [1st Dist.] 2009, no pet.); *Hyde-Way, Inc. v. Davis*, 2009 WL 2462438 (Tex. App.—Ft. Worth 2009, pet. denied); *Valley Mech. Contractors, Inc. v. Gonzales*, 894 S.W.2d 832 (Tex. App.—Corpus Christi 1995, no pet.). Reverse piercing is also used in the divorce context to permit the court to reach corporate assets and divide them as part

[3]In *North American Van Lines v. Emmons*, 50 S.W.3d 103 (Tex. App.—Beaumont 2001, no pet.), the court held that the single business enterprise theory is distinct from the alter-ego theory and that the evidence supported the jury's finding that a parent and subsidiary constituted a "single business enterprise" even though the evidence was insufficient to establish alter ego. According to the court, the alter-ego theory "generally involves proof of fraud," whereas the single business enterprise theory "relies on equity analogies to partnership principles of liability." The single business enterprise theory "looks to see if principles of equity support a holding that the two entities should be treated as one for purposes of liability for their acts." The court found that the control the parent exercised over its subsidiary was "part of the normal framework of a parent/subsidiary relationship" and did not require a finding of alter ego. However, the court concluded that the evidence was sufficient for the jury to find that the parent and subsidiary were operated as a single business enterprise. The evidence included the following: common officers, common employees, the subsidiary was created so that the parent's agents in Texas could pool their authority and create a broader coverage in the state, the parent described its relationships with its agents as a mutually dependent and cooperative enterprise, the parent received all the profits from the subsidiary, the van driver was wearing a uniform with the parent company's name on it for a move purportedly on behalf of the subsidiary, the parent performed various administrative functions for the subsidiary, and the accident report described the driver as a driver of the parent company.

of the community estate. *See Boyo v. Boyo*, 196 S.W.3d 409, 419-21 (Tex. App.—Beaumont 2006, no pet.); *Lifshutz v. Lifshutz*, 61 S.W.3d 511, 516-18 (Tex. App.—San Antonio 2001, pet. denied); *Zisblatt v. Zisblatt*, 693 S.W.2d 944, 952 (Tex. App.—Fort Worth 1985, writ dism'd). In the case of *In re Ward (Yaquinto v. Ward)*, 558 B.R. 771 (Bankr. N.D. Tex. 2016), the court discussed reverse piercing under Texas law and rejected the plaintiff's argument that reverse piercing is an independent cause of action that may be brought as a stand-alone claim (distinguishing divorce cases from the type of claim that the plaintiff was asserting). Because reverse piercing is a remedy and the plaintiff did not hold a judgment or assert in its complaint an underlying claim that would support recovery under a reverse-piercing theory, the court granted summary judgment against the plaintiff on the plaintiff's reverse-piercing claim. A peculiar application of reverse piercing occurred in *In re Smith,* 192 S.W.3d 564 (Tex. 2006). In that case, a judgment creditor in a post-judgment net worth proceeding (for purposes of determining the amount of security required to be posted by the judgment debtor in order to suspend enforcement of the judgment) argued that the net worth of a closely held corporation of which the judgment debtor was a shareholder should be included in the net worth of the judgment debtor shareholder on the basis of a finding of alter ego. The Texas Supreme Court held that an alter-ego finding is relevant in determining the judgment debtor's net worth because "'[a]lter ego applies when there is such unity between corporation and individual that the separateness of the corporation has ceased.'" Applying alter ego in the manner applied in this case would seem to result in a "double counting" of net worth since the judgment debtor's shares in the corporation would already be included in the judgment debtor's net worth, but that issue was not raised in the opinion.

Faced with a reverse piercing claim aimed at reaching the assets of a Texas LLC to satisfy a judgment against an individual whose wife was the sole shareholder of a corporation that was a 50% member of the LLC, a Texas bankruptcy court sounded a cautious note regarding the application of reverse piercing principles. *See In re Moore (Cadle Co. v. Brunswick Homes, LLC)*, 379 B.R. 284 (Bankr. N.D. Tex. 2007). The court rather perfunctorily concluded that whether an entity is an LLC or a corporation is a distinction without a difference for purposes of applying veil-piercing principles, and the court then proceeded to discuss in some depth the roots of reverse corporate veil piercing in Texas and the policy concerns that courts should recognize in applying reverse piercing principles.

In *Moore*, the bankruptcy court traced the development of the doctrine of reverse piercing in Texas, noting that the doctrine has not been addressed by the Texas Supreme Court and has "rather thin roots" in Texas. The court reviewed the Texas Supreme Court's decision in *Castleberry* and the legislature's response, pointing out that the legislature "aborted" the course the common law had taken and created a tougher standard with the enactment of Article 2.21 of the TBCA. The court noted that the statutory standards in Article 2.21 generally encompass only traditional piercing (i.e., an effort to impose a liability of the corporation on a shareholder). The court observed that the "affiliate" reference in the statute arguably encompasses reverse-piercing situations involving a corporate shareholder and its subsidiary, but the statute does not literally apply to an effort to hold a corporation liable for the debt of an *individual.* The court was troubled, however, that reverse piercing has made its way into the mainstream at the same time the legislature has been limiting the availability of traditional veil piercing and without close examination by the courts of the potential results of the doctrine's application. The court concluded that it was required to recognize the remedy of reverse corporate veil piercing inasmuch as the Fifth Circuit Court of Appeals has concluded that the remedy is available under Texas law, but the court noted policy concerns that would support a cautious approach to reverse piercing. Relying upon case law in other jurisdictions, the court stated that reverse veil piercing "should only be applied when it is clear that it will not prejudice non-culpable shareholders or other stakeholders (such as creditors) of the corporation."

Once the bankruptcy court in *Moore* concluded that reverse corporate veil piercing is a remedy that is available under Texas law, the court faced the question of whether an individual must be an owner of a corporation in order to apply the alter-ego doctrine to hold the corporation liable for a debt of the individual. Mr. Moore was active in the affairs of the LLC that was alleged to be his alter ego, and his wife was the sole shareholder of a corporation that was a 50% owner of the LLC, but Mr. Moore was not himself an owner of the LLC. Based on Fifth Circuit case law addressing the ownership question in a reverse-piercing context, the court in *Moore* held that an ownership interest is required to disregard the separateness of an individual and a corporation, but the ownership interest may exist in a *de facto* manner, such as where the actual record holder of shares in a corporation holds them as a sham for the individual.

Another bankruptcy court likewise concluded that it is possible to apply the alter-ego theory to an individual who does not directly own any shares in the corporation if it can be shown that the individual was at least a *de facto* owner. *In re Bass (Roberts v. J. Howard Bass & Assocs., Inc.)*, 2011 WL 560418 (Bankr. W.D. Tex. 2011). The court thus refused to dismiss a reverse-piercing alter-ego claim seeking to reach the assets of two corporations in which the debtor was involved but which were purportedly owned by the debtor's wife and son. One of the corporations was formed under the laws of the Cayman Islands, and the court acknowledged that the reverse-piercing claim would be governed by Caymanian law. However, the fact that Texas law did not apply to that corporation was not sufficient to conclude that the claim should be dismissed because the court examined veil-piercing cases under the law of the United Kingdom and found no reason to conclude that the reverse-piercing claim would not be recognized under the law of the Cayman Islands. *See also In re Juliet Homes, L.P.*, 2011 WL 6817928 (Bankr. S.D. Tex. 2011); *Bramante v. McClain*, 2007 WL 4555943 (W.D. Tex.2007).

C. Liability of Directors and Shareholders for Wrongful Distributions

The BOC imposes limitations on distributions to shareholders and provides for joint and several personal liability of directors to the extent a distribution approved by the directors exceeds the statutory limitations. Tex. Bus. Orgs. Code §§ 21.301, 21.303, 21.316(a). A "distribution" is a transfer of the corporation's property (including cash or the issuance of debt) to shareholders in the form of a dividend, a purchase or redemption of any of the corporation's shares, or a payment in liquidation of all or a portion of the corporation's assets. Tex. Bus. Orgs. Code § 21.002(6)(A). Generally, a corporation is not permitted to make a distribution if the corporation would be insolvent after the distribution or if the distribution exceeds the surplus of the corporation. Tex. Bus. Orgs. Code §§ 21.301(1)(B), 21.303(b). "Surplus" is the amount by which the net assets of the corporation exceed the stated capital. Tex. Bus. Orgs. Code § 21.002(12); *see also* Tex. Bus. Orgs. Code § 21.002(9), (11) (defining "net assets" and "stated capital"). In certain cases, the surplus limitation is replaced by a net assets limitation. Tex. Bus. Orgs. Code § 21.301(1)(A), (2). In the winding up context, the surplus and insolvency limitations do not apply so long as all of the liabilities of the corporation are paid or discharged or there is adequate provision made for their payment or discharge. Tex. Bus. Orgs. Code §§ 21.303(b), 11.053(a), (c). A corporation may also place additional restrictions on distributions in its certificate of formation. Tex. Bus. Orgs. Code § 21.303(a).

Under the BOC, directors who vote for or assent to an impermissible distribution are personally liable to the corporation for the amount by which the distribution exceeds the amount that was permitted to be distributed. Tex. Bus. Orgs. Code § 21.316(a); *see also In re Sherali*, 490 B.R. 104 (Bankr. N.D. Tex. 2013) (holding that sole director/officer of corporation was personally liable under the Texas Business Corporation Act and BOC for distributions he caused the corporation to make to himself as sole shareholder in 2006 through 2011 and that the liability was nondischargeable in bankruptcy as it arose from a defalcation in a fiduciary capacity). Because the directors' liability is to the corporation, it appears that a creditor who desires to pursue the directors on this basis would be required to assert the claim derivatively on behalf of the corporation. *See Smith v. Chapman*, 897 S.W.2d 399 (Tex. App.—Eastland 1995, no pet.).

There are several defenses a director may assert to liability for an impermissible distribution under the BOC. A director is not liable for the amount of a distribution that exceeded the statutory limitations to the extent a distribution of all or any part of the excess amount would have been permissible after the director authorized the distribution. Tex. Bus. Orgs. Code § 21.316(b). In essence, the violation can be retroactively cured by an increase in the surplus of the corporation after the distribution. In addition, a director may escape liability for authorizing an impermissible distribution if the director, in good faith and ordinary care, relied on certain types of financial information or other information or reports provided by certain persons. Tex. Bus. Orgs. Code § 21.316(c). The statute of limitations for an action to hold a director liable for authorizing an impermissible distribution under Section 21.316 of the BOC is two years from "the date the alleged act giving rise to the liability occurred." Tex. Bus. Orgs. Code § 21.317. It is not entirely clear whether the statute refers to the date of the distribution itself or the date on which the directors authorized the distribution.

The BOC provides that a shareholder may be held liable in contribution to a director who is held liable for authorizing an impermissible distribution. Tex. Bus. Orgs. Code § 21.318(a), (b). Under this provision, it is not clear whether or how a creditor would be able to assert a claim against the shareholder since the shareholder's liability is phrased in terms of liability to the directors. Further, a shareholder only has liability if the shareholder knew the distribution was improper. Tex. Bus. Orgs. Code § 21.318(a).

The liability of the directors and shareholders under the BOC with respect to an impermissible distribution is exclusive of any other liability to the corporation or a creditor of the corporation except for liability under Chapter 24 of the Texas Business and Commerce Code (the Texas Uniform Fraudulent Transfer Act) or the United States Bankruptcy Code. Tex. Bus. Orgs. Code §§ 21.316(d), (e), 21.318(c). The provisions specifying exclusivity of the statutory bases of liability were added to the Texas Business Corporation Act in 1991, thus preempting other common-law bases of liability (such as the trust fund and denuding doctrines) that had been applied by Texas courts with respect to wrongful distributions. *See Smith v. Chapman*, 897 S.W.2d 399 (Tex. App.—Eastland 1995, no pet.); *In re LaJet, Inc.*, 1994 WL 577357 (E.D. La. 1994). As the statute suggests, however, the Texas Uniform Fraudulent Transfer Act and the Bankruptcy Code contain provisions that may be asserted where distributions to shareholders deprive the corporation of assets needed to pay the corporation's creditors. Recovery of distributions from shareholders under these provisions would not present many of the obstacles present under the BOC. For example, under Section 24.006(a) of the Texas Uniform Fraudulent Transfer Act, a creditor could pursue recovery directly from a shareholder who received a distribution from an insolvent corporation regardless of whether the shareholder knew that the corporation was insolvent. Tex. Bus. & Com. Code § 24.006(a).

D. Liability of Directors and Officers for Debts Incurred After Tax Forfeiture of Corporation

Chapter 171 of the Texas Tax Code sets forth procedures for administrative forfeiture of the privileges of a corporation when the corporation fails to pay its franchise tax or file required reports. Forfeiture of a Texas corporation's privileges is followed by forfeiture of the corporation's charter (i.e., its certificate of formation) if the corporation's default is not cured. Among the effects of forfeiture of a corporation's privileges is personal liability of directors and officers for certain corporate obligations. Under the Tax Code, "[i]f the corporate privileges of a corporation are forfeited for the failure to file a report or pay a tax or penalty, each director or officer of the corporation is liable for each debt of the corporation that is created or incurred in this state after the date on which the report, tax, or penalty is due and before the corporate privileges are revived." Tex. Tax Code § 171.255(a). A director or officer has an affirmative defense to liability with respect to any debt created or incurred over the director's objection or without the director's knowledge if the exercise of reasonable diligence to become acquainted with the affairs of the corporation would not have revealed the intention to create the debt. Tex. Tax Code § 171.255(c). Note that once a corporation's privileges are forfeited (the first step in a forfeiture of the corporation's charter), Section 171.255 provides that the personal liability of officers and directors extends back to debts created or incurred after the report, tax, or penalty was due and continues until the privileges are revived. Revival of a corporation's charter and corporate privileges does not affect the liability of a director or officer for debts incurred before the corporate privileges are revived. Tex. Tax Code § 171.255(d). The specific inclusion of liability for "any tax or penalty" imposed by Chapter 171 of the Tax Code after the forfeiture does not limit the scope of the debts for which directors and officers have personal liability under Section 171.255. The statute expressly provides that officers and directors are liable for "each debt" incurred under the specified circumstances, in addition to the liability for taxes and penalties. *See Bosch v. Cirro Group, Inc.*, 2012 WL 5949481 (Tex. App.—Dallas 2012, pet. denied).

Over the years, courts have wrestled with when a debt was created or incurred for purposes of Section 171.255 or its statutory predecessor. *See, e.g.*, *Schwab v. Schlumberger Well Surveying Corp.*, 154 Tex. 379, 198 S.W.2d 79 (1946) (holding debt was created or incurred when original promissory note was executed before forfeiture rather than when subsequent renewal notes were executed); *Cain v. State*, 882 S.W.2d 515 (Tex. App.—Austin 1994, no writ) (applying rule of strict construction and holding debt for amounts expended by State of Texas to plug wells was created or incurred when state expended funds, rather than date of prior authorization by state to expend funds to plug wells, because debt was unliquidated obligation prior to actual expenditure); *River Oaks Shopping Center v. Pagan*, 712 S.W.2d 190 (Tex. App.—Houston [14th Dist.] 1986, writ ref'd n.r.e.) (holding post-forfeiture breach and damages related back to execution of lease so that debt was created or incurred on date of execution of lease); *Rogers v. Adler*, 697 S.W.2d 674 (Tex. App.—Dallas 1985, writ ref'd n.r.e.) (holding debt was created when contract was entered into prior to forfeiture rather than when judgment was entered after forfeiture); *Curry Auto Leasing, Inc. v. Byrd*, 683 S.W.3d 109 (Tex. App.—Dallas 1984, no writ) (holding corporate debts arising from failure to adhere to leasing contract related back to, and were created or incurred, when rental agreement was entered into rather than at the time defaults occurred).

Numerous recent cases have examined the issue of when a debt was created or incurred for purposes of liability of officers and directors under Section 171.255. In *Hovel v. Batzri*, 490 S.W.3d 132 (Tex. App.—Houston [1st Dist.] 2016, pet. denied), homeowners who had contracted with an LLC to build their home sued the LLC homebuilder for breach of contract and DTPA violations, and the LLC's privileges were forfeited due to failure to pay franchise taxes. The forfeiture occurred after the suit was filed but before any determination of liability. The plaintiffs obtained a default judgment against the LLC and then sought to hold the sole manager of the LLC personally liable for the LLC's debt under Section 171.255 of the Texas Tax Code. The trial court granted the manager's motion for summary judgment, and the court of appeals affirmed because there was no dispute that the contract was executed pre-forfeiture, and the breach, tortious conduct, and injury occurred pre-forfeiture. The plaintiffs argued that a debt does not come into existence until it is liquidated, relying in part on a narrow definition of "debt" adopted by the legislature in 1987. According to the plaintiffs, their damages remained unliquidated until they obtained the default judgment, and no debt was created or incurred until the default judgment issued during the forfeiture. Conversely, the LLC manager argued that the 1987 narrow definition of "debt" is no longer significant because the legislation enacting it has been repealed. The manager asserted a broad definition of "debt" that includes unliquidated obligations such that the LLC's debt was created or incurred before the forfeiture, when the acts or omissions that gave rise to the plaintiffs' claim occurred, and the default judgment related back to that time. Characterizing Section 171.255 as a penal statute such that any ambiguity must be "strictly construed" in favor of the party penalized by it, the court discussed numerous cases decided before the adoption of the definition of "debt" in 1987. The pre-1987 case law strictly construed the statute to treat debts as created or incurred at the time the relevant contractual obligations were incurred rather than at a later date when the obligations were breached or became due. Consistent with strict construction and this broad approach to "create or incur," the pre-1987 case law applied a "relation-back" doctrine. Next the court of appeals discussed the legislature's adoption and repeal of a narrow definition of "debt" and the subsequent case law in which the "relation-back" doctrine was applied inconsistently. The definition of "debt" adopted in the Tax Code in 1987 was "any legally enforceable obligation measured in a certain amount of money which must be performed or paid within an ascertainable period of time or on demand." This definition precluded corporations from deducting their contingent and unfixed losses from their taxable corporate surplus and thus increased revenue for the state. The definition also eliminated the ambiguity in "debt" and precluded courts from giving it a broad meaning. In 2008, the legislature repealed the definition of "debt" when it amended the Tax Code to adopt an entirely new method of calculating the franchise tax. After the repeal of the definition, the "relation-back" doctrine re-emerged, and courts again concluded that a judgment debt is created or incurred when the conduct or contract occurs, even if the obligation is unliquidated at that time. With the historical context above in mind, the court of appeals considered whether the trial court erred by concluding that the LLC's debt in this case was not a debt created or incurred during forfeiture and, as a result, the manager did not have individual liability under Section 171.255. Applying the rule of strict construction and relying on pre-1987 Texas Supreme Court case law defining the terms "created" and "incurred," the court of appeals in this case concluded that the debt evidenced by the default judgment obtained by the plaintiffs against the LLC was created or incurred pre-forfeiture at the time that the parties established their contractual and other obligations. Thus, the court held that the manager was not individually liable for the LLC's debt. The court identified public policy goals of Section 171.255 and concluded that its interpretation did not run afoul of these public policy considerations.

In a vigorous and lengthy dissenting opinion in *Hovel v. Batzri*, Justice Keyes differed in her interpretation of how the principle of "strict construction" affects the interpretation of Section 171.255 as well as how to interpret the case law defining "debt" for purposes of the statute. Justice Keyes would have held the manager personally liable in this case on the basis that this was a judgment debt for wrongful acts of the entity that occurred prior to forfeiture with knowledge of the manager although the debt was not reduced to a legally enforceable obligation until after forfeiture. In Justice Keyes' view, this is one of the types of debts for which officers and directors may be held personally liable under Section 171.255.

In *Taylor v. First Community Credit Union*, 316 S.W.3d 863 (Tex. App.—Houston [14th Dist.] 2010, no pet.), the court of appeals held an officer/director of a forfeited automobile dealership personally liable to a credit union for damages resulting from the corporation's breach of a dealership agreement on the basis that the debt was created or incurred when the agreement was breached, which occurred after the dealership's franchise tax report was due, rather than when the dealership entered into the contract in 2003, before the franchise tax was due. The court discussed a number of other cases dealing with the timing of when a debt is created or incurred for purposes of Section 171.255, and the court found earlier cases in which courts had based the creation or incurrence on the execution of the original contract were either distinguishable on their facts or impacted by a definition of "debt" adopted by the legislature in 1987. This definition stated that a "debt" is "any legally enforceable obligation measured in a certain amount of money which must be performed or paid within an ascertainable period of time or on demand." A holding that the execution of the dealer agreement in this case created a debt under Section 171.255 when no breach had occurred and no money was owed at that time would have conflicted with the statutory definition, and the court therefore declined to follow case law pre-dating the definition that would have equated the creation of the debt with entering into the contract. As discussed in *Hovel v. Batzri*, the definition relied upon by the court in *Taylor* was repealed in 2008 when the new margin tax provisions took effect, and there is currently no statutory definition of "debt" in Chapter 171 of the Tax Code.

Other recent cases in which the timing of the creation or incurrence of a contractual debt for purposes of Section 171.255 has been addressed include: *Breakwater Advanced Manufacturing, LLC v. East Texas Machine Works, Inc.*, 2020 WL 827139 (Tex. App.—Tyler 2020, pet. denied) (stating that individual members of an LLC whose charter was forfeited in 2017 could be held personally liable for debts incurred after date on which tax, report, or penalty was due, but remanding on issue of members' personal liability because summary judgment evidence did not show whether LLC was delinquent in December 2015 and January 2016 when transactions at issue occurred); *Haynes v. Gay*, 2018 WL 774334 (Tex. App.—Dallas 2018, no pet.) (stating that debt arising out of performance of contract is created or incurred when contract is entered into and holding members of forfeited LLC were not personally liable for debt at issue because record established debt of forfeited LLC was created or incurred prior to forfeiture); *B Choice Ltd. v. Epicentre Dev. Ass'n LLC*, 2017 WL 1227313 (S.D. Tex. 2017), report and recommendation adopted, 2017 WL 1160512 (S.D. Tex. 2017) (relying on *Hovel v. Batzri* and "relation back" doctrine and concluding that forfeited LLC's liability on promissory note was incurred before forfeiture of its privileges when it signed promissory note rather than at time of partial summary judgment after forfeiture); *Viajes Gerpa, S.A. v. Fazeli*, 522 S.W.3d 524 (Tex. App.—Houston [14th Dist.] 2016, pet. denied) (discussing "relation back" theory and effect of repeal of statutory definition of "debt" and concluding that debt under MSA was created or incurred before forfeiture even assuming without deciding that "relation back" theory did not apply because default existed before forfeiture); *Lindley v. Performance Food Grp. of Texas, L.P.*, 2016 WL 6242835 (Tex. App.—San Antonio 2016, no pet.) (relying on *Schwab v. Schlumberger* and distinguishing cases such as *Curry Auto Leasing* in which courts held that debts were incurred when initial contract or lease was signed; holding officer was personally liable for purchases of goods delivered when corporate charter was forfeited because debt on open account is incurred when goods or services are delivered or performed); *Super Ventures, Inc. v. Chaudry*, 501 S.W.3d 121 (Tex. App.—Fort Worth 2016, no pet.) (holding corporate officer personally liable under option provision of lease amendment because debt for breach of contract is created or incurred when contract in question is executed and lease amendment at issue was signed after corporation's franchise tax report was due and before corporation's privileges were reinstated); *Willis v. BPMT, LLC*, 471 S.W.3d 27 (Tex. App.–Houston [1st Dist.] 2015, no pet.) (relying on *Schwab* and discussing effect of repeal of definition of "debt" and holding that debts arising from obligations under lease agreement were created when lease agreement was entered into rather than later time when amount of money owed became certain); *Bon Amour Int'l, LLC v. Premier Place of Dallas, LLC*, 2015 WL 4736784 (Tex. App.—Dallas 2015, no pet.) (relying on *Beesley v. Hydrocarbon Separation* and holding officer of LLC was not personally liable for past due rent and other charges due in 2013 under lease executed in 2011 because LLC was in good standing when lease was entered into); *Rossmann v. Bishop Colorado Retail Plaza, L.P.*, 455 S.W.3d 797 (Tex. App.—Dallas 2015, pet. denied) (holding debt for damages for breach of lease agreement, including costs of re-letting, was created or incurred when lease was entered into in 2010, not in 2012 after forfeiture of lessee); *Beesley v. Hydrocarbon Separation, Inc.*, 358 S.W.3d 415, 423 (Tex. App.—Dallas 2012, no pet.) (discussing other cases in which debt was deemed to be created or incurred when underlying contract was originally entered into rather than when later breach, judgment, or renewal occurred and concluding debt was created when employment contract that required yearly payments was signed rather than when each payment became due); *Endsley Elec., Inc. v. Altech, Inc.*, 378 S.W.3d 15 (Tex. App.—Texarkana 2012, no pet.) (holding there was no evidence that liability was created or incurred after corporate forfeiture so as to hold officers of electrical subcontractor liable under Section 171.255 where contract between contractor and subcontractor was signed in October 2008 and completed in March or April 2010, suit was filed on April 14, 2010, subcontractor's charter was forfeited under Section 171.309 for failure to pay franchise taxes on January 28, 2011, and judgment was entered in August 2011).

In *Tryco Enterprises, Inc. v. Robinson*, 390 S.W.3d 497 (Tex. App.—Houston [1st Dist.] 2012, pet. dism'd), concurring and dissenting justices expressed differing views on whether James and Sharon Dixon, the owners and officers of a forfeited corporation, had personal liability under Section 171.255 of the Tax Code with respect to amounts owed by the corporation on a judgment stemming from violations of the Fair Labor Standards Act (FLSA). The corporation's charter was forfeited after the jury verdict and shortly before the judgment was entered. The majority found it unnecessary to reach the issue of the Dixons' liability under Section 171.255 because it concluded the record supported personal liability based on veil-piercing findings. The dissenting justice did not believe that the record supported personal liability on veil-piercing grounds and thus analyzed whether the Dixons had personal liability as officers under Section 171.255, i.e., whether the FLSA liability at issue was a debt "created or incurred in this state after the date on which the report, tax, or penalty is due and before the corporate privileges are revived." The dissenting justice concluded that the debt for unpaid overtime wages was created or incurred on the paydays for the pay periods in which the overtime labor was performed and that there was thus no liability for these amounts under Section 171.255 since the paydays preceded the event occasioning the forfeiture of corporate privileges. On the other hand, the dissent concluded that the Dixons did have personal liability under Section 171.255 for the statutory penalties and attorney's fees included in the judgment, reasoning that these amounts were not created or incurred until the trial court determined the amount of these awards in its judgment, which was entered after the forfeiture. In a lengthy analysis of the application of Section 171.255, the concurring justice concluded that the Dixons had personal liability for the entire amount of damages in the FLSA suit on the basis that the debt was not created until the judgment was entered after the corporation's forfeiture. The concurring justice reasoned that the damages were not the type of debt to which the relation-back doctrine applies and were not a sum certain (as required under the definition of "debt" in effect at the time) until the judgment in the FLSA lawsuit was entered.

In *Segarra v. Implemetrics Inc.*, 2013 WL 5936602 (S.D. Tex. 2013), the court held that the defendant corporation's "debt" to the plaintiff for violations of Title VII of the Civil Rights Act of 1964 and the Family and Medical Leave Act would arise if and when the court entered judgment on the claims. The plaintiff's allegations of discrimination spanned from August 2009 until September 2011. The corporation forfeited its privileges on February 8, 2008, and revived its privileges on October 24, 2011. The plaintiff thus sought to hold two individuals who were directors and officers of the corporation liable under Section 171.255 for the corporation's discrimination. The court likened a judgment debt more to an administrative penalty than to a contract, and the court stated that administrative penalties have been found to be created or incurred when assessed, whereas contractual debts are incurred when the parties enter into the contract regardless of the date of eventual default or judgment. Thus, the court dismissed the claims against the individual officers and directors and stated that the plaintiff could sue them to hold them personally liable under Section 171.255 if he obtained a judgment against the corporation and the corporation's privileges were forfeited at that time. *See also Lucky Dawg Movers, Inc. v. Wee Haul, Inc.*, 2011 WL 5009792 (Tex. App.—Dallas 2011, no pet.) (addressing whether a judgment rendered after corporate privileges were reinstated based on conduct that occurred while the privileges were forfeited could constitute a "debt" (under the repealed definition of "debt" that was in effect at the time of the suit) for which a director could be personally liable and concluding that the damages sustained as a result of the corporation's deceptive acts were assessed only when the jury returned its verdict, not at the time of the acts).

In *Anderson Petro-Equipment, Inc. v. State*, 2013 WL 5858010 (Tex. App.—Austin 2013, pet. denied), the State of Texas sought to impose liability on a corporate officer for money spent by the state to plug a well drilled by the corporation. The corporation ceased production on the well in 2002, and the corporation became noncompliant with Texas law when it failed to plug the well within 12 months of ceasing production. The corporation's charter was forfeited for failure to pay its franchise taxes in 2005. In 2006, the Texas Railroad Commission sent notice to the corporation to plug the well, and the Commission spent state funds to plug the well in 2009. Later in 2009, the state sued the corporation and an individual officer to recover the money spent to plug the well. The state relied on Section 171.255 to impose liability on the officer. The officer argued that his liability was extinguished when the corporation forfeited its charter. (The court noted that the officer did not contend that Section 171.255 can never be used to impose individual liability for plugging costs, but limited his contention to whether his liability was extinguished when the corporation's charter was forfeited assuming such potential liability exists.) The officer conceded that, for purposes of Section 171.255, the debt was created or incurred long after the corporation's taxes were due and its privileges were forfeited, but the officer argued that his liability, if any, ceased to exist once the corporation's charter was forfeited. The court understood the officer's argument to be that because a corporation could not be liable for a post-dissolution claim under Article 7.12 of the TBCA, neither could an individual officer of the corporation. (The court of appeals concluded earlier in the opinion that the state's claim in this case, though not ripe at the time the corporation's charter was forfeited, was nevertheless an "existing claim" as defined in Article 7.12 at the time of the corporation's dissolution because the facts giving rise to the cause of action occurred before the charter was forfeited.) The court stated that the officer's argument seemed to conflate the requirements for corporate liability contained in Article 7.12 of the TBCA, which addresses the corporation's liability for "existing claims," with the Tax Code requirements for an officer's individual liability for corporate "debts." The court pointed out that the Tax Code does not make any reference to forfeiture of the corporate charter, and the court found no language in the statute suggesting that an officer is liable only for debts incurred during the window of time after the corporation has failed to pay its franchise taxes but before it has forfeited its charter. The court stated that Section 171.255(a) clearly and unambiguously states that an officer is liable for debts incurred during the time period after the relevant tax was due (for which the privileges are later forfeited) and before the privileges are revived. Because the corporate debt for which the officer was liable in this case was created or incurred after the tax was due and the privileges were never revived, the officer was personally liable.

A bankruptcy court has held that claims against directors and officers arising under Section 171.255 of the Tax Code based on forfeiture of corporate privileges are direct claims belonging to the holders of claims rather than derivative claims of the debtor. *In re University General Hosp. Sys., Inc.*, 2016 WL 1620219 (Bankr. S.D. Tex. 2016). Thus, the assertion of such claims did not violate the provision of a Chapter 11 bankruptcy plan that enjoined the assertion of "derivative claims, including claims of third parties asserting alter ego claims, fraudulent transfer claims, guaranty claims, or any type of successor liability based on acts or omissions of the Debtors."

Some courts have concluded that "debts" for which directors and officers may have personal liability under Section 171.255 do not include tort liability based on negligence. *Williams v. Adams*, 74 S.W.3d 437 (Tex. App.—Corpus Christi 2002, pet. denied); *Suntide Sandpit, Inc. v. H & H Sand and Gravel, Inc.*, 2012 WL 2929605 (Tex. App.—Corpus Christi 2012, pet. denied). In *Nationwide Property & Casualty Insurance Company v. Revive Mfg., LLC*, 2018 WL 2248667 (Tex. App.—Fort Worth 2018, no pet.), the court noted that "[o]nly a few courts have addressed whether section 171.255 applies to 'contractual strangers with only tort claims being asserted,'" characterizing the issue as a "seemingly complicated, unresolved statutory-construction issue."

Under Section 171.255(c), a director or officer is not liable for a debt of the corporation if the director or officer shows that the debt was created or incurred over the director's objection or without the director's knowledge and that the exercise of reasonable diligence to become acquainted with the corporation's affairs would not have revealed the intention to create the debt. Courts have concluded that a director relying on an exception to liability under this provision has the burden of proof, i.e., that the exceptions are affirmative defenses. *See Priddy v. Rawson*, 282 S.W.3d 588 (Tex. App.—Houston [14th Dist.] 2009, pet. denied); *In re Trammell*, 246 S.W.3d 815 (Tex. App.—Dallas 2008, no pet.); *PACCAR Fin. Corp. v. Potter*, 239 S.W.3d 879 (Tex. App.—Dallas 2007, no pet.); *see also Surber v. Woy*, 2014 WL 1704258 (Tex. App.–Fort Worth 2014, no pet.).

E. Liability for Committing or Knowingly Participating in Tortious or Fraudulent Acts

Traditionally, Texas courts have held that corporate officers are personally liable when they commit or knowingly participate in tortious or fraudulent acts even though the conduct occurred while the officer was acting on behalf of the corporation. *See, e.g., Gore v. Scotland Golf, Inc.*, 136 S.W.3d 26, 32 (Tex. App.—San Antonio 2003, pet. denied); *Kingston v. Helm*, 825 S.W.3d 755, 764-67 (Tex. App.—Corpus Christi 2002, pet. denied). Most courts have held that the statutory actual-fraud requirement applicable in a veil-piercing case does not protect corporate shareholders/officers from liability for their own torts, even though such torts may have occurred while acting on behalf of the corporation in the context of a contractual transaction between the corporation and the plaintiff, but some recent cases have held that Tex. Bus. Orgs. Code § 21.224 precludes holding a corporate or LLC agent liable for a tortious act related to a contractual obligation of the entity unless the agent caused the entity to be used to perpetrate an actual fraud for the agent's direct personal benefit. *See, e.g., TecLogistics, Inc. v. Dresser-Rand Group, Inc.,* 527 S.W.3d 589 (Tex. App.—Houston [14th Dist.] 2017, no pet.); *Hong v. Havey*, 551 S.W.3d 875 (Tex. App.—Houston [14th Dist.] 2018, no pet.). In *Bates Energy Oil & Gas v. Complete Oilfield Services*, 361 F. Supp. 3d 633 (W.D. Tex. 2019), the court thoroughly discussed the traditional distinction between direct liability and liability based on veil piercing, and the court traced recent developments reflecting a lack of consensus by courts regarding direct liability of corporate and LLC agents for torts related to a contractual obligation of the entity.

In *Watkins v. Basurto*, 2011 WL 1414135 (Tex. App.—Houston [14th Dist.] 2011, no pet.), the court noted that Texas law is unsettled as to whether an agent of a corporation or LLC can be held individually liable for the tort of negligent hiring or supervision, i.e., whether an agent owes a duty to third parties to properly hire or supervise other agents of the principal.

Statutory or regulatory provisions may be interpreted in some cases to impose personal liability on agents for their actions or omissions constituting or causing violations by the entity. *See, e.g., Morello v. State*, 547 S.W.3d 881 (Tex. 2018).

F. Liability on Corporation's Contract as Agent of Partially Disclosed Principal or as Guarantor

An agent is not liable on a contract entered into on the principal's behalf if the agent discloses the agent's representative capacity and the identity of the principal. Conversely, if the representative capacity of the agent and the identity of the agent's principal are not disclosed to the other party to the contract at the time the contract is entered into, the agent is personally liable on the contract. Restatement (Third) of Agency §§ 6.01, 6.02 (2006); Restatement (Second) of Agency §§ 320, 322 (1957). There are numerous Texas cases applying these principles in the context of contracts entered into by corporate agents. The common corporate practice of doing business under assumed or trade names creates some peril for officers and other agents who contract under the assumed or trade name of the corporation without disclosing the actual legal name of the corporation. *See, e.g., John C. Flood of DC, Inc. v. SuperMedia, L.L.C.*, 408 S.W.3d 645 (Tex. App.—Dallas 2013, pet. denied); *Lake v. Premier Transp.*, 246 S.W.3d 167 (Tex. App.—Tyler 2007, no pet.); *Wynne v. Adcock Pipe and Supply*, 761 S.W.2d 67 (Tex. App.—San Antonio 1988, no writ); *A To Z Rental Center v. Burris,* 714 S.W.2d 433 (Tex. App.—Austin 1986, writ ref'd n.r.e.). The filing of an assumed name certificate that discloses the legal name of the corporation does not in itself protect agents who contract in the assumed name of the corporation because Texas courts have stated that actual knowledge or reason to know the principal's identity is the test of disclosure and that third parties have no duty to search for this information. *Wynne v. Adcock Pipe and Supply*, 761 S.W.2d 67 (Tex. App.—San Antonio 1988, no writ); *A To Z Rental Center v. Burris,* 714 S.W.2d 433 (Tex. App.—Austin 1986, writ ref'd n.r.e.).

Even if an agent discloses the identity of the principal and signs a contract indicating the agent's representative capacity, the language of the contract may subject the agent to liability as a guarantor or party to the contract. *See 84 Lumber Co., L.P. v. Powers*, 393 S.W.3d 299 (Tex. App.—Houston [1st Dist.] 2012, pet. denied) (holding individual who signed credit application as president of corporation liable as personal guarantor of the corporation's debt based on language above signature line stating that signatory personally guaranteed corporation's credit account); *Wholesale Builders Supply, Inc. v. Green-Source Dev., L.L.C.*, 2013 WL 6175210 (Ohio App. 2013) (holding individual who signed LLC credit application was personally liable based on language in credit application stating that signatory was "both personally and corporately liable for the total of purchases by you or anyone designated to sign for your purchases on your account"). Corporate and LLC representatives should be vigilant when signing credit applications and other contracts on behalf of the corporation or LLC in order to avoid subjecting themselves to personal liability under provisions that may be interpreted to obligate signatories in their individual capacities.

III. Limited Liability Companies

A. Limited Liability of Members and Managers

A limited liability company (LLC) provides its members and managers a full liability shield. The BOC provides for limited liability of members and managers except to the extent the company agreement specifically provides otherwise. Tex. Bus. Orgs. Code § 101.114. Under the prior tax classification regulations, it was, on occasion, preferable to subject a member (such as a corporation formed for this purpose) to liability in order to possess another corporate characteristic deemed desirable in that particular instance. With the advent of the "check-the-box" approach, there would not ordinarily be any reason to waive a member's limited liability. In addition to expressly providing for limited liability of LLC members, the BOC states that a member of an LLC is not a proper party to proceedings by or against an LLC except where the object is to enforce a member's right against or liability to the LLC. Tex. Bus. Orgs. Code § 101.113. As noted in Section III.E. below, courts have held that LLC members or managers are liable for their own fraudulent or tortious acts even if the acts are committed in the service of the LLC. *In re Williams,* 2011 WL 240466 (Bankr. W.D. Tex. 2011); *Sanchez v. Mulvaney*, 274 S.W.3d 708, 712 (Tex. App.—San Antonio 2008, no pet.); *LJ Charter, L.L.C. v. Air America Jet Charter, Inc.*, 2009 WL 4794242 (Tex. App.—Houston [14th Dist.] 2009, pet. denied); *but see Bates Energy Oil & Gas v. Complete Oilfield Servs.*, 361 F. Supp. 3d 633 (W.D. Tex. 2019) (discussing lack of consensus among cases regarding whether the statutory veil-piercing standard must be met to hold owners, managers, or officers liable for their torts committed in the context of a contractual transaction between the entity and the plaintiff). In *Watkins v. Basurto*, 2011 WL 1414135 (Tex. App.—Houston [14th Dist.] 2011, no pet.), the court noted that Texas law is unsettled as to whether an agent of a corporation or LLC can be held individually liable for the tort of negligent hiring or supervision, i.e., whether an agent owes a duty to third parties to properly hire or supervise other agents of the principal. Statutory or regulatory provisions may be interpreted in some cases to impose personal liability on agents for their actions or omissions constituting or causing violations by the entity. *See, e.g., Morello v. State*, 547 S.W.3d 881 (Tex. 2018).

B. Piercing (and Reverse Piercing) the Limited Liability Company Veil

1. Piercing the LLC Veil to Impose Liability on a Member

Generally the courts should respect the principle that the LLC is an entity separate and distinct from its members just as a corporation is an entity separate and distinct from its shareholders. *See Ingalls v. Standard Gypsum, L.L.C.*, 70 S.W.3d 252 (Tex. App.—San Antonio 2001, pet. denied) (analogizing to corporate parents and subsidiaries in rejecting argument that LLC's members were included with LLC as "employer" under the Workers' Compensation Act). Of course, it is possible to "pierce the veil" of a corporation and hold a shareholder liable for a corporate debt or obligation under certain circumstances. Like the predecessor Texas Limited Liability Company Act (TLLCA), the LLC provisions of the BOC as originally enacted did not address whether or under what circumstances a claimant may "pierce" the liability shield of an LLC in order to hold a member liable for a debt or other liability of the LLC. In 2011, the BOC was amended to provide that Sections 21.223-21.226, which include strict standards for piercing the corporate veil in a case arising out of a contract of the corporation, apply to LLCs.[4] *See* Tex. Bus. Orgs. Code § 101.002. One Texas commentator has argued that the statutory limitation of liability in the Texas LLC statute was intended to be absolute, i.e., that the legislature did not address veil piercing in the LLC statute because it did not intend for veil piercing to occur in the LLC context. *See* Byron F. Egan, *Choice of Entity Decision Tree After Margin Tax and Texas Business Organizations Code*, 42 TEX. J. BUS. L. 71, 173 (2007). Courts in Texas and other jurisdictions have thus far refused to hold that the statutory liability shield of an LLC is absolute, and the courts have predictably borrowed from the corporate veil-piercing jurisprudence in addressing LLC veil piercing.[5]

If the Texas LLC statute does not reflect a legislative intent to preclude veil piercing, then the Texas courts are faced with determining the standards for piercing the LLC veil. Effective September 1, 2011, the BOC makes clear that a member may not be held liable for an obligation of the LLC arising out of a contract of the LLC unless the strict standards of Section 21.223 are met. Tex. Bus. Orgs. Code § 101.002. Further, failure of the LLC to follow any formality required by the BOC or its governing documents is not a basis to hold a member liable for any type of obligation of the LLC. *Id.*

Even before the amendment of the BOC to incorporate by reference the provisions of Sections 21.223-21.226 of the BOC, courts in Texas defined the veil-piercing standards in the LLC context consistently with the corporate standards. *Chico Auto Parts & Serv., Inc. v. Crockett*, 512 S.W.3d 560 (Tex. App.—El Paso 2017, pet. denied) (pointing out that BOC § 101.002 did not become effective until after the contract in this case was entered and performed, but stating that Texas courts had uniformly applied the same common-law veil-piercing principles to LLCs as were previously applied to corporations notwithstanding BOC §§ 101.113, 101.114, and affirming summary judgment in favor of the managing member where the plaintiff never alleged that the managing member committed any fraud in the formation of the contract or that he used the LLC to fraudulently induce the plaintiff into entering into the alleged contract or otherwise used the LLC to perpetrate any fraud on the plaintiff); *Shook v. Walden*, 368 S.W.3d 604 (Tex. App.—Austin 2012, pet. denied) (analyzing common-law standard applicable to an LLC veil-piercing claim arising before enactment of BOC § 101.002 and, assuming without deciding that veil-piercing applied to LLCs, concluding that courts should be guided by the corporate statutory standards rather than the more liberal standards articulated in *Castleberry v. Branscum); Fin & Feather Club v. Leander,* 415 S.W.3d 548 (Tex. App.—Texarkana 2013, pet. denied) (relying on *Shook* for proposition that policies governing piercing of veil of corporation also apply to LLCs); *Metroplex Mailing Servs., L.L.C. v. RR Donnelly & Sons Co.,* 410 S.W.3d 889 (Tex. App.—Dallas 2013, no pet.) (relying on *Shook* for proposition that policies governing piercing of veil of corporation also apply to LLCs); *Spring St. Partners-IV, L.P. v. Lam*, 750 F.3d 427 (5th Cir. 2013) (noting that *Shook* held that a plaintiff seeking to pierce the veil of an LLC not covered by BOC Section 101.002 must meet the same requirements applicable to a corporation); *see also Doyle v.*

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[4]Legislation that would have incorporated by reference in the LLC statutes the standards from the corporate statutes was introduced in the 2009 legislative session. S.B. 1773 passed the Senate but died on the House calendar at the end of the session when the House process became stalled by a dispute over voter identification legislation. In the 2011 legislative session, a similar bill, S.B. 323, was passed by the legislature and signed by the governor. This bill became effective September 1, 2011.

[5]The LLC veil-piercing cases in jurisdictions other than Texas are too numerous to cite in this paper, but some of the cases are cited in Elizabeth S. Miller, *Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities*, 43 TEX. J. BUS. L. 405, 420-24 (2009). All state LLC statutes provide for limited liability of members, and some statutes specifically adopt corporate veil-piercing principles. *See, e.g.*, Cal. Corp. Code § 17101(a) & (b) (providing for limited liability of members, but adopting common law alter-ego doctrine as applied to corporate shareholders except that failure to follow formalities with respect to calling and conducting meetings shall not be considered); Colo. Rev. Stat. Ann. § 7-80-107 (stating that courts shall apply case law interpreting the conditions and circumstances under which the veil of a corporation may be pierced but that the failure of an LLC to observe formalities or requirements relating to its management and affairs is not itself grounds to impose liability on members); Minn. Stat. § 322B.303 subd. 2 (providing that the case law stating the conditions and circumstances under which the veil of a corporation may be pierced applies to LLCs). In most states, as was the case in Texas until 2011, the statutes are silent regarding veil piercing. *See, e.g.*, 6 Del. Code Ann. § 18-303 (providing that a member or manager shall not be obligated personally for any LLC debt, obligation, or liability solely by reason of being a member or acting as a manager); Nev. Rev. Stat. §§ 86.371, 86.381 (providing that members have limited liability and are not proper parties in a proceeding against an LLC). Thus far, courts have recognized the concept of veil piercing in the LLC context regardless of whether the state LLC statute at issue addresses veil piercing.

Kontemporary Builders, Inc., 370 S.W.3d 448 (Tex. App.—Dallas 2012, pet. denied) (discussing and applying case law and Section 21.223 of the BOC to claim that LLC was "sham corporation" as if LLC were corporation and concluding evidence was sufficient to support trial court's finding that LLC was not sole owner's alter ego); *Penhollow Custom Homes, LLC v. Kim,* 320 S.W.3d 366 (Tex. App.—El Paso 2010, no pet.) (discussing and applying corporate veil-piercing principles to LLC as if LLC were corporation and concluding that evidence owner took owner's draw rather than salary did not demonstrate lack of separateness between entity and owner, and jury's finding of alter ego could not stand); *In re HRM Holdings, LLC (Seidel v. Hosp. Res. Mgmt. LLC)*, 421 B.R. 244 (Bankr. N.D. Tex. 2009) (applying corporate veil-piercing principles in LLC context, noting that the TLLCA contained no analog to TBCA Article 2.21 but that "Texas courts and other jurisdictions have applied the same state law principles for veil-piercing that they have applied to corporations"); *In re JNS Aviation, LLC (Nick Corp. v. JNS Aviation, Inc.)*, 376 B.R. 500, 525-27 (Bankr. N.D. Tex. 2007) (determining that corporate veil-piercing principles apply to LLCs and citing Section 21.223 of the BOC for the proposition that a judgment creditor of an LLC must satisfy the statutory actual-fraud standard to pierce the LLC's veil and hold its members liable for a judgment based on the LLC's breach of contract); *McCarthy v. Wani Venture, A.S.*, 251 S.W.3d 573, 590-91 (Tex. App.—Houston [1st Dist.] 2007, pet. denied) (rejecting the argument that the TLLCA creates an impenetrable liability shield, stating that cases in Texas and other jurisdictions have applied to LLCs the state law veil-piercing principles applied to corporations, and concluding that the trial court did not err in piercing the LLC veil to impose liability on an LLC member given the jury's finding of actual fraud in response to a jury charge based on the actual-fraud standard in TBCA Article 2.21A(2)); *Pinebrook Props., Ltd. v. Brookhaven Lake Prop. Owners Ass'n,* 77 S.W.3d 487, 500-01 (Tex. App.—Texarkana 2002, pet. denied) (recognizing that the entity involved in the piercing analysis was an LLC and (without discussing whether or why corporate veil-piercing principles apply to LLCs) relying on corporate veil-piercing principles and TBCA Article 2.21A(3) for the proposition that failure to follow formalities is not a factor in determining alter ego); *Copeland v. D & J Constr. LLC*, 2015 WL 512590 (N.D. Tex. 2015) (stating that BOC §§ 101.113, 101.114 do not preclude application of veil-piercing doctrines in LLC context, noting that Texas courts have applied the statutory provisions on corporate veil piercing to LLCs, and concluding plaintiff's pleadings were sufficient to support a claim of liability for breach of the LLC's contract based on veil piercing as to one individual defendant but were not sufficient as to other defendants); *K-Solv, LP v. McDonald*, 2013 WL 1928798 (Tex. App.—Houston [1st Dist.] 2013, no pet.) (noting that no party argued that BOC § 101.002 applied but that plaintiff conceded it must show actual fraud for members' direct personal benefit to pierce LLC's veil and hold members liable; holding that trial court correctly granted summary judgment in favor of members based on absence of evidence of essential element of direct personal benefit); *Roustan v. Sanderson*, 2011 WL 4502265 (Tex. App.—Fort Worth 2011, pet. denied) (noting that courts apply to LLCs state law principles applied to pierce corporate veil and that fraud is basis to pierce veil but concluding claimants did not plead individual used LLC itself to perpetrate fraud and did not plead any other ground for disregarding corporate structure); *Watkins v. Basurto*, 2011 WL 1414135 (Tex. App.—Houston [14th Dist.] 2011, no pet.) (recognizing that courts have applied corporate veil-piercing principles to LLCs but concluding evidence did not show unity between member and his LLCs or that injustice would result if member was not held liable); *Phillips v. B.R. Brick and Masonry, Inc.*, 2010 WL 3564820 (Tex. App.—Houston [1st Dist.] 2010, no pet.) (noting that Texas has applied principles used to pierce corporate veil to LLCs and applying corporate veil-piercing cases in reviewing evidence (without reference to statutory veil-piercing standards because neither party argued that TBCA Article 2.21 or BOC Section 21.223 were applicable) and concluding evidence did not support piercing LLC veil to hold member liable to creditor of member's spouse); *Arsenault v. Orthopedics Specialist of Texarkana*, 2007 WL 3353730 (Tex. App.—Texarkana 2007, no pet.) (discussing corporate alter ego and single business enterprise theories and finding no factual basis in pleading or evidence supporting existence of alter ego or single business enterprise relationship between professional LLC and its owner for purposes of plaintiff's argument that service of expert report on entity constituted service on its owner); *In re Arnette (Ward Family Found. v. Arnette)*, 2011 WL 2292314 (Bankr. N.D. Tex. 2011) (noting that Texas has applied principles used to pierce corporate veil to pierce liability shield of LLC, discussing actual-fraud standard of Section 21.223, and concluding evidence supported application of alter ego but not sham to perpetrate fraud); *In re Pace (Osherow v. Hensley)*, 2011 WL 1870054 (Bankr. W.D. Tex. 2011) (noting that "corporate veil piercing law is equally applicable in the context of limited liability companies" and stating that evidence showing member solely controlled LLC and commingled funds was probably insufficient to pierce veil under alter-ego theory but evidence was sufficient to establish that member used LLC to perpetrate fraud where fraudulent transfer to LLC was involved); *Prospect Energy Corp. v. Dallas Gas Partners, LP*, 761 F.Supp.2d 579 (S.D. Tex. 2011) (noting that Texas permits application of corporate veil-piercing principles to LLCs); *In re Williams (Kwasneski v. Williams)*, 2011 WL 240466 (Bankr. W.D. Tex. 2011) (noting that Texas courts have applied statutory veil-piercing provisions applicable to corporations to LLCs); *Interplan Architects, Inc. v. C.L. Thomas, Inc.*, 2010 WL 4366990 (S.D. Tex. 2010) (relying on actual-fraud standard in corporate statutes in applying alter-ego theory in LLC context and concluding plaintiff did not show LLC was formed for purpose of wrongful conduct); *In re Houston Drywall, Inc. (West v. Seiffert)*, 2008 WL 2754526 (Bankr. S.D. Tex. 2008) (discussing and applying corporate veil-piercing principles as if LLC were corporation and concluding LLC in issue was "sham corporation"); *In re Moore (Cadle Co. v. Brunswick Homes, LLC)*, 379 B.R. 284 (Bankr. N.D. Tex. 2007) (applying corporate reverse veil-piercing principles to Texas LLC and stating that whether an entity is a corporation or an LLC is a "distinction without a difference" for purposes of veil piercing); *Bramante v. McClain*, 2007 WL 4555943 (W.D. Tex. 2007) (applying reverse corporate veil-piercing principles to various LLC defendants while speaking only in terms of corporations and without indicating whether the court realized that LLCs are not corporations).

In *Taurus IP, LLC v. DaimlerChrysler Corp.*, 534 F. Supp. 2d 849, 871-72 (W.D. Wis. 2008), the district court determined that TBCA Article 2.21 did not apply to a claim against an individual manager of a Texas LLC, but it appears the court was confused about the scope of the statute even with respect to corporations. The court did not believe that the statute limits alter-ego liability of an individual who is an officer or director of a corporation but not a "shareholder or owner." *Id.* at 871. (The court did not address the fact that the statute protects "affiliates" of the shareholders and of the corporation as well as shareholders, thereby protecting affiliated entities and non-shareholder directors and officers of the corporation to the extent a veil-piercing theory might be relied upon to impose liability on such persons for a contractually related obligation of the corporation. *See Phillips v. United Heritage Corp.*, 319 S.W.3d 156 (Tex. App.—Waco 2010, no pet.) Thus, it is not clear whether the court in *Taurus* would have applied the statute by analogy to the LLC manager if it had properly understood the statute's application in the corporate context.

In *Shook v. Walden*, 368 S.W.3d 604 (Tex. App.—Austin 2012, pet. denied), the Austin Court of Appeals engaged in a thorough analysis of the common-law standard applicable to an LLC veil-piercing claim arising before the addition of Section 101.002 of the BOC and concluded that courts should be guided by the corporate statutory standards rather than the more liberal standards articulated in *Castleberry v. Branscum*. The court of appeals in *Shook* noted the Wisconsin district court's opinion in *Taurus* and disagreed with that opinion. A dissenting justice in *Shook* argued that the equitable standard set forth in *Castleberry* should apply given the absence of a statutory standard.

From a policy standpoint, there is no apparent reason for courts to adopt common-law veil-piercing doctrines that provide less liability protection for an LLC member than that available to a corporate shareholder. Indeed, to the extent that courts have distinguished at all between the application of veil-piercing principles in the corporate and LLC context, they have generally indicated that certain factors that could lead to piercing the veil of a corporation may merit less consideration in the LLC context. *See, e.g., FILO America, Inc. v. Olhoss Trading Company, LLC*, 321 F. Supp. 2d 1266, 1269-70 (M.D. Ala. 2004) (concluding that it is possible to pierce the LLC veil under Alabama law and that the plaintiff stated a claim to pierce the defendant LLC's veil by alleging the members had a fraudulent purpose in the conception of their business, but noting that some factors applied in corporate veil piercing may not apply to LLCs in the same manner they apply to corporations); *In re Giampietro (AE Restaurant Assocs., LLC v. Giampietro)*, 317 B.R. 841, 848 n.10 (Bankr. D. Nev. 2004) (commenting that the factors analyzed under the corporate alter-ego doctrine may carry less weight in the LLC context and that domination by an owner may not justify piercing because LLC statutes allow members to manage the LLC and illustrate a legislative intent to allow small, one-person, and family owned businesses the freedom to operate their companies themselves and still enjoy protection from personal liability); *Kaycee Land and Livestock v. Flahive*, 46 P.3d 323, 328 (Wyo.2002) (concluding that there was no legal or policy reason to treat LLCs differently from corporations for purposes of veil piercing but acknowledging that the precise application of the factors may differ based upon the inherently flexible and informal nature of LLCs); *D.R. Horton Inc.-New Jersey v. Dynastar Development*, L.L.C., 2005 WL 1939778, at *33-36 (N.J. Super. L. 2005) (agreeing with judicial opinions and commentators that have concluded LLC veil-piercing law should be adapted to the special characteristics of LLCs and identifying adherence to corporate formalities, dominion and control by the owner, and undercapitalization as factors that should "not loom as large" in the LLC veil-piercing analysis as they do in the corporate context).

As mentioned above, even before the BOC was amended to add Section 101.002, Texas courts relied upon corporate veil-piercing principles when presented with the question of whether to pierce the LLC veil. In *Pinebrook Properties, Ltd. v. Brookhaven Lake Property Owners Association,* 77 S.W.3d 487 (Tex. App.—Texarkana 2002, pet. denied), the court, without discussing whether or why corporate veil-piercing principles apply to LLCs, relied upon corporate veil-piercing principles in analyzing the plaintiff's claim that an LLC was the alter ego of its member. The court cited corporate veil-piercing cases and relied upon Article 2.21A(3) of the TBCA as authority for the proposition that failure to follow formalities is not a factor in determining alter ego.

In *McCarthy v. Wani Venture, A.S.*, 251 S.W.3d 573 (Tex. App.—Houston [1st Dist.] 2007, pet. denied), the court of appeals rejected the argument that the TLLCA creates an impenetrable liability shield. The plaintiff sought to hold the defendant, a one-third member of a Texas LLC, liable for purchases made by the LLC from the plaintiff. The defendant argued that the LLC veil is impenetrable because the TLLCA does not address whether or under what circumstances a litigant may pierce the veil of an LLC. The court disagreed, stating that courts in Texas and other jurisdictions have applied to LLCs the same state law principles for veil piercing that are applicable to corporations. The jury charge included a question that inquired whether the defendant caused the LLC to be used to perpetrate an actual fraud, and did perpetrate an actual fraud upon the plaintiff, primarily for her own direct personal benefit (i.e., tracking the veil-piercing provision of Article 2.21A(2) of the TBCA). The jury answered this issue in the affirmative and found damages based on unpaid invoices owed by the LLC to the plaintiff. The court of appeals found the evidence sufficient to support the jury's verdict. A dissenting justice did not challenge the proposition that corporate veil-piercing principles apply to Texas LLCs, but disagreed with the majority that the evidence was sufficient to support the jury's finding that the defendant caused the LLC to perpetrate a fraud primarily for her direct personal benefit.

In the case of *In re HRM Holdings, LLC (Seidel v. Hospital Resources Management LLC)*, 421 B.R. 244 (Bankr. N.D. Tex. 2009), the bankruptcy court applied corporate veil-piercing standards in the LLC context, noting that "Texas courts and other jurisdictions have applied the same state law principles for veil-piercing that they have applied to corporations." The bankruptcy trustee sought to pierce the debtor LLC's veil and hold several affiliated LLCs liable as a single business enterprise based on actual fraud consisting of the debtor LLC's failure to notify creditors that it was terminating its business operations. (The trustee's first complaint had simply asserted the single business enterprise theory as a basis of liability without specifying fraud, and the court had allowed the trustee to replead and allege fraud as required by the corporate veil-piercing statutes.) According to the second amended complaint, the management of the LLC engineered the transfer of all the debtor LLC's assets to the defendant LLCs without notifying the creditors of the debtor LLC. The court concluded that the failure to give the statutorily required notice of winding up could constitute actual fraud under the Texas veil-piercing statutes, but the court found that the complaint failed to specify who the perpetrators of the fraud were and how the fraud benefitted the defendants. The court gave the trustee a final opportunity to further amend its complaint and admonished the trustee to examine the Texas veil-piercing statutes and the *SSP Partners* case when and if deciding to draft a third amended complaint.

In the case of *In re JNS Aviation, LLC (Nick Corp. v. JNS Aviation, Inc.)*, 376 B.R. 500 (Bankr. N.D. Tex. 2007), a bankruptcy court applying Texas law rejected the argument that a member's statutory liability protection under the Texas LLC statute precludes veil piercing and followed Texas cases that have applied corporate veil-piercing principles to LLCs. The court undertook a lengthy discussion of various veil-piercing theories under Texas law and found that the facts satisfied certain factors associated with several theories, but concluded that the facts best fit within the "sham to perpetrate a fraud" doctrine. The court found that shutting down the LLC without notice to the creditor (as required by the winding up provisions of the LLC statute), allowing the creditor to take a default judgment against the LLC, and distributing the LLC's assets to the owners who contributed the assets to a newly formed entity, was a scheme to isolate the judgment in a shell entity and constituted an actual fraud for the personal benefit of the owners of the entities.

In *Genssler v. Harris County*, 584 S.W.3d 1 (Tex. App.—Houston [1st Dist.] 2010, no pet.), the court analyzed the claim that an individual was liable for environmental violations committed by a group of entities that owned and operated two waste water facilities. Harris County and the State of Texas had obtained a receivership over the individual's property on the theory that the individual was the alter ego of the entities. The designators in the names of the entities indicate that the group of entities consisted of a limited partnership, two limited liability partnerships, and a limited liability company, but the court did not specify or discuss the nature of the entities. The court spoke in general terms about the separate legal existence of a "business entity" and the application of the alter-ego theory when "there is such unity between the business entity and the individual that the business entity has ceased to be a separate entity, and allowing the individual to avoid liability through the use of the business entity would work an injustice." The court analyzed the evidence and concluded the entities were not the individual's alter ego because there was no evidence he diverted profits for his individual use, owned any interest in the entities, or personally paid any debts owed by the entities. There was testimony that the individual was the president, the "man in charge," and "made all the decisions," but the court stated that the individual's status as an officer or director, standing alone, was insufficient to support application of the alter-ego theory.

In *Penhollow Custom Homes, LLC v. Kim,* 320 S.W.3d 366 (Tex. App.—El Paso 2010, no pet.), the court discussed and applied corporate veil-piercing principles to an LLC as if the LLC were a corporation and concluded that the jury's alter-ego finding could not stand. The court concluded that there was no evidence of such unity between the

LLC and its owner that the separateness of the LLC had ceased. Neither the owner's complete control over the entity nor the owner's practice of taking an owner's draw (requiring payment of quarterly estimates to the IRS) rather than a salary (which would be subject to withholding for federal income tax and medicare tax purposes) demonstrated a lack of separateness between the entity and its owner, and the court thus did not have to reach the question of whether the evidence was sufficient to prove that the owner used the LLC for the purpose of perpetrating an actual fraud for his direct personal benefit.

In *Doyle v. Kontemporary Builders, Inc.*, 370 S.W.3d 448 (Tex. App.—Dallas 2012, pet. denied), the court discussed and applied case law and Section 21.223 of the BOC to the plaintiff's claim that an LLC was a "sham corporation" and that its sole owner was its alter ego. The court noted that mere control and ownership of all of the stock of a corporation is not sufficient to ignore the distinction between the corporation and its shareholder. There was no evidence that the LLC was organized as a mere tool or business conduit of the owner, nor was there any evidence that the LLC's property was not kept separately from the owners or that the LLC was used for personal purposes. Thus, the trial court did not err in finding that the owner was not the alter ego of the LLC.

In *Fin & Feather Club v. Leander,* 415 S.W.3d 548 (Tex. App.—Texarkana 2013, pet. denied), the court relied on *Shook v. Walden* for the proposition that the policies governing corporate veil piercing also apply to LLCs and held that there was no evidence of actual fraud, i.e., no evidence of dishonesty of purpose or intent to deceive, so as to hold a member or manager of the LLC liable. The court held that there was no evidence of the identity of the principals of the LLC but noted that the legislature specifically authorized single-member LLCs and limited the liability of a member or manager. Even if there had been evidence to establish that there was only one principal of the LLC, there was no evidence of actual fraud to support holding him liable and thus no basis to hold the sole principal liable for the LLC's debt.

In *Metroplex Mailing Services, L.L.C. v. RR Donnelly & Sons Company,* 410 S.W.3d 889 (Tex. App.—Dallas 2013, no pet.), the court held that there was no evidence to support piercing an LLC's veil to hold the sole member liable for the return of a deposit owed by the LLC. The court noted that the legislature specifically authorized single-member LLCs and that the statutory liability protection afforded members and managers only gives way when a plaintiff can show that the LLC was used for the purpose of perpetrating and did perpetrate an actual fraud for the member's or manager's direct personal benefit. The court relied on *Shook v. Walden* for the proposition that the policies governing corporate veil piercing also apply to LLCs and equated actual fraud to dishonesty of purpose or intent to deceive. The court concluded that the member's "use of a single-member LLC, as statutorily authorized by the legislature, combined with an ordinary personal loan to purchase equipment for the company's use secured by that equipment, amounts to no evidence of actual fraud even in combination with" other facts in the case. Even assuming the evidence showed that the LLC used some of the deposit as operating funds in violation of its agreement with the plaintiff and without disclosing the fact to the plaintiff, the court stated that there was no evidence that this action resulted in any direct personal benefit to the LLC's member. Additionally, although the member shut down the LLC in the face of the plaintiff's demand for its deposit (which the LLC was not yet obligated to return), the evidence showed that the LLC shut down due to declining business and not to avoid returning the deposit.

In *Spring St. Partners-IV, L.P. v. Lam*, 750 F.3d 427 (5th Cir. 2013), the Fifth Circuit Court of Appeals pointed out that the legislature specified that the BOC provisions regulating and restricting veil piercing of corporations are applicable to LLCs and their members and managers by adding Section 101.002 to the BOC in 2011and that the court of appeals in *Shook v. Walden* held that a plaintiff seeking to pierce the veil of an LLC not covered by BOC Section 101.002 must also meet the same requirements applicable to a corporation. These requirements differ depending upon whether a claimant is seeking to recover based on a tort or a contract. The claimant in this case sought to recover based on a fraudulent transfer of assets to an LLC, and the claimant argued that it was not required to prove actual fraud to pierce the LLC veil because fraudulent transfer of assets is a tort under Texas law. The court concluded that it did not have to determine whether the claimants were required to prove actual fraud or merely constructive fraud because there was "ample evidence" of the members' actual fraud. This evidence included the formation of an LLC ten days after the members' brother received notice that his debts were being accelerated, transfer of the brother's interest in another LLC to the newly formed LLC for no consideration, signing a document transferring an asset of the newly formed LLC to another family member for no consideration, failing to disclose the transfer for over a year during the pendency of litigation against the newly formed entity, attempting to evade the Texas Uniform Fraudulent Transfer Act by allowing the new LLC's charter to lapse, and attempting to evade individual liability by claiming the charter had been reinstated. The court stated that the members were acting for their direct personal benefit with respect to these actions because they had no other interest to serve.

In the case of *In re Packer*, 520 B.R. 520 (Bankr. E.D. Tex. 2014), a Texas bankruptcy court rejected a judgment creditor's claim seeking to reach the assets of several LLCs and other entities in which the debtor owned most or all of the membership interests because alter-ego claims, including reverse veil-piercing actions, are property of the bankruptcy estate that the plaintiff lacked standing to pursue. The court commented on certain aspects of veil-piercing claims directed at single-member LLCs and expressed the view that piercing should not be based on a failure to follow formalities or the election to be treated as a disregarded entity for federal income tax purposes.

In Chico Auto Parts & Service, Inc. v. Crockett, 512 S.W.3d 560 (Tex. App.—El Paso 2017, pet. denied), the court cited Texas case law in the corporate context for the proposition that a corporation is a separate legal entity that generally shields its owners, directors, and officers from liability absent use of the corporation"as part of a basically unfair device to achieve an inequitable result." The court noted that "the most frequent basis for disregarding the corporate shield at common law was the use of the 'alter ego' theory, in which a corporate obligee was required to demonstrate that the corporate officer had essentially used the corporation for its own 'personal purposes,' without any regard for corporate formalities." The court pointed out that, in July 2011—when the plaintiff performed the services on which its claim was based—two statutes "severely limited the circumstances under which a member of an LLC could be held personally liable for an LLC's contractual obligations." Tex. Bus. Orgs. Code §§ 101.113, 101.114. Section 101.002, which made the actual-fraud requirement in Section 21.223 applicable to LLCs, did not become effective until September 1, 2011. The court further pointed out, however, that Texas courts did not view the statutory liability protection provided to a managing member as absolute, but uniformly applied the same common-law principles for "piercing the corporate veil" as were previously applied to corporations prior to the adoption of the actual-fraud requirement in the BOC in determining whether an LLC's member could be held liable for the LLC's contractual obligations. When a plaintiff at common law sought to hold a corporate affiliate personally liable for a contractual obligation of a corporation under any of the veil-piercing theories, the plaintiff had the burden to plead and prove the basis on which the plaintiff sought to pierce the veil. In both his answer and his motion for summary judgment, the managing member asserted that he was shielded from liability based on his status as a managing member of an LLC, and the plaintiff failed to come forward with any pleadings, argument, or evidence to establish that the managing member could be held liable on any veil-piercing theory. The plaintiff tried to salvage its veil-piercing claim by relying on its fraud claim against the managing member, but the court rejected this argument after reviewing the record and finding the only allegations of fraud related to alleged misrepresentations after the contract was entered into regarding whom to invoice for the work. The plaintiff never alleged that the managing member committed any fraud in the formation of the contract, or that he used the LLC to fraudulently induce the plaintiff into entering into the alleged contract or otherwise used the LLC to perpetrate any fraud on the plaintiff.

In *Tomlinson v. Clem (In re Clem)*, 583 B.R. 329 (Bankr. N.D. Tex. 2017), the court discussed veil-piercing principles in the LLC context but concluded that it was not necessary to pierce the veil of the LLC with whom the plaintiffs contracted to hold the defendant manager/member liable to the plaintiffs because an arbitration award imposed personal liability on the defendant based on the Texas Deceptive Trade Practices Act.

In *TecLogistics, Inc. v. Dresser-Rand Group, Inc.*, 527 S.W.3d 589 (Tex. App.—Houston [14th Dist.] 2017, no pet.), the court cited BOC Section 101.002 and noted that "the legislature expanded the reach of sections 21.223–.225 [of the BOC] in 2011, so that they now protect not only corporations and their affiliates, but also limited liability companies and their members, owners, assignees, affiliates, and subscribers."

In *U.S. KingKing, LLC v. Precision Energy Services, Inc.*, 555 S.W.3d 200 (Tex. App.—Houston [1st Dist.] 2018, no pet.), the court of appeals reversed the trial court's summary judgment that two LLCs were alter egos of each other. The court of appeals cited *McCarthy v. Wani Venture, A.S.* and BOC Section 101.002 for the proposition that "[t]he principles applicable to piercing the corporate veil apply equally to limited liability companies," and discussed and analyzed at length the application of corporate veil piercing principles (under BOC Section 21223 and case law) to the summary judgment evidence regarding the relationship of Amerril Energy, LLC ("Amerril")—the LLC with which the claimant contracted—and Amerril's parent company, U.S. KingKing, LLC ("KingKing"), whom the claimant sought to hold liable as Amerril's alter ego. The court reviewed the summary judgment evidence in light of numerous factors and held that the summary judgment evidence did not conclusively establish that there was such unity between Amerril and KingKing that the separate existence of Amerril had ceased and that holding only Amerril liable would result in injustice. The court of appeals also concluded that the claimant failed to conclusively establish that KingKing used Amerril to perpetrate an actual fraud on the claimant for KingKing's direct personal benefit. The court stated that the evidence at most established that, at some point, the claimant received a balance sheet of KingKing that contained several overstated values, but the evidence did not conclusively establish that Amerril or KingKing acted with "dishonesty of purpose or intent to deceive."

In *Bates Energy Oil & Gas v. Complete Oilfield Services*, 361 F. Supp. 3d 633 (W.D. Tex. 2019), the court dismissed (with leave to amend) veil-piercing claims against the managing member of an LLC because the allegations did not demonstrate a basis for finding that the alleged fraud was for the direct personal benefit of the managing member. The claimant's tort claims related to or arose from the LLC's contractual obligations under an escrow agreement, and the claimant did not dispute that BOC Section 21.223 (applicable to LLCs by virtue of Section 101.002) required the claimant to allege that the managing member caused the LLC to be used for the purpose of perpetrating and did perpetrate an actual fraud on the claimant primarily for the direct personal benefit of the managing member in order to impose vicarious liability on the managing member based on veil piercing. The managing member also argued that Section 21.223 applied to the claims for direct liability because the alleged torts were committed in his representative capacity for the LLC. After a lengthy analysis of Sections 21.223 and 21.224 (and the predecessor provisions in Article 2.21 of the Texas Business Corporation Act) and the case law interpreting the statutory provisions, the court concluded that Section 21.223 did not apply to the claims for direct liability. With respect to the adequacy of the claimant's allegations of vicarious liability against the managing member based on veil piercing, the court concluded that the claimant did not sufficiently plead facts demonstrating that the fraud was primarily for the managing member's direct personal benefit because the allegations all referred to the managing member and the LLC as one. The court noted that most cases in which the courts determined that the requirement of "direct personal benefit" had been met included evidence showing that "'funds derived from the corporations' allegedly fraudulent conduct were pocketed by or diverted to the individual defendant.'" According to the court, "[w]hen the funds were used for the corporation's benefit, that has been held insufficient, even where it indirectly benefits the corporate officers and agents because the corporation is 'able to live another day due to its ability to satisfy some demands' or because their ownership interest retains its value, and this appears true even where the individual is the sole shareholder and where corporate formalities are disregarded." Because the allegations in the instant case either stated that money was given to the LLC or to the LLC/managing member, the pleadings did not demonstrate a basis for finding that the fraud was primarily for the managing member's direct personal benefit.

In *R&M Mixed Beverage Consultants, Inc. v. Safe Harbor Benefits, Inc.*, 578 S.W.3d 218 (Tex. App.—El Paso 2019, no pet.), the court stated that § 21.223(b) of the Business Organizations Code "has been interpreted to apply to LLC's ... and [courts have] held that in order to pierce the corporate veil of an LLC, the plaintiff must prove that the defendant used the LLC to perpetrate an actual fraud for the defendant's direct personal benefit. The principles applicable to piercing the corporate veil apply equally to limited liability companies."

In *Garza v. CMM Enterprises, LLC (In re Garza)*, 605 B.R. 817 (Bankr. S.D. Tex. 2019), the plaintiff instituted an adversary complaint against CMM Enterprises, LLC for violation of the automatic stay, and the plaintiff argued that Sanchez, the LLC's manager who exercised self-help in repossessing the plaintiff's vehicle on behalf of the LLC, should be held personally liable for the actions of the LLC. The manager filed a motion for judgment on partial findings, arguing that the plaintiff failed to bring forth any evidence showing that the manager acted outside of his capacity as a representative of the LLC. The court observed that "[t]he bedrock principle of corporate law is that an individual can incorporate a business and thereby normally shield himself from personal liability for the corporation's obligations." That court stated that this limited liability protection is also afforded in LLCs but noted that the limited liability can be disregarded under an alter-ego theory of piercing the corporate veil—a theory which applies equally to LLCs. The court concluded that the plaintiff was unable to establish that the manager was the alter ego of the LLC because she did not plead or submit any evidence that the manager kept his and the LLC's property together, that the manager was acting individually instead of through the LLC, that the manager was using the LLC for personal purposes, or that the manager and the LLC were considered a single entity. The plaintiff also argued that members of an LLC are not protected from liability for their own tortious actions and that, in such a case, no finding of alter ego is necessary. The court agreed with the legal proposition, but found no evidence that the manager should be liable because she failed to present any evidence that the manager committed any tortious or fraudulent act. The plaintiff presented two statutory claims—violation of the automatic stay under Section 362 of the Bankruptcy Code and violation of the Texas Debt Collection Act—but the court apparently did not consider these claims "tortious or fraudulent acts." The bankruptcy court did find that the LLC willfully violated the automatic stay and awarded actual and punitive damages against the LLC.

In *Trinkets and Tea, LLC v. Hunt (In re Hunt)*, 605 B.R. 758 (Bankr. N.D. Tex. 2019), the court stated: "[M]anagers/members of LLCs are not individually liable for the contractual debts and obligations of the LLC, unless there is a finding that the contractual debt or obligation was incurred by actual fraud for the direct personal benefit of the manager/member. If there is a finding of actual fraud, then the veil may be pierced to hold the manager/member personally liable on the contractual debt or obligation. ... [T]he veil-piercing exercise is not necessary if the manager/member is otherwise personally liable under an 'other applicable statute.' ... The evolution of defining actual fraud in the context of piercing the corporate veil is well documented by the Fifth Circuit in *Spring Street Partners–IV, L.P. v. Lam*, 730 F.3d 427 (5th Cir. 2013). Notably, actual fraud in this veil-piercing context is not equivalent to the tort of fraud. Rather, 'actual fraud is defined as involving dishonesty of purpose or intent to deceive.'"

In *Phelps v. Hunt (In re Hunt)*, 608 B.R. 477 (Bankr. N.D. Tex. 2019), Phelps sought to establish a non-dischargeable claim against Hunt, the owner and manager of Tea 2 Go, LLC, based in part upon alleged fraud committed by Hunt in connection with the purchase by Phelps of franchise rights from Tea 2 Go, LLC. The court noted that a manager/member of an LLC is not individually liable for contractual debts and obligations of the LLC unless there is a finding that the debt or obligation was incurred through actual fraud for the direct personal benefit of the manager/member. Phelps alleged that he was defrauded by Hunt and that such fraud personally benefitted Hunt. The court observed that actual fraud in the veil-piercing context is not equivalent to the tort of fraud. Rather, actual fraud is defined as involving dishonesty of purpose or intent to deceive.

In *White v. Cyr*, 2020 WL 1644047 (W.D. Tex. 2020), the court concluded that the plaintiff failed to sufficiently plead an alter-ego claim in order to hold an LLC's member liable for sums owed by the LLC to the plaintiff. The court noted the liability protection provided by an LLC, quoting BOC § 101.114, and stated that a plaintiff seeking to impose individual liability on an owner must "pierce the corporate veil." To do so under the alter-ego theory, the court stated that "a court must find (1) that the entity 'is the alter ego of the debtor, and (2) that the corporate fiction was used for an illegitimate purpose, that is, to perpetrate an actual fraud on the plaintiff for the defendant's direct personal benefit.'" The court concluded that the plaintiff's allegation that LLC funds were used for the member's personal purposes was conclusory. "Absent factual allegations in support of the conclusion that [the member] used [the LLC's] profits to support his lifestyle or factual allegations that show corporate formalities were not followed, that corporate and private property, funds, or assets were commingled, or that [the member] otherwise abused the corporate form, [the plaintiff's] amended complaint fails to demonstrate 'such unity' between [the LLC] and [the member] 'that the separateness of the corporation has ceased and holding only the corporation liable would result in injustice.'"

In *Yang Wu International, Inc. v. LS & CS, LLC*, 2020 WL 2395937 (E.D. Tex. 2020), the plaintiffs established that certain LLCs were the alter egos of other affiliated LLCs for purposes of alleged violation of the Perishable Agricultural Commodities Act. The court cited case law for the proposition that alter-ego doctrinal considerations are the same regardless of whether the companies have a parent-subsidiary or sister-sister relationship, and the court found the evidence was sufficient to establish unity of the affiliated LLCs. The court relied upon the alter-ego doctrine as applied to corporations without mentioning or discussing that the "Business Entity Defendants" in the case were LLCs.

In *Stover v. ADM Milling Co.*, 2018 WL 6818561 (Tex. App.—Dallas 2018, pet. denied), the court of appeals held that the evidence was sufficient to support the finding that the members of an LLC used the LLC to perpetrate an actual fraud for their direct personal benefit for purposes of imposing liability on the members for the LLC's breach of contract, fraud, and statutory fraud under the alternative veil-piercing theories of sham to perpetrate a fraud or alter ego. The members challenged the sufficiency of the evidence that supported the jury's findings imposing on them personal liability for the LLC's breach of contract and fraud under the alternative theories of sham to perpetrate a fraud and alter ego, arguing that the evidence did not show they used the LLC to perpetrate an actual fraud for their direct personal benefit as required by BOC Section 21.223(b). The court explained that "actual fraud" for purposes of piercing the corporate veil is not the equivalent of the tort of fraud; rather, "actual fraud" in the veil-piercing context involves "dishonesty of purpose or intent to deceive." The court also explained that the phrase "primarily for the direct personal benefit" is not defined by Section 21.223, but courts have concluded that this requirement has been met when funds derived from a corporation's fraudulent conduct have been "pocketed by or diverted to" the individual defendant. The court concluded that the evidence was sufficient to meet these standards.

In *BSG Clearing Solutions North America, LLC v. Durham Technology, LLC*, 2018 WL 6219812 (W.D. Tex. 2018), the court granted a motion for no-answer default judgment against an individual and six LLCs and five corporations controlled and operated by the individual defendant. The allegations established that the LLCs and corporations were liable on contracts with the plaintiffs, and the allegations were sufficient to show that the individual was the alter ego of the entities and used the entities to achieve an inequitable result such that it would be unjust to hold only the entity defendants liable.

In *Skrastina v. Breckinridge-Taylor Design, LLC*, 2018 WL 3078689 (Tex. App.—Dallas 2018, no pet.), the court pointed out that veil-piercing doctrines are not substantive causes of action. Because the plaintiff failed to produce evidence of the underlying causes of action creating liability of the LLC, the trial court did not err by granting summary judgment in favor of the LLC members on the plaintiff's veil-piercing theories.

In *Clement v. Blackwood*, 2018 WL 826856 (Tex. App.—Eastland 2018, pet. denied), the court discussed reverse veil-piercing principles and held that an LLC was liable for the fraudulent actions of its members. The court concluded that the LLC was the alter ego of its members and that the members caused the LLC to be used to perpetrate fraud for the direct personal benefit of the members.

In the case of *In re Primera Energy, LLC*, 2017 WL 6760640 (Bankr. W.D. Tex. 2017), the court noted that "Section 21.223 of the Texas Business Organizations Code pertaining to corporations applies to limited liability companies."

In *Luppino v. York*, 2017 WL 8161008 (W.D. Tex. 2017), an individual claimed that an LLC made fraudulent statements in the subscription agreements entered into with the individual. Assuming the individual's allegations against the LLC's members were sufficient to raise a veil-piercing claim, the claim failed because a claimant asserting a veil-piercing claim is required to demonstrate that the business entity's owner used the entity to perpetrate an actual fraud for the owner's direct personal benefit, and the claimant in this case failed to plead the fraud he believed to justify veil piercing with particularity.

In *B Choice Ltd. v. Epicentre Dev. Assocs., LLC*, 2017 WL 1227313 (S.D. Tex. 2017), report and recommendation adopted, 2017 WL 1160512 (S.D. Tex. 2017), the court identified three broad categories in which Texas law allows plaintiffs to "pierce the corporate veil"—when the corporation is used as the shareholder's alter ego, when it is used for illegal purposes, and when it is used as a sham to perpetuate a fraud. While the court recognized the theory of sham to perpetuate a fraud requires different levels of fraud in tort cases (in which constructive fraud suffices) than in contractual disputes (in which actual fraud is required), the court found there was evidence of the defendants' actual fraud that would meet either standard. Based on the LLC defendants' sharing of office space, directors, and officers, the movement of money that the plaintiff invested freely between the LLCs, and allegations of actual fraud, the court found there was a fact issue as to whether the corporate form should be pierced so as to impose liability for the breach-of-contract claim against these LLCs.

In *Austin Capital Collision, LLC v. Pampalone*, 2016 WL 7187478 (Tex. App.–Austin 2016, no pet.), the court cited and relied on BOC § 21.223 and case law in the corporate context in concluding that trial court's findings and evidence did not satisfy all of the elements required to pierce the veil under the alter-ego theory.

In *Rocklon, LLC v. Paris*, 2016 WL 6110911 (Tex. App.—Beaumont 2016, no pet.), the court of appeals discussed the validity of the sole initial member's purported assignment of his membership interest to his son in the course of analyzing the ownership of an LLC for purposes of determining whether there was evidence of an alter-ego relationship between the LLC and its alleged member. The court of appeals concluded that the trial court could have reasonably determined that the assignment was void due to its failure to meet the requirements of the company agreement for a valid assignment. The court also considered various instances of sloppy documentation and commingling of funds in concluding that there was evidence that the member had used the LLC as his alter ego and had fraudulently transferred the LLC's bank account to his son after the member was involved in a fatal car accident.

In *E & S Land Development, L.P. v. Shuomali (In re Shuomali)*, 2016 WL 4991490 (Bankr. E.D. Tex. 2016), the court discussed "reverse veil piercing" and characterized the application of veil-piercing principles, particularly reverse veil piercing, as "rather problematic when dealing with an individual's role with a limited liability company, particularly with a single-member LLC" for the reason that "many smaller LLC's are managed by few members, perhaps a single member, who are actively involved in all phases of the LLC's business." The court said that the disregard of corporate formalities—a key factor in veil-piercing determinations—is simply inapplicable in these situations because the liability protection should not hinge on "'meaningless formalities such as formal meetings.'"The court explained that the Texas legislature has adopted the same principles for veil piercing in an LLC context as have been previously adopted in the corporate context, including that the corporate veil may not be pierced in Texas based on failure to follow corporate formalities. The court concluded its discussion of Texas veil piercing by noting that the Texas business organization statutes generally allow veil piercing only on proof of actual fraud for the direct personal benefit of a shareholder based upon a showing of dishonesty of purpose or an intent to deceive.

In *Key v. Richards*, 2016 WL 240773 (Tex. App.—Austin 2016, no pet.), the court discussed statutory developments in Texas regarding veil piercing of LLCs and concluded that the jury instructions submitted in the case were derived from applicable case law and were accurate statements of the law on veil piercing. The court went on to conclude that it was not necessary to rely on veil-piercing principles to hold the owners of the LLC liable in this case because the owners were directly liable for their own participation in a fraudulent transfer. A dissenting justice pointed out that the court in *Shook v. Walden* did not actually address the argument that Texas law simply does not allow the piercing of an LLC's veil in the same manner as a business corporation, and the defendants had not preserved the argument in the case at bar. The dissenting justice characterized this as "potentially a more vexing question than one might assume initially because of the curious phrasing of section 101.002 of the Business Organizations Code, which applies to LLCs the statutory provisions governing veil-piercing of business corporations, but with the preceding qualifier, 'Subject to Section 101.114,' a reference to the general statutory limitations on the liability of LLC members." While the dissenting justice found the reference to Section 101.114 puzzling, it may be explained on the basis that Section 101.114 itself qualifies the limitation on personal liability with the phrase "Except as and to the extent the company agreement specifically provides otherwise." Thus, the reference to Section 101.114 can be understood to recognize that the standard set forth in Section 101.002 need not be met to hold a member personally liable for a contractually-related obligation of the LLC if the company agreement has waived the liability protection generally provided by Section 101.114.

In *Fisher v. Blue Cross and Blue Shield of Texas, Inc.*, 2015 WL 5603711 (N.D. Tex. 2015), the court held that a genuine dispute of material fact precluded summary judgment as to veil-piercing and alter-ego theories of liability asserted against a physician and several LLCs owned by the physician. The court quoted from Fifth Circuit case law in which the Fifth Circuit pointed out that veil piercing is a remedial measure used to impose liability on an owner of a corporation or LLC and that veil-piercing and alter-ego principles apply equally to corporations and LLCs. The court further quoted the Fifth Circuit in stating that "'[s]eparate corporate structures may be ignored when 'the corporate form has been used as part of a basically unfair device to achieve an inequitable result.'" Because the claim of money had and received was quasi-contractual in nature, the court agreed that the claimant must prove that the physician "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" to establish alter-ego liability. The court pointed out that Section 21.223(b) applies to LLCs, members, owners, and managers under Section 101.002. The court determined that there were genuine disputes of material fact as to issues related to the veil-piercing claims and denied the motion of the physician and his entities for summary judgment. See also *Paragon Office Services, LLC v. Aetna Inc.*, 2015 WL 4602943 (N.D. Tex. 2015).

In *Copeland v. D & J Construction LLC*, 2015 WL 512590 (N.D. Tex. 2015), the individual defendants contended that as members and managers of a Texas LLC, they could not be held liable for the LLC's debts, obligations, or liabilities based on BOC §§ 101.113, 101.114. In response, the plaintiff alleged that the individual defendants could be held liable under the "corporate veil doctrine" because the LLC was the alter ego of one of the individual defendants, and the defendants were operating a sham and committing fraud upon the public. The court explained that the traditional alter-ego doctrine was changed substantially by the codification of the doctrine in Section 21.223 of the BOC, and the court noted that Texas courts have applied the statutory provisions on corporate veil piercing to LLCs. The court held that the plaintiff's pleadings, liberally construed, sufficiently alleged facts to support a finding of actual fraud (i.e., "dishonesty of purpose or intent to deceive") for purposes of piercing the corporate veil. The plaintiff asserted generally that *all* of the individual defendants' business model was to receive payment for work done but refuse to pay the workers who actually did the work. Because the plaintiff also alleged that the individual defendants agreed to hire the plaintiff for specific tasks on behalf of the LLC and then refused to pay him, the court concluded that he pled sufficient facts showing that the individual defendants had the intent to deceive him, showing actual fraud. The plaintiff also sufficiently alleged that the sole member of the LLC defendant reaped personal benefit by alleging that the member used the debit cards of the business for his personal expenses. Additionally, the plaintiff alleged that the member perpetrated fraud by hiring workers and refusing to pay them once the work was completed. The plaintiff also contended that the member did not obtain the required liability insurance for the LLC and that the lack of formality was additional evidence that the LLC was a mere front for the member to perpetuate fraud. Liberally construing the plaintiff's assertions, the plaintiff sufficiently alleged actual fraud and use of the LLC to perpetrate fraud to allow piercing the LLC's corporate veil. The plaintiff did not, however, provide facts showing that two other individual defendants perpetrated the fraud for direct benefit to themselves.

In *Ogbonna v. USPLabs, LLC*, 2014 WL 2592097 (W.D. Tex. 2014), the plaintiff sued two individuals and four LLCs asserting claims arising out of the sale of allegedly harmful dietary supplements. The plaintiff sought to impose collective liability on all these defendants based on veil piercing. The defendants sought dismissal on the basis that the plaintiff failed to adequately allege that veil piercing was warranted. The court first addressed the law governing the case and applied Texas choice-of-law principles since the events allegedly occurred in Texas. Under Texas choice-of-law rules, whether a corporation, LLC, or individual may be held liable pursuant to veil-piercing theory is governed by the law of the state in which the entity is organized. Three of the LLCs were Wyoming LLCs, and the other LLC and the two individuals were a Texas LLC and Texas residents. The court proceeded to analyze the veil-piercing claims as to the Wyoming LLCs under Wyoming law and the claims against the Texas defendants under Texas law and concluded that the complaint was insufficient to allege veil-piercing claims as to both sets of defendants. With respect to the Texas veil-piercing claims, the court analyzed the veil-piercing allegations separately with respect to the plaintiff's tort claims and her claims for breach of warranty because a showing of actual fraud is required in the contract context but not the tort context. The court further broke down its analysis in the tort context to separately address alter ego and sham to perpetrate a fraud. With respect to whether the Texas defendants undertook a sham to perpetrate a fraud, the court held that the heightened pleading requirement of Rule 9(b) applied and that alleging the Texas LLCs were formed solely to escape liability for selling dangerous products and misleading customers failed to meet the particularity requirement under Rule 9(b). The allegations lumped all the LLC defendants together and did not differentiate or specify each LLC's specific connection to the alleged fraud. Although the complaint specified that the individuals controlled and managed the LLCs, the complaint contained only minimal allegations as to the individuals' roles. Because the plaintiff's claims for breach of warranty sounded in contract, the court stated that the plaintiff was required to sufficiently plead actual fraud for the defendants' direct personal benefit (see Tex. Bus. Orgs. Code § 21.223). The court stated that actual fraud for this purpose means dishonesty of purpose or intent to deceive and is not equivalent to the tort of fraud. Because of the fraud component, the court stated that the heightened pleading requirement of Rule 9(b) applied. The plaintiff's allegations of actual fraud, like her allegations of sham to perpetrate a fraud, lumped all the defendants together without differentiating them and thus failed to satisfy Rule 9(b).

In *Weston Group, Inc. v. Southwest Home Health Care, L.P.*, 2014 WL 940329 (N.D. Tex. 2014), the court addressed a motion to dismiss in which individual defendants argued that the plaintiff failed to state a claim against them. The individuals argued that the plaintiff must meet a heightened pleading standard (requiring particularity) applicable to a fraud claim because the plaintiff must prove "actual fraud" under the Texas Business Organizations Code to pierce the veil of the entities (which included LLCs) and hold the individuals liable. The court distinguished "actual fraud" for purposes of veil piercing, which simply requires "dishonesty of purpose or intent to deceive" and is less burdensome than a showing of common-law fraud, and the court held that the plaintiff's veil-piercing claims were not subject to the heightened pleading standard of Rule 9(b). In determining whether the plaintiff stated a claim against the individual defendants under Rule 12(b)(6), the court discussed the standard imposed by Section 21.223 with respect to a claim to pierce the veil of a Texas corporation or LLC. The court analyzed the plaintiff's complaint and concluded that the allegations were sufficient for a jury to infer actual fraud.

In *Roustan v. Sanderson*, 2011 WL 4502265 (Tex. App.—Fort Worth 2011, pet. denied), the court held that the plaintiffs did not plead or prove a ground for ignoring the limitation of liability afforded in LLCs and did not allege that the limitation should be disregarded to hold Roustan, the president of the LLC's managing member, liable for the LLC's breach of contract. The court noted that courts apply to LLCs the state law principles applied to pierce the corporate veil, and fraud is a ground for disregarding the corporate form. The plaintiffs pled that Roustan fraudulently induced them to enter a contract, but they did not plead that Roustan used the LLC itself to perpetrate a fraud and that the entity should be disregarded to hold Roustan personally liable, and they did not plead any other ground for disregarding the corporate structure.

In *Watkins v. Basurto*, 2011 WL 1414135 (Tex. App.—Houston [14th Dist.] 2011, no pet.), Basurto sued Watkins for personal injuries suffered in an assault by bouncers at a bar known as The Tavern. Two LLCs (which were not defendants) were involved in the operation of The Tavern. The trial court found that Watkins was liable for negligent hiring and supervision and as the alter ego of the LLCs operating The Tavern. The court recognized that members and managers of an LLC are not liable for judgments against the LLC but that courts have applied corporate veil-piercing principles to LLCs. Thus, an LLC member may be held individually liable for obligations of the LLC if the LLC is the mere alter ego of the member. The court concluded that there was insufficient evidence that unity existed between Watkins and the entities that operated The Tavern or that injustice would result if Watkins was not held liable. Basurto presented no evidence that Watkins mingled his personal property with that of the companies or that he used either company for personal purposes. The record did not show the extent of Watkins' ownership interest, but the evidence did show he exercised extensive control. However, mere control is insufficient to impose liability. Basurto also presented no evidence of failure to follow corporate formalities, so the court said it was not necessary to determine if corporate formalities remain a factor to be considered in piercing the LLC veil, noting that a corporate shareholder cannot be held liable on the basis of failing to follow corporate formalities. Finally, Basurto argued that the entities could not have satisfied his judgment, but he failed to present any evidence to support this argument.

In *Phillips v. B.R. Brick and Masonry, Inc.*, 2010 WL 3564820 (Tex. App.—Houston [1st Dist.] 2010, no pet.), the creditor of an individual obtained a favorable veil-piercing verdict against the individual's spouse based on her operating of an LLC of which the spouse was the sole member. The jury charge included three corporate veil-piercing theories: alter ego, evading an existing obligation, and sham to perpetrate a fraud. The court noted that Texas has applied corporate veil-piercing principles to LLCs, and the court applied corporate veil-piercing cases in reviewing the sufficiency of the evidence to support the verdict. Because neither party argued that TBCA Article 2.21 or BOC Section 21.223 were applicable, the court stated that it would review the sufficiency of the evidence solely with reference to the jury instruction (there having been no objection to the instruction in the trial court). The court concluded that the evidence did not support piercing the LLC veil to hold the member liable to the creditor of the member's spouse. Although there was evidence that the member's spouse improperly used the LLC to avoid paying his obligation to the creditor, there was no evidence that the member or the LLC had any obligation to the creditor, and there was no evidence that the member was acting as the LLC's alter ego, used the LLC to avoid any obligation she had to the creditor, or acted with "dishonesty of purpose or intent to deceive."

In *In re Arnette (Ward Family Foundation v. Arnette)*, 2011 WL 2292314 (Bankr. N.D. Tex. 2011), the debtor was the president, sole shareholder, and sole decision maker of a corporation and the sole member and sole decision maker of an LLC. The plaintiff in this adversary proceeding sought to hold the debtor liable for claims against the entities under veil-piercing theories. The plaintiff asserted fraud, breach of contract, and various other claims against the debtor and his entities in connection with over $1.7 million lent to the entities by the plaintiff. The court noted that Texas has applied the principles used to pierce the corporate veil to pierce the liability shield of an LLC, and the court applied the same standards to the corporation and LLC in this case. First the court addressed the question of whether the actual-fraud standard of Section 21.223 of the BOC applied to the claims in this case, i.e., whether the claims were tort claims outside the scope of the statute or were based on a contractual obligation of the entities. The court concluded that the plaintiff had satisfied the actual-fraud standard assuming it applied. The court stated that "actual fraud" within the meaning of the statute is not the same as the common-law tort of fraud and simply requires proof of dishonesty of purpose or intent to deceive. The court described how the debtor was dishonest in his dealings with the plaintiff and intended to mislead the plaintiff in order to induce the plaintiff to invest in the debtor's entities. The court also had no doubt that the debtor used the entities to perpetrate a fraud that primarily served to directly benefit him. The court did not, however, find that the sham to perpetrate a fraud theory applied in this case because neither of the debtor's entities were resorted to as a means of evading an existing legal obligation. Both entities existed before the plaintiff invested, and the debtor did not transfer assets among his companies with the purpose of using the corporate form to shield those assets from creditors. The court did conclude that the evidence supported a finding of alter ego based on evidence that included a showing of blended finances of the debtor and his two entities, sole ownership and control by the debtor of the entities, commingling of funds of the entities with his personal funds, the debtor's taking of loans and distributions to fund his lifestyle rather than any regular salary, and occasional use of the entities for personal purposes without proper documentation. The court also found that the plaintiff proved that the debtor defrauded the plaintiff through the entities and that the entities were out of business and had no assets to satisfy a judgment.

In *In re Williams*, 2011 WL 6180060 (Bankr. W.D. Tex. 2011), the plaintiffs sought to establish that their claim against the debtors, Norman and Joan Williams, was nondischargeable. Norman and Jean Williams were the sole owners, managers, and employees of Williams Building Consultants, LLC, and the plaintiffs' claim was based on the breach of a construction contract between the LLC and the plaintiffs. The court concluded that the plaintiffs had a breach-of-contract claim against the debtors even though the contract was with their LLC. The court stated that the debtors completely disregarded the corporate form throughout the negotiations and closing process and that the LLC was "essentially a sham corporation." The LLC had no employees, no significant assets, and very little money in the bank. Mrs. Williams testified the LLC was created for the sole purpose of building the home purchased by the plaintiffs. The LLC did not file separate tax returns from the debtors. The debtors consistently referred to their home building business in terms of "we" rather than the LLC. The plaintiffs always understood the debtors to be the sellers of the property rather than the LLC. On this basis, the court allowed the plaintiffs' claim against the debtors. The court determined that the debt was dischargeable, rejecting the plaintiffs' argument that the debt was based on false pretenses, false representations, or actual fraud of the debtors.

In *In re Pace (Osherow v. Hensley)*, 2011 WL 1870054 (Bankr. W.D. Tex. 2011), the court determined that the transfer of a condominium from the debtor's corporation to an LLC owned by Hensley, a friend of the debtor, was a fraudulent transfer. The court then proceeded to analyze whether Hensley was jointly and severally liable with his LLC under veil-piercing theories. The court relied upon corporate veil-piercing principles, noting that "corporate veil piercing law is equally applicable in the context of limited liability companies." The court stated that the evidence showed that Hensley solely controlled the LLC and commingled funds but stated that this evidence was probably insufficient to pierce the veil under an alter-ego theory. Nevertheless, the court found the evidence sufficient to establish that Hensley used the LLC to perpetrate a fraud. The court based this conclusion on its previous finding that Hensley did not act in good faith in connection with the transfer of the condo and helped the debtor carry out a fraudulent transfer. Therefore, Hensley was jointly and severally liable with the LLC.

In *Interplan Architects, Inc. v. C.L. Thomas, Inc.*, 2010 WL 4366990 (S.D. Tex. 2010), the court relied on the actual-fraud standard in Section 21.223 of the BOC in applying the alter-ego theory in the LLC context and concluded the plaintiff did not show that the LLC was formed for the purpose of wrongful conduct.

In *In re Houston Drywall, Inc. (West v. Seiffert)*, 2008 WL 2754526 (Bankr. S.D. Tex. 2008), the bankruptcy court concluded that an LLC general partner of a limited partnership was a "sham corporation," and that the individuals in control of the LLC were thus personally liable for breaches of fiduciary duties as general partners of the limited partnership. Although the court identified and referred to the general partner as a limited liability company in reciting the facts earlier in the opinion, the court discussed and applied corporate veil-piercing principles to the LLC as if it were a corporation.

The bankruptcy court in *In re Supplement Spot, LLC (Floyd v. Option One Mortgage Corporation)*, 409 B.R. 187 (Bankr. S. D. Tex. 2009) discussed and applied corporate case law as if the debtor, a Texas LLC, were a corporation, and the court characterized as "individual piercing" (although the result was actually consistent with traditional piercing) its conclusion that an account held in the name of the LLC debtor's president was property of the LLC. In this case, the bankruptcy trustee brought an action to avoid payments that were made from an account funded by the debtor LLC's business operations. The account was styled "Marcella Ortega dba Young Again Nutrients," and Marcella Ortega was president of the debtor LLC. The payments challenged by the trustee were payments on mortgage debts of Ortega, and the court held that they were avoidable as fraudulent transfers. In order to find that the payments were fraudulent transfers, the court had to find that the account was the property of the debtor LLC. The court found that the account was properly considered property of the LLC because the court could pierce the "individual veil" and view the account as property of the LLC. The court explained that a court may sometimes "pierce the corporate veil" to determine whether the activities and property of a corporation should be attributed to its individual principal or principals, but stated that the court here was being asked to do the opposite—to "pierce the individual veil" and attribute property of Ortega to the debtor LLC. The court noted that courts generally protect the individual assets from the reach of a corporation's bankruptcy, but cited the corporate alter-ego doctrine as a basis to treat individual property as corporate property. The court stated that it would treat the account as property of the LLC because Ortega herself disregarded the separation between the LLC's funds and her funds by using the account exclusively to pay her personal expenses when the account was funded exclusively by the LLC's business. Further, the court noted that injustice would result if the account were not treated as the property of the debtor because the fraudulent transfers, if not avoided, would seriously hinder the trustee's ability to administer the bankruptcy case.

In *DDH Aviation, LLC v. Holly*, 2005 WL 770595 (N.D. Tex. 2005), the court relied upon Texas corporate veil-piercing principles in analyzing whether to pierce the veil of a Texas LLC. The opinion states that DDH was initially "formed as a corporation but later altered its business form to become a limited liability company." The court did not indicate when the change in form took place or what events took place while DDH was a corporation versus an LLC. At one point in the opinion, the court identified DDH as a "limited liability corporation." Thus, it is not clear that the court made a conscious decision to apply corporate veil-piercing principles to an LLC or whether the court even recognized the distinction between an LLC and a corporation. *See also Arsenault v. Orthopedics Specialist of Texarkana*, 2007 WL 3353730 (Tex. App.—Texarkana 2007, no pet.) (finding no pleading or evidence supporting alter ego and single business enterprise veil-piercing claims against owner of professional LLC).

Courts in other jurisdictions have generally relied on corporate veil-piercing principles in the LLC context. *See, e.g., NetJets Aviation, Inc. v. LHC Commc'ns, LLC*, 537 F.3d 168, 178-84 (2d Cir. 2008) (stating Delaware corporate veil-piercing principles apply to LLCs and concluding questions of whether single member LLC was operated as alter ego of its member and whether LLC was operated with overall element of injustice or unfairness were questions for factfinder at trial); *Kaycee Land and Livestock v. Flahive*, 46 P.3d 323, 327-28 (Wyo. 2002) (concluding no legal or policy reason exists to distinguish LLCs from corporations for purposes of veil piercing but acknowledging precise application of factors may differ based on inherently more flexible and informal nature of LLCs). For additional cases in other states that have addressed veil piercing of LLCs, see Elizabeth S. Miller, *More Than a Decade of LLP and LLC*

Case Law: A Cumulative Survey of Cases Dealing With Limited Liability Partnerships and Limited Liability Companies, June 2007, and subsequent case law updates available at http://www.baylor.edu/law.

2. Piercing the LLC Veil in the Personal Jurisdiction Context

Piercing the LLC veil is also addressed in a number of cases involving a court's exercise of personal jurisdiction. *See, e.g., Domain Protection, LLC v. Sea Wasp, LLC,* 2019 WL 5189200 (E.D. Tex. 2019); *Di Piazza v. Weather Grp. Television, LLC,* 2019 WL 8107917 (N.D. Tex. 2019); *Ball Up, LLC v. Strategic Partners Corp.*, 2018 WL 3673044 (Tex. App.—Fort Worth 2018, no pet.); *Wormald v. Villarina*, 543 S.W.3d 315 (Tex. App.—Houston [14th Dist.] 2017, no pet.); *Northern Frac Proppants, II, LLC v. 2011 NF Holdings, LLC*, 2017 WL 3275896 (Tex. App.—Dallas 2017, no pet.); *Mt. McKinley Ins. Co. v. Grupo Mexico, S.A.B. De C.V.*, 2013 WL 1683641 (Tex. App.—Corpus Christi 2013, no pet.); *Haferkamp v. Grunstein*, 2012 WL 1632009 (Tex. App.—Eastland 2012, pet. denied); *Breckenridge Enters., Inc. v. Avio Alternatives, LLC*, 2009 WL 1469808 (N.D. Tex. 2009); *Gonzalez v. Lehtinen*, 2008 WL 668600 (Tex. App.— Corpus Christi 2008, pet. denied); *Wolf v. Summers-Wood, L.P.*, 214 S.W.3d 783 (Tex. App.—Dallas 2007, no pet.); *Morris v. Powell*, 150 S.W.3d 212 (Tex. App.—San Antonio 2004, no pet.); *Stauffacher v. Lone Star Mud, Inc.*, 54 S.W.3d 810 (Tex. App.—Texarkana 2001, no pet.); *Royal Mortg. Corp. v. Montague*, 41 S.W.3d 721 (Tex. App.—Fort Worth 2001, no pet.); *Taurus IP, LLC v. DaimlerChrysler Corp.*, 519 F.Supp.2d 905 (W.D. Wis. 2007); *Quebecor World (USA), Inc. v. Harsha Assocs. L.L.C.*, 455 F.Supp.2d 236 (W.D. N.Y. 2006); *LaSalle Bank N.A. v. Mobile Hotel Props., LLC,* 274 F.Supp.2d 1293 (S.D. Ala. 2003); *XL Vision, LLC v. Holloway*, 850 So.2d 1063 (Fla. App. 2003); *Int'l Bancorp, L.L.C. v. Societe des Bains de Mer et du Cercle des Entrangers a Monaco*, 192 F.Supp.2d 467 (E.D. Va. 2002); *ING (U.S.) Securities, Futures & Options, Inc. v. Bingham Inv. Fund, L.L.C.*, 934 F.Supp. 987 (N.D. Ill.1996). The Texas Supreme Court's analysis of the distinction between "jurisdictional piercing" and "substantive piercing" presumably applies as well in the LLC context. *See PHC-Minden, L.P. v. Kimberly-Clark Corp.*, 235 S.W.3d 163 (Tex. 2007).

3. Reverse LLC Veil Piercing

"Reverse piercing," i.e., holding the LLC liable for a member's obligation, or otherwise treating the LLC's assets as the assets of the owner, has been recognized in some cases in Texas and other states.

A judgment creditor sought to reverse pierce the veil of an LLC to impose liability on the LLC for the creditor's judgment against an individual debtor in the case of *In re Moore (Cadle Company v. Brunswick Homes, LLC)*, 379 B.R. 284 (Bankr. N.D. Tex. 2007). The court discussed the development of both traditional and reverse corporate veil-piercing under Texas law and concluded that the doctrine of reverse veil piercing is applicable under Texas law although the doctrine has "rather thin roots" in Texas. Noting that neither the Texas Supreme Court nor the Texas legislature has opined on reverse veil piercing, the court relied upon Fifth Circuit case law that has recognized the doctrine under Texas law. The court, however, was troubled by the fact that the doctrine of reverse piercing has evolved and been accepted into the mainstream of Texas veil-piercing jurisprudence at the same time the Texas legislature has been limiting traditional veil piercing and without meaningful discussion of what the doctrine in substance accomplishes. The court concluded that the concept should be applied only when it is clear that it will not prejudice non-culpable shareholders or other stakeholders (such as creditors) of the corporation. The court applied corporate veil-piercing principles to the LLC in issue, stating that whether an entity is a corporation or an LLC is a "distinction without a difference" for purposes of veil piercing. The fact that reverse piercing was sought with respect to an individual who was not a record or nominal equity owner of the LLC did not preclude the claim since the plaintiffs sought to establish that the individual had a *de facto* interest in the LLC. The court concluded that fact issues precluded summary judgment for the LLC on the reverse veil-piercing claim and a claim for constructive trust on the LLC's assets. The court held that the ten-year statute of limitations for enforcement of a judgment applied to the reverse alter-ego and constructive-trust claims since the claims were being pursued to collect a judgment.

In *Clement v. Blackwood*, 2018 WL 826856 (Tex. App.—Eastland 2018, pet. denied), the court held that Clement Cattle LLC was liable for the fraudulent actions of its members, the Clements, under reverse veil-piercing principles. The court described alter ego as a legal basis to disregard the corporate fiction where there is unity between the entity and the individual such that the entity's separate existence has ceased. The court explained that the doctrine has traditionally been applied to hold an individual liable for the debts of a corporation but that Texas also allows the alter-ego doctrine to be applied in reverse so that a corporation's assets can be used to satisfy the liabilities of an individual who treated the corporation as the individual's alter ego. The court stated that courts look to the total dealings of the entity and the individual (listing a number of factors) to determine whether the individual is operating the entity as the individual's alter ego or "shadow of his personality." The court also cited BOC Section 21.223 for the proposition that there must be evidence that the Clements perpetrated actual fraud for their direct personal benefit in order to pierce the veil of Clement Cattle LLC. The court held that the evidence supported the finding that a $240,000 loan by the plaintiffs to avoid foreclosure on the Clements family ranch—which was owned by Clements Cattle LLC—was the product of actual fraud and that the loan was for the Clements' direct personal benefit. The defendants cited cases involving LLCs to support their argument that only Clement Cattle LLC received a direct benefit when the loan was paid off. The defendants contended that the fact that they could continue living on the ranch was merely an "incidental benefit," akin to a shareholder receiving property or a corporation reducing its debt. However, the court stated that the defendants ignored the fact "that Clement Cattle LLC's sole purpose was to own the Clements family ranch. It was formed for 'estate planning' purposes, not to operate a business" and "it existed exclusively to directly benefit the Clements." The Clements directly benefitted when the plaintiffs satisfied Clement Cattle LLC's mortgage because the Clements continued to have a place to live. Because Clement Cattle LLC was an alter ego of the Clements, it was also liable for the Clements' fraudulent actions.

In *Transfirst Group, Inc. v. Magliarditi*, 2017 WL 528776 (N.D. Tex. 2017), the court applied reverse corporate veil-piercing principles to exercise personal jurisdiction over a trust, a corporation, and two Nevada LLCs, on the basis that these entities were the alter ego of a judgment debtor who allegedly used the entities to hide assets and defraud the judgment creditor. The court stated that reverse veil piercing "'is a common-law doctrine in many states, including Nevada and Texas, that renders the assets of a corporation liable for the debts of a corporate insider based on a showing of alter ego of the individual.'" The court cited the Nevada Supreme Court for the proposition that Nevada courts have found it "'particularly appropriate to apply the alter ego doctrine in 'reverse' when the controlling party uses the controlled entity to hide assets or secretly to conduct business to avoid a pre-existing liability fo the controlling party.'" The court listed the factors considered under Nevada law as indicative of an alter-ego relationship and concluded that the plaintiff had sufficiently alleged a prima facie case of personal jurisdiction over the entities at issue.

In *E & S Land Development, L.P. v. Shuomali (In re Shuomali)*, 2016 WL 4991490 (Bankr. E.D. Tex. 2016), the court discussed "reverse veil piercing" and explained that this doctrine is a common-law doctrine under which the assets of a corporation or other entity are deemed to be the assets of its shareholder. The court stated that this doctrine "'appl[ies] the traditional veil piercing doctrine in reverse, so that a corporation's assets are held accountable for the liabilities of individuals who treated the corporation as their alter ego.'" The court characterized the application of veil-piercing principles, particularly reverse veil piercing, as "rather problematic when dealing with an individual's role with a limited liability company, particularly with a single-member LLC" for the reason that "many smaller LLC's are managed by few members, perhaps a single member, who are actively involved in all phases of the LLC's business." The court said that the disregard of corporate formalities—a key factor in veil-piercing determinations—is simply inapplicable in these situations because the liability protection should not hinge on "'meaningless formalities such as formal meetings.'" In this regard, the court explained that the Texas legislature has adopted the same principles for veil piercing in an LLC context as have been previously adopted in the corporate context, including that the corporate veil may not be pierced in Texas based on failure to follow corporate formalities. The court concluded its discussion of Texas veil piercing by noting that the Texas business organization statutes generally allow veil piercing only on proof of actual fraud for the direct personal benefit of a shareholder based upon a showing of dishonesty of purpose or an intent to deceive.

In *In re Packer*, 520 B.R. 520 (Bankr. E.D. Tex. 2014), a Texas bankruptcy court rejected a judgment creditor's claim seeking to reach the assets of several LLCs and other entities in which the debtor owned most or all of the membership interests because alter-ego claims, including reverse veil-piercing actions, are property of the bankruptcy estate that the plaintiff lacked standing to pursue.

In *In re Boyd (Rodriguez v. Four Dominion Drive, LLC)*, 2012 WL 5199141 (Bankr. W.D. Tex. 2012), the bankruptcy trustee of the individual debtor sought to treat the debtor and his law firm, a professional LLC, as a single entity based on reverse veil-piercing principles. The court assumed that the corporate alter-ego doctrine applied in this context and held that the trustee's reverse veil- piercing claim was not a "core" proceeding but conceivably fell within the court's "related to" jurisdiction.

In *Bramante v. McClain*, 2007 WL 4555943 (W.D. Tex. 2007), the plaintiffs, judgment creditors of an individual, sought to reverse pierce numerous LLCs on the basis that the LLCs were the alter egos of the individual under Texas veil-piercing principles. The LLCs sought summary judgment, arguing that there was no evidence of unity between the LLCs and the individual because the plaintiffs could not show that the individual had an ownership interest in, or control over, the LLCs. The court, however, found that the plaintiffs raised a fact question based on summary judgment evidence that the individual created a group of entities that ultimately became the LLC defendants in the case. Evidence that the individual was the sole owner of the entities that ultimately became the LLC defendants constituted evidence sufficient to raise a fact question regarding the individual's ownership and control of the LLCs. The court also found that the plaintiffs had raised a fact question as to whether the individual judgment debtor used entities owned by him to fraudulently transfer assets to the LLCs. Further, the court concluded that the plaintiffs stated a claim against the LLCs for conspiring by agreement to commit fraudulent transfers to avoid collection on the judgment. The court found no authority, however, supporting liability beyond the amounts actually transferred. *See also In re Juliet Homes, L.P.*, 2011 WL 6817928 (Bankr. S.D. Tex. 2011) (concluding allegations adequately stated claim for reverse veil piercing under Texas law where trustee sought to count assets of non-debtor entities as assets of their owner-debtors for purposes of asserting fraudulent and preferential transfer claims against the non-debtor entities).

As amended in 2007, the charging order provision of the LLC statute provides that "[a] creditor of a member or of any other owner of a membership interest does not have the right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited liability company." Tex. Bus. Orgs. Code § 101.112(f); *see also* Tex. Rev. Civ. Stat. art. 1528n, art. 4.06E (expired eff. Jan. 1, 2010). This provision might be interpreted to preclude reverse piercing of a Texas LLC by a member's creditor. On the other hand, a creditor of an LLC member could presumably still resort to the fraudulent transfer statutes to recover property fraudulently transferred to the LLC, and it might similarly be argued that disregard of the LLC's separate existence under reverse piercing principles is not precluded by the charging order provision.

Cases applying reverse piercing principles in the LLC context in other jurisdictions include: *Mattingly Law Firm, P.C. v. Henson*, 466 P.3d 590 (Ok. Ct. App. 2019) *McKay v. Longman*, 211 A.3d 20 (Conn. 2019); *Sky Cable, LLC v. DIRECTV, Inc.*, 886 F.3d 375 (4th Cir. 2018); *Curci Invs., LLC v. Baldwin*, 14 Cal. App. 5th 214, 221 Cal. Rptr. 3d 847 (2017); *Litchfield Asset Mgmt. Corp. v. Howell*, 799 A.2d 298 (Conn. App. 2002); *Great Neck Plaza, L.P. v. Le Peep Restaurant, LLC*, 37 P.3d 485 (Colo. App. 2001); *In re Schwab*, 378 B.R. 854 (Bankr. D. Minn. 2007). *See also In re Turner (Kendall v. Turner),* 335 B.R. 140 (Bankr. N.D. Cal. 2005). *Cf. In re Schaefers,* 2020 WL 7687871 (B.A.P. 9th Cir. 2020) (affirming bankruptcy court's rejection of individual debtor's attempt to use reverse veil piercing to claim homestead exemption in LLC's real property notwithstanding that state court relied on reverse veil-piercing principles to conclude individual debtor's LLC was his alter ego for purposes of allowing individual's creditor to reach LLC's property; noting that separate existence of entity is disregarded so that owners will be liable for entity's acts or vice versa, but veil piercing almost never allows person who actually dominates and controls company to disregard company's separate existence); *In re Bianchini (Bianchini v. Ryan)*, 346 B.R. 593 (Bankr. D. Conn. 2006) (commenting that many jurisdictions permit both offensive and defensive reverse piercing, but declining to allow debtor to benefit by disregarding record title to property placed in LLC for unjust purposes).

C. Liability of Members for Wrongful Distributions

The BOC prohibits a distribution by an LLC to its members if the distribution would leave the LLC insolvent using a balance sheet test. The statute provides that an LLC may not make a distribution to a member if, immediately after the distribution, the company's total liabilities (excluding liabilities to members for unpaid distributions) would exceed the company's total assets. Tex. Bus. Orgs. Code § 101.206(a), (b)(1). If the LLC has any liability for which recourse is limited to specific assets of the LLC, the liability is excluded from the calculation. Tex. Bus. Orgs. Code § 101.206(b)(2). Likewise, the calculation includes the fair value of an asset subject to a liability for which recourse of the creditor is limited only to the extent that the fair value of the asset exceeds the liability. Tex. Bus. Orgs. Code § 101.206(c).

The BOC provides that a member who impermissibly receives a distribution has no obligation to return it to the LLC unless the member knew that it violated the statutory restriction. Tex. Bus. Orgs. Code § 101.206(d). The statute does not expressly grant creditors the right to enforce the return of a distribution to the LLC, but a court might recognize a creditor's standing to bring a derivative action to do so. The statute does not affect any obligation a member may have to return a distribution under "other state or federal law." Tex. Bus. Orgs. Code § 101.206(e). Thus, the United States Bankruptcy Code (11 U.S.C. §§ 101 et seq.) and Texas Uniform Fraudulent Transfer Act (Tex. Bus. & Com. Code §§ 24.001 et seq.) present creditors with other means to pursue recovery. *See In re Brentwood Lexford Partners, LLC*, 202 B.R. 255 (Bankr. N.D.Tex. 2003) (holding certain excess cash-flow distributions to LLC members were fraudulent transfers because they were made with intent to hinder or delay collection of a note owed by the LLC). Knowledge or intent is not always required under these other fraudulent transfer provisions. *See* Tex. Bus. & Com. Code § 24.006(a).

In 2009, the BOC was amended to clarify that the limitation on distributions to LLC members does not include payments to members for reasonable compensation or reasonable payments in the ordinary course of business pursuant to a bona fide retirement plan or other benefits program. Tex. Bus. Orgs. Code § 101.206(f). In addition, the statute was amended to make clear that a distribution that is in compliance with Chapter 11 of the BOC does not violate the limitation on distributions. Tex. Bus. Orgs. Code § 101.206(a). In other words, an LLC that is winding up might technically be insolvent as a result of a distribution but would not violate the limitation on distributions if "adequate provision" has been made for the payment of the remaining liabilities, such as by the assumption of the liabilities by a purchaser of the LLC's assets. *See* Tex. Bus. Orgs. Code § 11.053(a).

The limitation on distributions under the BOC is primarily for the protection of creditors but also protects members from the undue depletion of LLC assets. Additionally, the company agreement may impose stricter requirements on members to return distributions. The statute expressly provides that it does not affect any obligation of the members under the company agreement to return a distribution. Tex. Bus. Orgs. Code § 101.206(e). Release of a member's obligation to return an impermissible distribution requires consent of all members unless otherwise provided by the company agreement. Tex. Bus. Orgs. Code § 101.154. A creditor who acts in reliance on an enforceable obligation to return a distribution may enforce the obligation even though it has been settled or released if the obligation is stated in a document that is signed by the member and the document has not been amended or canceled to evidence the release or settlement. Tex. Bus. Orgs. Code § 101.155.

D. Liability of "Directors and Officers" for Debts Incurred After Tax Forfeiture of LLC

As discussed in II.D. above, forfeiture of a corporation's privileges due to failure to pay franchise taxes or file required reports results in personal liability of directors and officers for certain corporate debts. Under the Tax Code, "[i]f the corporate privileges of a corporation are forfeited for the failure to file a report or pay a tax or penalty, each director or officer of the corporation is liable for each debt of the corporation that is created or incurred in this state after the date on which the report, tax, or penalty is due and before the corporate privileges are revived." Tex. Tax Code § 171.255(a). Issues arising in interpreting and applying these provisions are further discussed in II.D. above. Although these provisions are expressed in corporate terms, they also apply to other taxable entities, such as limited partnerships and limited liability companies. Tex. Tax Code § 171.2515(b). The statute does not state who is a "director" or "officer" of an LLC for purposes of Section 171.255. The Public Information Report required by the Tax Code to be filed annually by a corporation or LLC requires the entity to list each officer and director of the entity. Tex. Tax Code 171.203. The instructions to the Public Information Report state that an LLC should list its managers, its members, if the LLC is member-managed, and its officers, if any. *See Bruce v. Freeman Decorating Servs., Inc.*, 2011 WL 3585619 (Tex. App.—Houston [14th Dist.] 2011, pet. denied) (rejecting argument that Section 171.255 only applies to corporations and holding that individual who signed LLC's Public Information Reports in years preceding forfeiture and who was listed as officer and/or director of LLC in such reports could reasonably be inferred to be officer or director at time debt at issue was created or incurred and was personally liable for amounts owed for services provided to LLC after forfeiture).

E. Liability for Committing or Knowingly Participating in Tortious or Fraudulent Acts

As noted above in Section II.E., traditionally courts have held that corporate officers are personally liable when they commit or knowingly participate in tortious or fraudulent acts even though the conduct occurred while the officer was acting on behalf of the corporation. *See, e.g., Gore v. Scotland Golf, Inc.*, 136 S.W.3d 26, 32 (Tex. App.—San Antonio 2003, pet. denied); *Kingston v. Helm*, 825 S.W.3d 755, 764-67 (Tex. App.—Corpus Christi 2002, pet. denied). Similarly, Texas courts have held that LLC members and managers are liable for their own fraudulent or tortious acts even if the acts are committed in the service of the LLC. *See Nwokedi v. Unlimited Restoration Specialists*, 428 S.W.3d 191 (Tex. App.—Houston [1st Dist.] 2014, pet. denied) (holding controlling member of LLC was personally liable for knowingly participating in LLC's fraud in relation to LLC's contract and fraudulent transfers of LLC assets based on the principle that a corporate officer who knowingly participates in tortious or fraudulent acts may be held individually liable to third persons even though the officer was acting as an agent of the corporation); *see also In re Arnette,* 454 B.R. 663 (Bankr. N.D. Tex. 2011); *In re Williams,* 2011 WL 240466 (Bankr. W.D. Tex. 2011); *Sanchez v. Mulvaney*, 274 S.W.3d 708, 712 (Tex. App.—San Antonio 2008, no pet.); *LJ Charter, L.L.C. v. Air America Jet Charter, Inc.*, 2009 WL 4794242 (Tex. App.—Houston [14th Dist.] 2009, pet. denied). There is currently come disagreement among courts, however, with respect to whether statutory requirements applicable in the veil-piercing context apply when a claimant seeks to hold a corporate or LLC agent liable for committing a tortious act in connection with a contractual obligation of the entity. Most courts have held that the statutory actual-fraud requirement applicable in a veil-piercing case does not protect corporate shareholders/officers from liability for their own torts, even though such torts may have occurred while acting on behalf of the corporation in the context of a contractual transaction between the corporation and the plaintiff, but some recent cases have held that Tex. Bus. Orgs. Code § 21.224 precludes holding a corporate or LLC agent liable for a tortious act related to a contractual obligation of the entity unless the agent caused the entity to be used to perpetrate an actual fraud for the agent's direct personal benefit. *See, e.g., TecLogistics, Inc. v. Dresser-Rand Group, Inc.,* 527 S.W.3d 589 (Tex. App.—Houston [14th Dist.] 2017, no pet.); *Hong v. Havey*, 551 S.W.3d 875 (Tex. App.—Houston [14th Dist.] 2018, no pet.). In *Bates Energy Oil & Gas v. Complete Oilfield Services*, 361 F. Supp. 3d 633 (W.D. Tex. 2019), the court thoroughly discussed the traditional distinction between direct liability and liability based on veil piercing, and the court traced recent developments reflecting a lack of consensus by courts regarding direct liability of corporate and LLC agents for torts related to a contractual obligation of the entity.

In *Phelps v. Hunt (In re Hunt)*, 608 B.R. 477 (Bankr. N.D. Tex. 2019), Phelps sought to establish a non-dischargeable claim against Hunt, the owner and manager of Tea 2 Go, LLC, based in part upon alleged fraud committed by Hunt in connection with the purchase by Phelps of franchise rights from Tea 2 Go, LLC. The court noted that a manager/member of an LLC is not individually liable for contractual debts and obligations of the LLC unless there is a finding that the debt or obligation was incurred through actual fraud for the direct personal benefit of the manager/member. Phelps alleged that he was defrauded by Hunt and that such fraud personally benefitted Hunt. The court observed that actual fraud in the veil-piercing context is not equivalent to the tort of fraud. Rather, actual fraud is defined as involving dishonesty of purpose or intent to deceive. The court stated that if it could not conclude that Hunt's conduct amounted to actual fraud under Texas law, then there can be no debt to discharge, rendering moot any dischargeability issue under § 523(a)(2)(A) of the Bankruptcy Code. The court stated, however, that Hunt could also be liable, without the need for veil piercing, if he personally committed a fraudulent or intentionally tortious act. The court noted that agents of corporations are personally liable for their own tortious conduct under the common law. Tea 2 Go, LLC's company agreement did not appoint an agent, but it did vest the manager (Hunt) with authority to designate an agent at the manager's sole discretion. Moreover, § 101.254(a) of the BOC provides that "each governing person of a limited liability company and each officer of a limited liability company vested with actual or apparent authority by the governing authority of the company is an agent of the company for purposes of carrying out the company's business." The court concluded, therefore, that Hunt was an agent of Tea 2 Go, LLC and was carrying out the company's business when transacting with Phelps regarding the franchise sales. If Hunt obtained funds from Phelps by "false pretenses, a false representation, or actual fraud" with the requisite intent, Hunt could be held personally liable for such conduct as an agent of Tea 2 Go, LLC.

In *Watkins v. Basurto*, 2011 WL 1414135 (Tex. App.—Houston [14th Dist.] 2011, no pet.), the court noted that Texas law is unsettled as to whether an agent of a corporation or LLC can be held individually liable for the tort of negligent hiring or supervision, i.e., whether an agent owes a duty to third parties to properly hire or supervise other agents of the principal.

Statutory or regulatory provisions may be interpreted in some cases to impose personal liability on LLC members, managers, or other agents for their actions or omissions constituting or causing violations by the entity. *See, e.g., Morello v. State*, 547 S.W.3d 881 (Tex. 2018).

F. Liability on LLC's Contract as Agent of Partially Disclosed Principal or as Guarantor

As noted above in Section II.F., an agent is not liable on a contract entered into on the principal's behalf if the agent discloses the agent's representative capacity and the identity of the principal. Conversely, if the representative capacity of the agent and the identity of the agent's principal are not disclosed to the other party to the contract at the time the contract is entered into, the agent is personally liable on the contract. Restatement (Third) of Agency §§ 6.01, 6.02 (2006); Restatement (Second) of Agency §§ 320, 322 (1957). There are numerous Texas cases applying these principles in the context of contracts entered into by corporate agents. The common corporate practice of doing business under assumed or trade names creates some peril for officers and other agents who contract under the assumed or trade name of the corporation without disclosing the actual legal name of the corporation. *See, e.g., John C. Flood of DC, Inc. v. SuperMedia, L.L.C.*, 408 S.W.3d 645 (Tex. App.—Dallas 2013, pet. denied); *Lake v. Premier Transp.*, 246 S.W.3d 167 (Tex.App.– Tyler 2007, no pet.); *Wynne v. Adcock Pipe and Supply*, 761 S.W.2d 67 (Tex.App.—San Antonio 1988, no writ); *A To Z Rental Center v. Burris,* 714 S.W.2d 433 (Tex. App.—Austin 1986, writ ref'd n.r.e.). The filing of an assumed name certificate that discloses the legal name of the corporation does not in itself protect agents who contract in the assumed name of the corporation because Texas courts have stated that actual knowledge or reason to know the principal's identity is the test of disclosure and that third parties have no duty to search for this information. *Wynne v. Adcock Pipe and Supply*, 761 S.W.2d 67 (Tex. App.—San Antonio 1988, no writ); *A To Z Rental Center v. Burris,* 714 S.W.2d 433 (Tex. App.—Austin 1986, writ ref'd n.r.e.). These basic agency principles have application in the LLC as well as the corporate context. *See, e.g., Water, Waste & Land, Inc. v. Lanham*, 955 P.2d 997 (Colo. 1998) (holding member-managers of LLC personally liable under common law of agency with respect to contract entered into on behalf of LLC where LLC was partially disclosed principal).

Even if an agent discloses the identity of the principal and signs a contract indicating the agent's representative capacity, the language of the contract may subject the agent to liability as a guarantor or party to the contract. *See 84 Lumber Co., L.P. v. Powers*, 393 S.W.3d 299 (Tex. App.—Houston [1st Dist.] 2012, pet. denied) (holding individual who signed credit application as president of corporation liable as personal guarantor of the corporation's debt based on language above the signature line stating that the signatory personally guaranteed the credit account of the corporation); *Wholesale Builders Supply, Inc. v. Green-Source Dev., L.L.C.*, 2013 WL 6175210 (Ohio App. 2013) (holding individual who signed LLC credit application was personally liable based on language in the credit application stating that the signatory was "both personally and corporately liable for the total of purchases by you or anyone designated to sign for your purchases on your account"). Corporate and LLC representatives should be vigilant when signing credit applications and other contracts on behalf of the corporation or LLC in order to avoid subjecting themselves to personal liability under provisions that may be interpreted to obligate signatories in their individual capacities.

IV. Limited Partnerships

In the 1990s and early 2000s, limited partnerships increased in popularity for franchise tax reasons. Effective January 1, 2008, limited partnerships generally became subject to a revised franchise tax (the so-called "margin tax"). Limited partnerships that qualify as "passive" under the margin tax provisions are exempt from the margin tax, but limited partnerships are generally subject to the margin tax. The issues associated with liability protection in the limited partnership form are more complicated than they are in the corporate or LLC form. With the elimination of the state tax advantage that limited partnerships have enjoyed and the additional complexities associated with owner liability protection, limited partnerships have decreased in popularity, at least for operating businesses.

A. General Partner Personal Liability

General partners in a limited partnership have joint and several personal liability for all the debts and obligations of the partnership. Corporate or LLC general partners are commonly used to minimize this disadvantage; however, this technique complicates the structure and involves some additional expense (legal and filing fees associated with formation of an additional entity, franchise tax obligations of the entity general partner, accounting fees associated with filing an additional tax return, etc.). Liability issues associated with this more complicated structure are further discussed below.

B. Limited Partner Limited Liability; Statutory Exceptions

Under the Texas Revised Limited Partnership Act (TRLPA), a limited partner was not liable for partnership debts and obligations unless (i) the limited partner was also a general partner, (ii) the limited partner participated in the control of the business and a person transacting business with the limited partnership reasonably believed, based upon the limited partner's conduct, that the limited partner was a general partner, or (iii) the limited partner permitted its name to be used in the partnership name and a creditor extended credit to the partnership without knowledge that the limited partner was not a general partner.[6] Tex. Rev. Civ. Stat. art. 6132a-1, § 3.03 (expired eff. Jan. 1, 2010). Section 153.102 of the Business Organizations Code carries forward these rules with one exception. The prohibition on use of a limited partner's name in the limited partnership name (and the resulting potential liability if the limited partner's name is so used) was not carried forward in the BOC. *See* Tex. Bus. Orgs. Code §§ 5.055, 153.102.

The risk associated with participation in the control of the business may appear at first blush to be a substantial threat to a limited partner's liability protection; however, the statute's lengthy laundry list of activities that are deemed

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[6]There were certain exceptions to the TRLPA prohibition on use of a limited partner's name in the partnership name. The TRLPA permitted a limited partner's name to be used in the partnership name in the following circumstances: (i) the limited partner's name was also the name of a general partner, or (ii) the business of the limited partnership had been carried on under that name prior to admission of the limited partner. Tex. Rev. Civ. Stat. art. 6132a-1, § 1.03(1) (expired eff. Jan. 1, 2010).

not to constitute participation in the control of the business provides a limited partner substantial leeway in this area.[7] Tex. Bus. Orgs. Code § 153.103. The list of specified activities that are not deemed to constitute participation in the control of the business is not an exclusive list; therefore, other activities not specified in the list may also be determined to fall outside the scope of participation in the control of the business. Tex. Bus. Orgs. Code § 153.104. Even if a limited partner's activities fall outside the safe harbor and constitute participation in the control of the business, the reliance test provides another hurdle a creditor must overcome to hold the limited partner liable as a general partner. Tex. Bus. Orgs. Code § 153.102(b).

The statutory laundry list of capacities and powers that do not constitute participation in control by a limited partner is quite broad. For example, the provision states that a limited partner does not participate in control so as to risk liability for the partnership's obligations if the limited partner acts as (1) a contractor for or an officer or other agent or employee of the partnership; (2) a contractor for or an agent or employee of a general partner; (3) an officer, director, or shareholder of a corporate general partner; (4) a partner of a partnership that is a general partner; (5) a member or manager of an LLC general partner; (6) or any similar capacity with any person that is a general partner. Tex. Bus. Orgs. Code § 153.103(1) and (2). This provision is frequently relied upon to involve limited partners in management of the limited partnership through ownership and management of a corporate or LLC general partner.

C. Risk Associated With Complexity of Corporate or LLC General Partners

As noted above, corporate or LLC general partners are frequently used to avoid exposing individuals to liability as general partners. Often, one or more individuals involved in the corporate or LLC general partner are limited partners who must avoid "participating in control" of the business of the partnership to preserve their liability protection as limited partners. The statutory carve-outs regarding participation in control permit a limited partner to act as shareholder, officer, or director of a corporate general partner, or a member or manager of an LLC general partner, and, theoretically, there should be little risk in doing so. However, the practical down-side is the complexity that comes with this approach. Consider the proper signature form for a limited partnership contract being executed by an individual acting as president of the corporate general partner:

XYZ Enterprises, LTD.
By: XYZ Management, Inc., general partner

By: ____________________________
Jane Jones, president

It would not be surprising if Jane Jones forgot one or more designations involved in the various agency relationships reflected above. If Jane Jones is sloppy in this regard, there may then be an issue as to the capacity in which she was acting or appeared to be acting, and her liability protection may be jeopardized. It may be easier for Jane Jones to understand and remember her role if she is simply appointed an officer of the limited partnership. Though there was no explicit provision in the TRLPA regarding officers of a limited partnership, Section 3.03 recognized that a limited partner may serve as an "agent" of the limited partnership without thereby "participating in control" of the partnership, and there was nothing in the TRLPA that would appear to preclude the partnership agreement from providing for officer/agents. Section 3.103 of the BOC expressly provides for the election or appointment of officers by any type of domestic entity, including a limited partnership. In 2009, a new section was added to the BOC to make the partnership's authority to appoint officers under Section 3.103 even clearer. Tex. Bus. Orgs. Code § 151.004. The list of capacities in which a limited partner may serve without risking liability as a general partner (which already included acting as an agent or employee of the limited partnership) was also amended to add a specific reference to acting as an officer. Tex. Bus. Orgs. Code § 153.103(1)(A).

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[7]The limited partnership statutes of most other states contain similar provisions exposing a limited partner to liability for participation in the control of the business and providing safe harbor activities that do not constitute participation in the control of the business. The new Uniform Limited Partnership Act (2001) ("ULPA 2001"), which is a complete revision of the prior Revised Uniform Limited Partnership Act (1976 with 1985 amendments), provides for limited liability of limited partners without regard to whether they participate in the control of the business. As of the beginning of 2021, ULPA 2001had been adopted in twenty-one states and the District of Columbia.

The risk attendant to structures in which a limited partner is careless while relying on the statutory safe harbors is illustrated by *OCP, S.A. v. Colorado OTR, LP*, 2013 WL 6491170 (S.D. Tex. 2013). In that case, the plaintiff sought to hold Harris personally liable on breach-of-contract and warranty claims arising out of the plaintiff's purchase of 42 off-the-road tires from a limited partnership. The jury found that Harris, a limited partner, participated in the control of the limited partnership and that the plaintiff reasonably believed that Harris was a general partner based on his conduct. Harris argued that there was no evidence that he participated in the control of the business so as to render him liable because he engaged only in conduct protected by the safe harbor provisions of Section 153.103(1)(A), (B), and (E) of the BOC. Specifically, Harris claimed that he was acting at all times in his capacity as the managing member of the LLC general partner or as president and CEO of the limited partnership. At trial, however, the evidence showed that Harris, while negotiating a contract with the plaintiff, signed correspondence identifying himself as "Partner–Colorado OTR LP," not as an agent, employee, or officer of the partnership. Further, he handed out business cards representing himself as "partner." The plaintiff's witnesses testified that they believed Harris was the person in charge at the limited partnership's business and that they were unaware that he was president of the company. The court concluded that this was ample evidence to support the jury's findings that Harris participated in the control of the limited partnership as if he were a general partner and that, as a result of his conduct, the plaintiff reasonably believed that Harris was a general partner when the plaintiff agreed to the contract.

In *Humphreys v. Medical Towers, Ltd.*, 893 F.Supp. 672 (S.D. Tex.1995), aff'd without opinion, 100 F.3d 952 (5th Cir.1996), a building manager brought a sexual harassment suit against her employer, a limited partnership that owned the building. The plaintiff also sued an individual, Lawson, who was a limited partner and the sole shareholder and president of the corporate general partner. The court acknowledged that Section 3.03 of the TRLPA provided that a limited partner was not liable for the obligations of the partnership unless the limited partner participated in the control of the business and a person transacting business with the partnership reasonably believed that the limited partner is a general partner. The court also acknowledged that Section 3.03 stated that a limited partner did not participate in the control of the business by acting as an officer, director, or shareholder of a corporate general partner. Nevertheless the court denied Lawson's motion for summary judgment. In support of its conclusion that there were fact issues on this matter, the court noted the following: the plaintiff's assertion that Lawson controlled all aspects of the business; the plaintiff's assertion that she reasonably believed him to be a general partner since he reported to no one else and had complete control of the limited partnership; the plaintiff's assertion that Lawson never said he was merely a limited partner and that she did not see any document stating that he was merely a limited partner; deposition testimony from the bookkeeper of the partnership that Lawson was the general partner; deposition testimony from the stationary engineer that Lawson owned the building.

A New York bankruptcy court engaged in a lengthy analysis of Section 17-303 of the Delaware Revised Uniform Limited Partnership Act in the case of *In re Adelphia Communications Corp.*, 376 B.R. 87 (Bankr. S.D. N.Y. 2007). Section 17-303 of the Delaware limited partnership statute, like the BOC and predecessor TRLPA provisions, provides that a limited partner is not liable for the obligations of a limited partnership unless the limited partner is also a general partner or, in addition to the exercise of the rights and powers of a limited partner, participates in the control of the business. The Delaware statute also provides, like the Texas provisions, that a limited partner who participates in the control of the business is liable only to persons who transact business with the partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner. The New York bankruptcy court concluded, however, that this provision can result in liability to a third party based on the limited partner's acting as a *de facto* general partner even if the third party has actual knowledge of the limited partner's "on paper" status as a limited partner.

In *Asshauer v. Wells Fargo Foothill*, 263 S.W.3d 468 (Tex. App.—Dallas 2008, pet. denied), investors in several limited partnerships sued the mezzanine lender, Wells Fargo, who also became a limited partner of the master partnership. The trial court dismissed the plaintiffs' suit against Wells Fargo on the basis that the plaintiffs did not have standing to sue for injuries suffered by the partnerships. The plaintiffs argued that the limited partnerships were set up to perpetuate fraud and that the entities should be ignored so that the plaintiffs could sue Wells Fargo in their own capacities. The court stated that it would have to ignore the rules in Section 3.03(a) of the TRLPA to accept the argument made by the plaintiffs because nothing in the TRLPA provided an exception for a limited partner to sue the limited partnership or another limited partner directly when the entities were allegedly part of a fraudulent scheme. To the extent the plaintiffs argued that Wells Fargo was a *de facto* general partner, the court concluded that they failed to plead any facts that would establish Wells Fargo acted as a general partner or participated in the control of the business, or that the plaintiffs conducted business with Wells Fargo because they reasonably believed it was a general partner.

D. Veil Piercing of Limited Partnership or Entity General Partners

1. Piercing (and Reverse Piercing) the Limited Partnership Veil

There is little case law dealing with veil piercing of limited partnerships, presumably because there is always at least one general partner who has personal liability for the debts and obligations of the partnership (absent an LLP registration, which is a relatively recent phenomenon and is not available to limited parnerships in all states). When veil piercing of the limited partnership has been pursued, it has tended to involve a reverse-piercing claim to hold the limited partnership liable with respect to liabilities of the general partner. For example, in *Carr v. Weiss*, 984 S.W.2d 753 (Tex. App.—Amarillo 1999, pet. denied), the general partner of an Oklahoma limited partnership was held liable for damages and constructive trust arising out of breach of an oral agreement to purchase and jointly own an apartment complex. The limited partnership, which held title to the apartment complex, was found to be the general partner's alter ego and thus jointly and severally liable with the general partner. In *Northern Tankers (Cyprus) Ltd. v. Backstrom*, 967 F.Supp. 1391 (D.Conn.1997), a federal maritime case, the court applied the alter-ego theory to reverse pierce various entities the court found were fraudulently created as personal investment vehicles for an individual. The court was apparently referring to a group of entities that owned substantial real estate and personal property in Colorado. The group consisted of a grantor trust, two corporations, a limited partnership, and two LLCs. The court specifically found that the limited partnership and its corporate general partner were "alter egos" of the individual and expressly disregarded their "corporate" existence. In *C. F. Trust, Inc. v. First Flight Limited Partnership*, 580 S.E.2d 806 (Va. 2003), the Virginia Supreme Court held that Virginia recognizes the concept of outsider reverse veil-piercing and that the concept can be applied to limited partnerships.

In *Lifshutz v. Lifshutz*, 61 S.W.2d 511 (Tex. App.—San Antonio 2001, pet. denied), the trial court pierced the veil of various corporate and partnership entities in which the husband's ownership interests were separate property in order to reach and characterize assets of the entities as community property. On appeal, the court held that the Texas Revised Partnership Act did not permit a court to award assets of a partnership to a non-partner spouse in a divorce action, relying on Section 5.01 of the TRPA (dealing with partnership property) and the commentary to that section.

As amended in 2007, the charging order provision of the limited partnership statute provides that "[a] creditor of a partner or of any other owner of a partnership interest does not have the right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited partnership." Tex. Bus. Orgs. Code § 153.256(f); *see also* Tex. Rev. Civ. Stat. art. 6132a-1,§ 7.03(e) (expired Jan. 1, 2010). This provision might be interpreted to preclude reverse piercing of a Texas limited partnership by a partner's creditor. On the other hand, a creditor of a partner could presumably still resort to the fraudulent transfer statutes to recover property fraudulently transferred to the limited partnership, and it might similarly be argued that disregard of the limited partnership's separate existence under reverse-piercing principles is not precluded by the charging order provision.

Several Texas courts of appeals have held that traditional corporate veil-piercing principles are inapplicable to a partnership. In *Pinebrook Properties, Ltd. v. Brookhaven Lake Property Owners Ass'n*, 77 S.W.3d 487, 499-500 (Tex. App.—Texarkana 2002, pet. denied), the court reasoned that "there is no veil that needs piercing, even when dealing with a limited partnership, because the general partner is always liable for the debts and obligations of the partnership to third parties." In *Asshauer v. Wells Fargo Foothill*, 263 S.W.3d 468 (Tex. App.–Dallas 2008, pet. denied), the court relied upon *Pinebrook Properties* and similarly concluded that alter-ego or other corporate veil-piercing principles are inapplicable to a limited partnership because the general partner is always liable for the debts and obligations of the partnership and there is thus no veil that needs piercing. In *Peterson Group, Inc. v. PLTQ Lotus Group, L.P.*, 417 S.W.3d 46 (Tex. App.—Houston [1st Dist.] 2013, pet. denied), the court noted that "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," and the court concluded that "[t]o impose a limited partnership's liability on its limited partner in this case under the guise of the equitable veil-piercing doctrine would eviscerate the statutory framework governing the limitation of liability of limited partnerships as expressed in section 153.102(b)" of the BOC. The claimant did not assert that the limited partner could be held liable under Section 153.102, and the court of appeals held that the trial court erred in applying equitable veil-piercing principles to impose liability on the limited partner. *See also Seidler v. Morgan*, 277 S.W.3d 549 (Tex. App.—Texarkana 2009, pet. denied) (stating that veil-piercing claim against individual who was officer and shareholder of corporate general partner would have to occur through general partner and not limited partnership because veil piercing is inapplicable to limited partnerships); *Waller v. DB3 Holdings, Inc.*, 2008 WL 373155 (N.D. Tex. 2008) (stating that parties who sought to hold limited partner liable were essentially disregarding formal statutory rules and advancing what appeared to be veil-piercing theory, commenting that claimants cited no authority for such proposition, and noting that at least one court has rejected application of veil piercing to limited partnerships (citing *Pinebrook*

Properties)); *In re Heritage Org., L.L.C. (Faulkner v. Kornman)*, 413 B.R. 438 (Bankr. N.D. 2009) (noting that it was unclear if alter-ego theory applies to limited partnerships in Delaware and finding reasoning in *Pinebrook Properties* persuasive given similarity between Texas and Delaware limited partnership statutes); *ADD Real Estate, Ltd. v. United States*, 2009 WL 10677322 (E.D. Tex. 2009) (stating in footnote that alter-ego theory does not apply to partnerships in Texas and that IRS failed to produce substantial evidence indicating limited partnership was alter ego of taxpayer even if court assumed alter-ego theory could apply to limited partnerships); *Prospect Energy Corp. v. Dallas Gas Partners, LP*, 761 F.Supp.2d 579 (S.D. Tex. 2011) (noting that veil-piercing theories do not apply to Texas limited partnerships to reach limited partners but holding limited partners liable for breach of covenant not to sue because limited partners signed covenant in individual capacities).

The reasoning that veil-piercing principles do not apply to a limited partnership because there is always a general partner with personal liability for the debts and obligations of the partnership obviously raises the question of the applicability of veil piercing to limited liability partnerships. Texas courts have not discussed that issue. One court appears to have confused LLPs and limited partnerships in concluding that the alter-ego theory would not apply to the relationship between an LLP and one of its partners. *See Skidmore Energy, Inc. v. KPMG*, 2004 WL 3019097 (N.D. Tex. 2004) (citing *Pinebrook Properties* in support of statement that alter-ego liability was inapplicable to relationship between KPMG LLP and its Moroccan member firm because KPMG is not corporate entity but rather is LLP organized under Delaware law). *Cf. Joiner v. Coast Paper & Supply*, 2008 WL 2895851 (Tex. App.—Corpus Christi 2008, no pet.) (analyzing personal jurisdiction with respect to individuals who were limited partners as well as officers and shareholders of corporate general partner of limited partnership and citing *Pinebrook Properties* for proposition that alter-ego doctrine is not applicable "'with regard to a limited liability partnership [sic] because there is no veil that needs piercing'").

Notwithstanding the statements in the numerous cases cited above that the alter-ego doctrine does not apply to limited partnerships, some courts applying Texas law have entertained the possibility of applying veil-piercing principles to limited partnerships. In *Genssler v. Harris County*, 584 S.W.3d. 1 (Tex. App.—Houston [1st Dist.] 2010, no pet.), the court analyzed the claim that an individual was liable for environmental violations committed by a group of entities that owned and operated two waste water facilities. Harris County and the State of Texas had obtained a receivership over the individual's property on the theory that the individual was the alter ego of the entities. The designators in the names of the entities indicate that the group of entities consisted of a limited partnership, two limited liability partnerships, and a limited liability company, but the court did not specify or discuss the nature of the entities. The court spoke in general terms about the separate legal existence of a "business entity" and the application of the alter-ego theory when "there is such unity between the business entity and the individual that the business entity has ceased to be a separate entity, and allowing the individual to avoid liability through the use of the business entity would work an injustice." The court analyzed the evidence and concluded the entities were not the individual's alter ego because there was no evidence he diverted profits for his individual use, owned any interest in the entities, or personally paid any debts owed by the entities. There was testimony that the individual was the president, the "man in charge," and "made all the decisions," but the court stated that the individual's status as an officer or director, standing alone, was insufficient to support application of the alter-ego theory.

In *Shoop v. Devon Energy Production Company, L.P.*, 2013 WL 12251353 (N.D. Tex. 2013), the court held that there was a material fact issue as to whether the defendant limited partnership and an affiliated limited partnership should be treated as the same entity on the basis that they entered into a "sham transaction" to deprive the plaintiff of higher royalties. The court explained that "alleging a sham transaction is a vehicle to disregard the lines between legally distinct entities in an effort to avoid a transaction without imputing liability." In other words, the plaintiffs were not attempting to impute liability but rather were alleging that the sale between the defendant and its affiliate should be disregarded because the defendant and its affiliate should be treated as one and the same. The defendant relied on the Texas Supreme Court's holding in *SSP Partners v. Gladstrong Investments (USA) Corp.*, 275 S.W.3d 444, 447 (Tex. 2008), that affiliates cannot be liable for each other's actions under the single business enterprise doctrine, but the court distinguished the case as follows: "[W]hile the Texas Supreme Court noted that it has never 'approved of imposing joint liability on separate entities merely because they were a part of a single business enterprise,' the issue in *that case* did not involve a theory espousing that the corporate structure was abused to 'perpetuate fraud.' *SSP Partners*, 275 S.W.3d at 451. Rather than hitting a brick wall by merely alleging corporate affinity, this claim positively breaks through with evidence supporting the notion a corporate structure was 'used as part of a basically unfair device to achieve an inequitable result." *Id.* (quoting *Castleberry v. Branscum*, 721 S.W.2d 270, 271 (Tex. 1986)).'"

A Texas bankruptcy court applied the alter-ego doctrine to a limited partnership and concluded it was a "straw man" for the benefit of individuals who would not otherwise be able to collect on a judgment against the debtors because the individuals were co-defendants with the debtors. *In re Sewell (Alvarado Land Dev., Inc. v. Sewell)*, 413 B.R. 562 (Bankr. E.D. Tex. 2009). The court recognized the principle that a limited partnership is an entity separate and distinct from its partners, but stated that Texas law allows the separateness of the entity to be ignored if the limited partnership is used as a straw man for the purpose of obtaining an impermissible result under Texas law. Relying on corporate veil-piercing principles, the court concluded that the limited partnership, assuming it paid and was assigned the judgment that it was trying to collect against the debtors, was acting as a straw man for individuals who were also judgment debtors and thus was not a creditor with standing to bring an action against the debtors.

In *Gandy Marketing. & Trucking, Inc. v. Tree Town Holdings, Ltd.*, 2010 WL 11579503 (S.D. Tex. 2010), report and recommendation adopted, 2010 WL 11579494 (S.D. Tex. 2010), the court held that there were fact issues precluding summary judgment with respect to the IRS's claims that a taxpayer fraudulently transferred assets to a limited partnership and other entities and that the limited partnership and other entities were the alter ego or nominee of the taxpayer.

The bankruptcy court in the case of *In re Adelphia Communications Corp.*, 376 B.R. 87 (Bankr. S.D. N.Y. 2007) concluded that there was nothing in the nature of a limited partnership (though the court mistakenly referred to a limited partnership as a limited liability partnership) that would preclude recourse to veil piercing as an equitable remedy in appropriate circumstances, but commented that veil piercing may not be used as an "end run" around the proof required under the statute to hold a limited partner liable based upon the limited partner's participation in the control of the partnership, and the court further commented that a claimant likely would not be able to meet the more stringent requirements to pierce the partnership veil if the claimant could not meet its burden to establish liability under the statutory provisions.

2. Piercing the Entity General Partner

The use of entity general partners to shield upstream parties from liability has become common. *See, e.g., Peterson Grp., Inc. v. PLTQ Lotus Grp., LP*, 417 S.W.3d 46 (Tex. App.—Houston [1st Dist.] 2013, pet. denied); *Ted Trout Architect Assocs., Ltd. v. Basaldua*, 2013 WL 4318695 (Tex App.—Houston [14th Dist.] 2013, no pet.). Often these entities are formed for the sole purpose of serving as general partner of the limited partnership, and the activities of such an entity thus consist solely of acting in a managerial capacity for the partnership. One question that may arise in such a case is what level of capitalization is appropriate to avoid being characterized as "undercapitalized" for veil-piercing purposes. There is not a great deal of case law addressing this or other veil-piercing issues in this context. In the cases in which the issue has arisen, some courts have been more receptive to veil-piercing arguments than others.

In *Paul Steelman, Ltd. v. Omni Realty Partners*, 885 P.2d 549 (Nev.1994), the Nevada Supreme Court was not troubled by a corporate general partner that was capitalized with only a $200 receivable. In that case, a partnership creditor sought to hold the shareholders of the corporate general partner personally liable for a partnership debt. The court acknowledged that the corporation was formed to shield individuals from liability as general partners. The plaintiff claimed that the corporate general partner should be pierced because it was intentionally undercapitalized. Although the corporation was only capitalized with a $200 receivable, the court stated that the real value of the corporation was best measured by the collective expertise of its shareholders. The court noted that the record established that the manner of capitalization was not uncommon for corporations of its type and that the limited partnership itself was adequately capitalized. The court stated that undercapitalization is only one factor to be considered in a piercing case and concluded that, assuming *arguendo* the corporation was undercapitalized, there was no showing the corporation was a sham designed to perpetuate fraud or injustice.

In *Pinebrook Properties, Ltd. v. Brookhaven Lake Owners Ass'n,* 77 S.W.3d 487 (Tex. App.—Texarkana 2002, pet. denied), the court of appeals found that there was no evidence to support the trial court's finding that an LLC general partner was the alter ego of the LLC's member. The court recognized that an LLC is a separate entity that provides liability protection to its members but went on to analyze whether there was evidence to support the trial court's alter-ego finding. The court of appeals apparently assumed that the corporate alter-ego doctrine was applicable to an LLC; however, the court found no evidence to support the finding that the LLC general partner was the alter ego of its member. (The court cited corporate veil-piercing cases and relied on Article 2.21 of the TBCA in the course of its discussion. The LLC statute was silent at that time with respect to veil-piercing standards in the LLC context; however, as discussed above, most courts have looked to the law in the corporate context both before and after the addition of Section 101.002 of the BOC.) The standard the court applied was whether there was evidence of a unity of interest between Musgrave, the LLC's member, and the LLC such that the separateness had ceased to exist and holding only the LLC as the general partner liable would result in injustice. The evidence of alter ego presented was that the LLC had no checking account and had not filed a tax return, and that Musgrave had sent a letter under his own signature without designating any representative capacity. A second letter signed without designating any representative capacity was also argued to show lack of regard for the "corporate" structure. Additionally, there was evidence that the LLC's only source of income was contributions or loans from Musgrave, and Musgrave once made a statement characterizing himself as the owner of the property owned by the limited partnership. The court noted that the evidence clearly showed that the LLC had never had the need, or been required, to file a tax return. (Presumably, the LLC was a disregarded entity for tax purposes under the check-the-box rules because Musgrave was its sole member.) The court stated that lack of corporate formalities is not a factor in determining alter ego (relying on Article 2.21A(3) of the TBCA and corporate case law) and held that there was no evidence of alter ego, pointing to the absence of evidence of any commingling of funds or that Musgrave disregarded the "corporate" structure, the fact that Musgrave was not the only manager of the LLC, and the absence of evidence that the LLC was used for personal purposes. The court's comment that the evidence revealed Musgrave was not the only manager of the LLC might lead to an inference that serving as the sole manager and member of an LLC would constitute evidence of lack of separateness. There is no reason, however, that a single member/manager LLC should be any more susceptible to veil piercing than a sole shareholder/director corporation. Both are authorized by statute, and such a structure in and of itself should not constitute any evidence of lack of separateness. *See Fin & Feather Club v. Leander,* 415 S.W.3d 548 (Tex. App.—Texarkana 2013, pet. denied) (holding there was no evidence of actual fraud to support piercing the LLC veil even if evidence established that there was only one principal of the LLC; noting that the legislature specifically authorized single-member LLCs); *Metroplex Mailing Servs., L.L.C. v. RR Donnelly & Sons Co.,* 410 S.W.3d 889 (Tex. App.—Dallas 2013, no pet.) (noting that the legislature specifically authorized single-member LLCs and holding that there was no evidence that the LLC's sole member used the LLC to commit actual fraud for the member's direct personal benefit).

A federal district court applying Texas law in *Humphreys v. Medical Towers, Ltd.,* 893 F.Supp. 672 (S.D. Tex.1995), aff'd without opinion, 100 F.3d 952 (5th Cir.1996), concluded that the sole shareholder and president of a corporate general partner was not entitled to summary judgment on the plaintiff's veil-piercing claim. In that case, a building manager brought a sexual harassment suit against her employer, a limited partnership. The general partner was a corporation. The plaintiff sued the sole shareholder and president of the corporate general partner, alleging he was personally liable because he exercised control of the business and was the alter ego of the corporate general partner. With respect to the alter-ego claim, the plaintiff pointed out that the defendant was the corporation's sole shareholder, that the corporation was undercapitalized, that it derived all of its income from the limited partnership, and that it paid some of the defendant's personal expenses. On this basis, and with little discussion, the court found that the plaintiff had raised a fact issue so as to avoid summary judgment.

Another federal district court in Texas went into greater detail in addressing the potential viability of veil-piercing claims aimed at corporate general partners of two limited partnerships that owned and operated nursing homes. In *Autrey v. 22 Texas Services Inc.*, 79 F.Supp.2d 735 (S.D. Tex. 2000), a wrongful death case arising out of the death of a nursing home resident, much of the court's attention was focused on the possible undercapitalization of the corporate general partners in issue. In the case of the corporate general partner of one of the limited partnerships, the court was concerned that the corporate general partner had a net worth of "only" $42,000 and little in the way of liquid assets when it bore "one hundred percent of the liability for the operation of numerous nursing homes." However, because the plaintiffs did not present evidence of the financial condition at the time of incorporation, the court concluded that the plaintiffs had not conclusively established undercapitalization. The corporate general partner of the other limited partnership defendant was incorporated with an initial capitalization of "only" $25,000 and had a negative net worth six months after formation. The court concluded that engaging in the ownership of 49 nursing homes while also maintaining no net assets amounted to a disputable issue regarding undercapitalization. (The overall picture was not helped by the apparent precarious financial condition of the limited partnership itself, which the court pointed out in footnotes.) As further damaging evidence, the court pointed out that the corporate general partners had no employees, office space, or expenses. In addition, with respect to the corporate general partner of one of the defendant partnerships, the court found it suspicious that there were apparently individuals who were non-functioning corporate officers.

When considering whether the corporations were adequately capitalized, the court in *Autrey* stressed that the corporate general partners were responsible for 100% of the liabilities of their respective limited partnerships. A critical step in the analysis is missing, however, if the inquiry focuses solely on whether the general partner has sufficient assets to meet the potential liabilities and obligations of the partnership. Assessment of whether a corporate general partner is adequately capitalized for its business of managing a limited partnership should include consideration of the assets and insurance of the limited partnership itself. In this regard, the defendants in the *Autrey* case argued that a combined $21,000,000 in liability insurance made the weak balance sheets of the corporate general partners of the two defendant limited partnerships irrelevant. The court, however, found more fact issues. First, the court noted that there were possible issues as to the policies' coverage of the occurrences in question. In addition, the court found significant the fact that there were questions as to whether the corporate general partners themselves were covered by the insurance, as to whether the corporate general partners secured and paid for the insurance, and whether the insurance coverage would have "transformed [the corporate general partners] into financially responsible corporate entities." With respect to the issue of injustice, the court accepted, for purposes of deciding defendants' motion for summary judgment, the plaintiff's argument that, if proved, the effort to avoid personal liability by creating sham corporate shields constitutes a type of injustice that would satisfy that element of the piercing standard.

The veil-piercing law applied by the court in *Autrey* was Pennsylvania law because the corporate general partners were incorporated in Pennsylvania. There is little to suggest, however, that the court would have approached the issue any differently under Texas law. As discussed above, under Texas law, piercing to impose liability on a shareholder for a liability of the corporation that relates to or arises out of a contractual obligation is by statute subject to a stringent actual-fraud standard. Tex. Bus. Orgs. Code § 21.223(a)(2), (b); *see also* Tex. Bus. Corp. Act art. 2.21A(2) (expired eff. Jan. 1, 2010). This statutory actual-fraud standard is not applicable, however, to a claim that does not relate to or arise out of a contractual obligation of the corporation. Thus, even under Texas law, it does not appear that the court would have been required to apply the statutory standard to the alter-ego claim. Conceivably, it might be argued that the wrongful death claim, which was based on negligent care of the nursing home resident, arose out of the nursing home's contract to provide care to the resident. It is certainly not clear that the statute may be read that broadly. That the case involved a tort claim, that the limited partnerships were in the nursing home business, and that the limited partnerships themselves may have been severely undercapitalized probably explain the court's tone. Nevertheless, the discussion highlights areas that merit consideration in structuring a limited partnership with an entity general partner. *See also House v. 22 Texas Services, Inc.*, 60 F.Supp.2d 602 (S.D. Tex. 1999), another wrongful death case against the same limited partnerships involved in the *Autrey* case. In that case, the court pierced the corporate veil of the corporate general partners to exercise personal jurisdiction over certain individual defendants who were shareholders and officers of the corporate general partners.

In *In re Houston Drywall, Inc. (West v. Seiffert)*, 2008 WL 2754526 (Bankr. S.D. Tex. 2008), the bankruptcy court concluded that an LLC that was the general partner of a limited partnership, was a "sham corporation," and that the individuals in control of the LLC were thus personally liable for breaches of fiduciary duties as general partners of the limited partnership. Although the court identified and referred to the general partner as a limited liability company in reciting the facts earlier in the opinion, the court discussed and applied corporate veil-piercing principles to the LLC as if it were a corporation. The court stated that the corporate veil may be pierced when: (1) there is such a unity that the separateness of the corporation has ceased to exist and (2) the facts are such that adherence to the fiction of the separate existence of the corporation would, under the particular circumstances, promote injustice. Matt Seiffert created the LLC to replace the initial general partner of the limited partnership. Although Seiffert's daughter was the sole member of the LLC and served as a manager and president, the court found that Seiffert, who held positions as a manager and vice president, had complete control over the LLC. Seiffert's daughter simply did as her father instructed. The court found that there was no separateness between the LLC and Seiffert and his daughter. Both individuals had "plenary authority" to take all actions they deemed necessary. Though such a grant of power is not alone sufficient to constitute unity between a corporation and individual, the court stated that the power was used to "fleece unknowing limited partners" of the limited partnership while attempting to protect Seiffert and his daughter from personal liability. Seiffert formed the LLC to replace the initial general partner without notifying all of the owners of limited partnership interests in the limited partnership and saw to it that his daughter was the sole owner of the LLC while he remained in complete control. He used his position as manager of the LLC and president of the limited partnership to transfer the partnership's only valuable unencumbered asset to himself, his three daughters, and other insiders. The court stated that allowing Seiffert and his daughter to escape liability by hiding behind the corporate veil of the LLC would unjustly benefit Seiffert and his daughters at the expense of the trustees of bankrupt limited partners who were excluded from the distribution of the partnership's asset. Thus, the court treated Seiffert and his daughter as general partners for purposes of analyzing claims for breach of fiduciary duty against them.

E. Liability of Partners of Limited Partnership for Wrongful Distributions

The BOC prohibits a distribution to partners of a limited partnership if the distribution would leave the partnership insolvent using a balance sheet test. The statute provides that a limited partnership may not make a distribution to a limited partner if, immediately after the distribution, the partnership's total liabilities (excluding liabilities to partners for unpaid distributions) would exceed the partnership's total assets. Tex. Bus. Orgs. Code § 153.210(a). If the limited partnership has any liability for which recourse is limited to specific assets of the partnership, the liability is excluded from the calculation, and the calculation includes the fair value of an asset subject to a liability for which recourse of the creditor is limited only to the extent that the fair value of the asset exceeds the liability. Tex. Bus. Orgs. Code § 153.210(a).

The BOC provides that a limited partner who impermissibly receives a distribution has no obligation to return it unless the partner knew that it violated the statutory restriction. Tex. Bus. Orgs. Code § 153.112. The statute does not expressly grant creditors the right to enforce the return of a distribution to the partnership, but a court might recognize a creditor's standing to bring a derivative action to do so. The statute does not affect any obligation a limited partner may have to return a distribution under "other applicable law." Tex. Bus. Orgs. Code § 153.112. Thus, the United States Bankruptcy Code (11 U.S.C. §§ 101 et seq.) and Texas Uniform Fraudulent Transfer Act (Tex. Bus. & Com. Code §§ 24.001 et seq.) present creditors with other means to pursue recovery. Knowledge or intent is not always required under these other fraudulent transfer provisions. *See, e.g.,* Tex. Bus. & Com. Code § 24.006(a).

In 2009, the BOC was amended to clarify that the limitation on distributions to partners of a limited partnership does not include payments to partners for reasonable compensation or reasonable payments in the ordinary course of business pursuant to a bona fide retirement plan or other benefits program. Tex. Bus. Orgs. Code § 153.210(b). In addition, the statute was amended to make clear that a distribution that is in compliance with Chapter 11 of the BOC does not violate the limitation on distributions. Tex. Bus. Orgs. Code § 153.210(a). In other words, a limited partnership that is winding up might technically be insolvent as a result of a distribution but would not violate the limitation on distributions if "adequate provision" has been made for the payment of the remaining liabilities, such as by the assumption of the liabilities by a purchaser of the partnership's assets. *See* Tex. Bus. Orgs. Code § 11.053(a).

The limitation on distributions under the BOC is primarily for the protection of creditors but also protects partners from the undue depletion of the limited partnership's assets. Additionally, the partnership agreement may impose stricter requirements on limited partners to return distributions. The statute expressly provides that it does not affect any obligation of the limited partners under the partnership agreement to return a distribution. Tex. Bus. Orgs. Code § 153.112. Release of a partner's obligation to return an impermissible distribution requires consent of all partners unless otherwise provided by the partnership agreement. Tex. Bus. Orgs. Code § 153.203. A creditor who acts in reliance on an enforceable obligation to return a distribution may enforce the obligation even though it has been settled or released if the obligation is stated in a document that is signed by the partner and the document has not been amended or canceled to evidence the release or settlement. Tex. Bus. Orgs. Code § 153.204(a). A general partner continues to be liable to third parties to the same extent as a general partner in a general partnership notwithstanding any compromise or release of the general partner's liability by the other partners. Tex. Bus. Orgs. Code § 153.204(a).

F. Liability of "Directors and Officers" for Debts Incurred After Tax Forfeiture of Limited Partnership

As discussed in Section II.D. above, forfeiture of a corporation's privileges due to failure to pay franchise taxes or file required reports results in personal liability of directors and officers for certain corporate debts. Under the Tax Code, "[i]f the corporate privileges of a corporation are forfeited for the failure to file a report or pay a tax or penalty, each director or officer of the corporation is liable for each debt of the corporation that is created or incurred in this state after the date on which the report, tax, or penalty is due and before the corporate privileges are revived." Tex. Tax Code § 171.255(a). Issues arising in interpreting and applying these provisions are further discussed in Section II.D. above. Although these provisions are expressed in corporate terms, they also apply to other taxable entities, such as limited partnerships and limited liability companies. Tex. Tax Code § 171.2515(b). The statute does not state who is a "director" or "officer" of a limited partnership for purposes of Section 171.255.

G. Liability for Committing or Knowingly Participating in Tortious or Fraudulent Acts

As noted in Section II.E., courts have long held that corporate officers may be held personally liable when they commit or knowingly participate in tortious or fraudulent acts even though the conduct occurred while the officer was acting on behalf of the corporation. *See, e.g., Gore v. Scotland Golf, Inc.*, 136 S.W.3d 26, 32 (Tex. App.—San Antonio 2003, pet. denied); *Kingston v. Helm*, 825 S.W.3d 755, 764-67 (Tex. App.—Corpus Christi 2002, pet. denied). Similarly, as discussed in Section III.E., Texas courts have held that LLC members and managers are liable for their own fraudulent or tortious acts even if the acts are committed in the service of the LLC. *See Nwokedi v. Unlimited Restoration Specialists*, 428 S.W.3d 191 (Tex. App.—Houston [1st Dist.] 2014, pet. denied) (holding controlling member of LLC was personally liable for knowingly participating in LLC's fraud in relation to LLC's contract and fraudulent transfers of LLC assets based on the principle that a corporate officer who knowingly participates in tortious or fraudulent acts may be held individually liable to third persons even though the officer was acting as an agent of the corporation). These principles would apply as well to officers and agents in the limited partnership context.

H. Liability on Limited Partnership's Contract as Agent of Partially Disclosed Principal, as Guarantor, or as Person Identified as General Partner

As discussed in Sections II.F. and III.F., an agent is not liable on a contract entered into on the principal's behalf if the agent discloses the agent's representative capacity and the identity of the principal, but the agent is personally liable on the contract if the representative capacity of the agent and the identity of the agent's principal are not disclosed to the other party to the contract at the time the contract is entered into. Restatement (Third) of Agency §§ 6.01, 6.02 (2006); Restatement (Second) of Agency §§ 320, 322 (1957). These principles would apply to an officer or other agent of a limited partnership. Additionally, a person who signs a contract of a limited partnership as a guarantor or co-signer would have liability as such on the contract. Entity representatives should be vigilant when signing credit applications and other contracts on behalf of the entity in order to avoid subjecting themselves to personal liability under provisions that may be interpreted to obligate signatories in their individual capacities. Furthermore, erroneously identifying oneself as a general partner in a contract entered into on behalf of a limited partnership may also result in liability on the contract. *See Al-Asaud v. Youtoo Media, L.P.*, 754 F. App'x 246 (5th Cir. 2018).

V. Limited Liability Partnerships

A registered limited liability partnership (LLP) is a partnership that has availed itself of statutory procedures so as to alter the traditional rule that general partners have personal liability for all partnership debts and obligations. The statutory provisions applicable to general partnerships (or those applicable to limited partnerships in the case of a limited partnership that has registered as an LLP) continue to apply to a partnership after it registers as an LLP—it is the same entity as it was prior to registration. Sections 152.801-152.805 of the BOC merely modify the rule regarding liability of partners and specify the requirements for obtaining and maintaining LLP status.

Texas was the first jurisdiction to pass LLP legislation in 1991. The concept was quickly copied in other states, and all states and the District of Columbia added LLP provisions to their partnership statutes. The major accounting firms were a significant force in lobbying for such legislation across the country. Although the states were quick to borrow the LLP concept from Texas, they were not reluctant to vary and refine it, and there are significant variations in the LLP statutes around the country. For example, most states, like Texas, permit any type of partnership to become an LLP, while a few states permit only professional partnerships to become LLPs. Some states limit the liability protection provided by an LLP to liabilities arising out of some type of tortious or wrongful conduct, while LLPs in Texas and many other states provide partners liability protection extending to contractual obligations of the partnership. The differences among the states should be considered if a business will have dealings or contacts outside of Texas. For instance, New York statutes provide that a non-professional LLP's liability shield will not be respected in New York.

A. General Rule: Full Liability Limitation

The feature that distinguishes an LLP from a partnership that is not an LLP is the limitation on the personal liability of partners in an LLP. The BOC provides that a partner in an LLP is not individually liable for debts and obligations of the partnership incurred while the partnership is an LLP. Tex. Bus. Orgs. Code § 152.801(a). As originally enacted, the Texas LLP provisions only shielded partners from liability arising out of the errors, omissions, negligence, incompetence, or malfeasance of other partners or representatives of the partnership. In 1997, the LLP provisions were amended to provide protection from all debts and obligations of the partnership as a general rule. Thus, the current language generally shields partners from tort and contract obligations of the partnership. Language was also added to prevent indirect attempts to hold partners liable through indemnity and contribution. The LLP provisions do not shield a partner from liability imposed by law or contract independently of the partner's status as a partner, such as when a partner personally commits a tort or personally guarantees a contractual obligation. Tex. Bus. Orgs. Code § 152.801(e)(2). The limitation of partner liability also does not affect the liability of the partnership to pay its obligations out of partnership property or the manner in which service of citation or other civil process may be served in an action against a partnership. Tex. Bus. Orgs. Code § 152.801(e)(1).

B. Exceptions to Tort-Type Liability Protection Before September 1, 2011

As mentioned above, as originally enacted, the Texas LLP provisions only shielded partners from liability arising out of the errors, omissions, negligence, incompetence, or malfeasance of other partners or representatives of the partnership. Even this protection was subject to certain exceptions. Under these exceptions, a partner's liability was not limited with respect to another's errors, omissions, negligence, incompetence, or malfeasance if such occurred under the partner's supervision, the partner was directly involved in the specific activity, or the partner had notice or knowledge and failed to take reasonable steps to prevent or cure the situation. When the 1997 amendments broadened the liability protection to all debts and obligations of the partnership, the language dealing with the exceptions to the protection from tort-type liabilities was retained. Though the construction of the TRPA provision was awkward, the apparent intent was to retain the pre-1997 exceptions from tort-type liability protection, i.e., a partner's liability for another's errors, omissions, negligence, incompetence, or malfeasance if such occurred under the partner's supervision, the partner was directly involved in the specific activity, or the partner had notice or knowledge and failed to take reasonable steps to prevent or cure the situation. *See* Tex. Rev. Civ. Stat. art. 6132b-3.08(a)(2) (expired eff. Jan. 1, 2010). When these provisions were carried forward in the BOC, this principle was stated in a less awkward fashion. *See* Tex. Bus. Orgs. Code § 152.801(b) as in effect before September 1, 2011.

The exceptions to an LLP partner's protection from liability presented some interesting questions of interpretation. First, a partner who "supervised" or "directed" the errant partner or partnership representative was not shielded from liability. Did this mean that managing partners were always liable? The Comments to the 1991 amendments suggest that the answer to this question is "no" and that the supervision was required to be fairly specific for liability to attach to a supervising partner. *See* Tex. Rev. Civ. Stat. art. 6132b, § 15 (expired Jan. 1, 1999), Source and Comments by Alan R. Bromberg (Vernon Supp. 2009). Additionally, a partner was not shielded from liability if the partner was "directly involved" in the activity or had "notice or knowledge" of and "failed to take reasonable steps to prevent or cure" the errors, omissions, negligence, incompetence, or malfeasance.

Arguably, the provisions imposing liability with respect to supervision, direct involvement, and notice or knowledge stated nothing more than the principle that persons are always liable for their own torts. Given the revolutionary effect of the LLP provisions on the traditional rule of partner personal liability, it is somewhat understandable that the legislation included this sort of reassuring language. The provisions were initially drafted with the thought that only professional partnerships would be LLPs. Although the provisions were ultimately not limited to professional partnerships, it was nevertheless recognized that professional firms would be the primary beneficiaries of the provisions. That said, the resulting LLP provisions were somewhat anomalous given the approach of the professional corporation statutes to liability issues. The Texas Professional Corporation Act expressly disavowed any implication that a supervisory duty was created by the terms of the statute. That act stated that "a shareholder of a professional corporation, as such, shall have no duty to supervise the manner or means whereby the officers or employees of the corporation perform their respective duties." Tex. Rev. Civ. Stat. art. 1528e § 5 (expired eff. Jan. 1, 2010). Chapter 303 of the BOC similarly states that a shareholder of a professional corporation is not required to supervise the performance of duties by an officer or employee of the corporation and further states that a shareholder of a professional corporation has no greater liability than a shareholder of a for-profit corporation. Tex. Bus. Orgs. Code § 303.002. The BOC, like the predecessor Texas Professional Corporation Act, makes clear that the individual professional and the corporation have liability for the individual professional's errors, omissions, negligence, incompetence, or malfeasance. Tex. Bus. Orgs. Code § 301.010. The extent to which the LLP liability protection for errors, omissions, negligence, incompetence, or malfeasance differed from that provided by a professional corporation is debatable, but the different articulation appeared to present opportunities for plaintiffs to target partners in addition to the errant partner or employee.

In *Software Publishers Association v. Scott & Scott, LLP*, 2007 WL 92391 (N.D. Tex. 2007), the court declined to dismiss claims against the managing partner of an LLP law firm that allegedly engaged in cybersquatting and copyright and trademark infringement and dilution. The court noted the provision of the Texas LLP statute providing for liability of a partner who was directly involved in the specific activity in which the negligence or malfeasance of another occurred or who had notice or knowledge of negligence or malfeasance at the time of the occurrence and failed to take reasonable steps to prevent or cure the negligence or malfeasance. The court also pointed out that the liability of a partner independent of his partner status is not affected by the statute. The plaintiff alleged that the managing partner "controlled" the activities of the law firm complained of in the complaint. The court found this allegation sufficient to survive a motion to dismiss because the allegation supported recovery under the theory that the managing partner was directly involved in the wrongful conduct or had knowledge of the wrongful conduct but failed to take reasonable steps to prevent it. In the course of its discussion, the court commented that no limited liability partnership law in any state extends so far as to shield a partner from his own wrongful conduct.

In *Rhodes Colleges, Inc. v. Johnson*, 2012 WL 627273 (N.D. Tex. 2012), the court applied the LLP statute in effect before September 1, 2011, to claims based on allegedly defamatory statements published before the 2011 amendments. The plaintiff sought to hold Van Wey, a partner in an LLP law firm, liable for allegedly defamatory statements posted on the firm's website by another partner, Johnson. Van Wey maintained that she was not supervising or directing Johnson and that she was not in any way directly involved in Johnson's actions. Van Wey stated that she was unaware of the content Johnson added to the firm website, and Van Wey adduced evidence that she did not regularly monitor the site. The plaintiff failed to present evidence that would enable a reasonable trier of fact to find that any of the exceptions in Section 152.801(b) of the BOC (as in effect before September 1, 2011) applied, and the court thus granted summary judgment in favor of Van Wey.

In *Garcia v. Jenkins/Babb LLP*, 2013 WL 3789830 (N.D. Tex. 2013), the court dismissed the plaintiff's attempt to hold Babb, a partner of an LLP law firm, vicariously liable under the Fair Debt Collections Practices Act. The collection efforts at issue were taken by another partner, and the plaintiff argued that Babb, as a principal of the LLP, "was aware or should have been aware of the actions taken by" the other partner and that Babb "had a duty to oversee [those] actions." The complaint, however, did not allege that Babb participated in or was even aware of the other partner's actions with regard to the collection efforts against the plaintiff. The events giving rise to the plaintiff's claim occurred before September 1, 2011, and the court thus applied Section 152.801 of the BOC as in effect before the amendment. The court stated that the complaint asserted no facts to support a finding that any of the exceptions in Section 152.801(b) applied in this case, and the court dismissed the claim against Babb.

A Connecticut court held that two partners in a three-partner LLP law firm did not have liability for the third partner's wrongful acts toward a client where the two partners shared no benefit in the dealings of the third partner in question, did not have supervision or control over him, and did not know of the matter until after it occurred. *See Kus v. Irving*, 735 A.2d 946 (Conn. Super. 1999).

C. Expiration or Termination of Protection

A partnership must be an LLP at the time a debt or obligation is incurred for the liability limitations to apply. A 2010 decision by the Fifth Circuit Court of Appeals concluded that the partners of a partnership that was registered as an LLP at the time of the trademark infringement underlying a later judgment against the partnership were not protected from personal liability because the partnership was not registered as an LLP at the time the judgment was entered. *See Evanston Ins. Co. v. Dillard Dept. Stores Inc.*, 602 F.3d 610 (5th Cir. 2010). The reasoning of the court is questionable, and the legislature amended the LLP provisions in 2011 to make clear that an obligation is incurred while the partnership is an LLP if the obligation relates to an action or omission occurring while the partnership is an LLP or the obligation arises under a contract or commitment entered into while the partnership is an LLP. Tex. Bus. Orgs. Code § 152.801(c).

An annual renewal of the registration was required to maintain LLP status under the law as it was in effect before January 1, 2016. Effective January 1, 2016, the Business Organizations Code was amended to replace the annual renewal feature with an annual report requirement. Before January 1, 2016, an LLP's failure to file a renewal by the one-year anniversary date of its registration resulted in an automatic lapse of LLP status and loss of the associated liability protection. There was no procedure to retroactively restore the lapse in liability protection. As amended, the statute requires an LLP to file an annual report. The annual report is due on June 1 of each year, but the failure to file the report by that date will not result in automatic loss of LLP status. Tex. Bus. Orgs. Code §152.806(a), (b). Instead, the LLP will have a period of one year to cure the delinquency. If the delinquent report is not filed by May 31 of the following year, the LLP's registration will automatically terminate. BOC §152.806(c). After involuntary termination of the registration, there is a three-year period during which the registration may be retroactively reinstated. Tex. Bus. Orgs. Code §152.806(e)-(h). Thus, the risk of a lapse in liability protection is substantially lessened under the new annual reporting scheme. The 2015 amendments also include a provision regarding the effect of acceptance by the Secretary of State of an LLP registration and a provision specifying a "substantial compliance" standard with respect to the registration and annual reporting requirements. Effective January 1, 2016, an LLP registration that is accepted by the Secretary of State is an effective registration and is conclusive evidence of the satisfaction of all conditions precedent to an effective registration. Tex. Bus. Orgs. Code § 152.802(c-1) (eff. Jan. 1, 2016). Additionally, except in a proceeding by the state to terminate an LLP's registration, the registration continues in effect so long as there has been substantial compliance with the registration and annual reporting requirements of the statute. Tex. Bus. Orgs. Code § 152.802(k) (eff. Jan. 1, 2016). This standard should mitigate potential liability concerns arising from minor compliance errors, such as an error in reporting the number of partners.

D. Name

An LLP's name must contain an appropriate designator such as the abbreviation "LLP." The BOC states that an LLP's name must contain the phrase "limited liability partnership" or an abbreviation of the phrase. Tex. Bus. Orgs. Code §§ 5.063, 152.803. An LLP that is careless about use of the designator in its dealings with third parties might expect a plaintiff to make an issue of it even though the partnership name specified in the application filed with the Secretary of State contains the required designator.

E. Insurance or Financial Responsibility Before September 1, 2011

Although common in the first generation of LLP statutes, insurance requirements were dropped from most LLP statutes that included such a requirement relatively soon after the development of LLP statutes. Texas was slower to drop its requirement for insurance or financial responsibility. Until September 1, 2011, the Texas LLP provisions still included an insurance or financial responsibility requirement. Tex. Bus. Orgs. Code § 152.804 (repealed eff. Sept. 1, 2011). Under the Texas provision, an LLP was required to carry at least $100,000 of liability insurance designed to cover the kinds of errors, omissions, negligence, incompetence, or malfeasance for which liability is limited. In lieu of carrying such insurance, an LLP could choose to provide $100,000 of funds specifically designated and segregated for the satisfaction of judgments against the partnership. Such funds were required to be in cash, certificates of deposit, or U.S. treasury obligations deposited in trust or in bank escrow, or the funds could be represented by a bank letter of credit or insurance company bond. There were a number of troublesome issues of interpretation associated with compliance with the insurance or financial responsibility requirement, particularly if an LLC was relying on insurance to satisfy the requirement, as was the case for most LLPs. The insurance requirement provided a plaintiff potential opportunities to make an issue of policy exclusions, deductibles, nature and timing of coverage, etc. in an attempt to attack the liability protection. The elimination of the insurance and financial responsibility requirement eliminated these avenues of attack on an LLP's liability shield.

In *Edward B. Elmer, M.D., P.A. v. Santa Fe Properties, Inc.*, 2006 WL 3612359 (Tex. App.—San Antonio 2006, no pet.), the court concluded that an LLP's failure to carry the required insurance rendered the liability shield ineffective even though the liability in issue stemmed from breach of a lease and thus was not the type of liability that would have been covered by the insurance. The plaintiff sued the partnership and its two partners for breach of a commercial lease. The plaintiff obtained a judgment against the partnership, and that judgment was severed and became final. After the plaintiff was not able to collect the judgment from the partnership, the plaintiff obtained a summary judgment against one of the partners. The partner appealed arguing that the plaintiff's suit against the partner was barred because the plaintiff initially obtained judgment against the partnership alleging it was an LLP. The court held that the partner was not protected from individual liability because the partnership was not a properly registered limited liability partnership under the Texas Revised Partnership Act at the time it incurred the lease obligations. The Texas LLP provisions required that an LLP carry insurance or meet certain financial responsibility requirements. The court noted that, unlike the limited partnership statute, the LLP provisions contain no substantial compliance language. Therefore, the court concluded that strict compliance with the statute is required. Although the partner itself carried errors and omissions insurance, the court pointed out that the policy did not appear to cover the partnership or the other partner. Because the partnership did not have the required insurance or other forms of financial responsibility designated by the statute, it was not a properly registered LLP, and the partner was not protected from liability.

In *Fleming v. Kirklin Law Firm, P.C.*, 2015 WL 7258700 (Tex. App.—Houston [14th Dist.] 2015, no pet.), the plaintiffs prevailed on breach-of-contract claims against a law firm for breach of two referral agreements entered into in 2001. The plaintiffs sought to hold an individual partner liable for the breaches in addition to the firm on the basis that the firm had failed to comply with the statutory requirements for maintenance of LLP status. The parties disagreed as to whether the Texas Revised Partnership Act applied to the dispute. Assuming without deciding that the Texas Revised Partnership Act applied, the court of appeals held that the trial court did not err in refusing to hold the individual partner liable for the contractual obligations of the firm because the law firm was registered as an LLP and presented evidence, which the plaintiffs failed to refute, that the firm had complied with the financial responsibility requirements of the Texas Revised Partnership Act.

F. LLP Case Law

There is little case law addressing the issues discussed above. In *Apcar Investment Partners VI, Ltd. v. Gaus*, 161 S.W.3d 137 (Tex. App.—Eastland 2005, no pet.), the court acknowledged the liability protection afforded partners in an LLP, but the partners were held personally liable on a lease executed by the partnership in its LLP name because the lease was executed more than three years after the initial registration had expired. The court found the language of the LLP statute clearly required the partnership to be registered when the lease obligation was incurred for the partners to avoid liability on the lease. As discussed above, the annual renewal feature that was in effect when this case was decided has been replaced by an annual reporting requirement. The annual reporting provisions provide more opportunities to cure a failure to comply with the annual filing requirements.

In *Bennett v. Cochran*, 2004 WL 852298 (Tex. App.—Houston [14th Dist.] 2004, no pet.), a partner in a law firm LLP argued the other partner had orally agreed to pay half of all expenses of the partnership. The court noted that partners in an LLP have no personal liability for the debts and obligations of the partnership and concluded there was no evidence the partners agreed to be personally liable for the expenses and overhead of the partnership as opposed to merely having their partnership interests equally burdened by the financial obligations of the partnership.

In *Edward B. Elmer, M.D., P.A. v. Santa Fe Properties, Inc.*, 2006 WL 3612359 (Tex. App.—San Antonio 2006, no pet.), the court concluded that an LLP's failure to carry the required insurance rendered the liability shield ineffective. As noted above, the insurance requirement was eliminated from the Texas LLP statute effective September 1, 2011.

In *Software Publishers Association v. Scott & Scott, LLP*, 2007 WL 92391 (N.D. Tex. 2007), the court declined to dismiss claims against the managing partner of an LLP law firm that allegedly engaged in cybersquatting and copyright and trademark infringement and dilution because the complaint alleged that the managing partner "controlled" the activities of the law firm complained of in the complaint. This allegation was sufficient to survive a motion to dismiss because the allegation supported recovery under the theory that the managing partner was directly involved in the wrongful conduct or had knowledge of the wrongful conduct but failed to take reasonable steps to prevent it. As noted above, the Texas LLP provisions were amended in 2011 to eliminate the language providing for liability of a partner based on the partner's supervision of, direct involvement in, or notice or knowledge of another's errors, omissions, negligence, incompetence, or malfeasance.

In *Rhodes Colleges, Inc. v. Johnson*, 2012 WL 627273 (N.D. Tex. 2012), the plaintiff sought to hold Van Wey, a partner in an LLP law firm, liable for allegedly defamatory statements posted on the firm's website by another partner, Johnson. Van Wey maintained that she was not supervising or directing Johnson and that she was not in any way directly involved in Johnson's actions. Van Wey stated that she was unaware of the content Johnson added to the firm website, and Van Wey adduced evidence that she did not regularly monitor the site. The plaintiff failed to present evidence that would enable a reasonable trier of fact to find that any of the exceptions in section 152.801(b) of the BOC (as in effect before September 1, 2011) applied, and the court thus granted summary judgment in favor of Van Wey.

In *Garcia v. Jenkins/Babb LLP*, 2013 WL 3789830 (N.D. Tex. 2013), the court dismissed the plaintiff's attempt to hold Babb, a partner of an LLP law firm, vicariously liable under the Fair Debt Collections Practices Act. The collection efforts at issue were taken by another partner, and the complaint did not allege that Babb participated in or was even aware of the other partner's actions with regard to the collection efforts against the plaintiff. The events giving rise to the plaintiff's claim occurred before September 1, 2011, and the court thus applied Section 152.801 of the BOC as in effect before the amendment. The court stated that the complaint asserted no facts to support a finding that any of the exceptions in Section 152.801(b) applied in this case, and the court dismissed the claim against Babb.

In *Fleming v. Kirklin Law Firm, P.C.*, 2015 WL 7258700 (Tex. App.—Houston [14th Dist.] 2015, no pet.), the plaintiffs prevailed on breach-of-contract claims against a law firm for breach of two referral agreements entered into in 2001. The plaintiffs sought to hold an individual partner liable for the breaches in addition to the firm on the basis that the firm had failed to comply with the statutory requirements for maintenance of LLP status. The parties disagreed as to whether the Texas Revised Partnership Act applied to the dispute. Assuming without deciding that the Texas Revised Partnership Act applied, the court of appeals held that the trial court did not err in refusing to hold the individual partner liable for the contractual obligations of the firm because the law firm was registered as an LLP and presented evidence, which the plaintiffs failed to refute, that the firm had complied with the financial responsibility requirements of the Texas Revised Partnership Act.

In *Evanston Insurance Company v. Dillard Department Stores Inc.*, 602 F.3d 610 (5th Cir. 2010), the court concluded that the partners were personally liable for a judgment against the partnership even though the trademark infringement on which the judgment was based occurred when the partnership was an LLP. The LLP dissolved and allowed its registration to expire during the pendency of the law suit against the partnership, and the court concluded that the partners were not protected from liability on the judgment. In this case, Dillard Department Stores, Inc. ("Dillard's") sued a law firm, Chargois & Ernster, L.L.P., in 2003 for federal and state trademark infringement, cyberpiracy, and various business torts based on the law firm's use of the Dillard's name and logo on a website developed by the law firm to solicit clients with claims against Dillard's. The law firm was registered as a Texas LLP. Early in 2004, while the litigation with Dillard's was ongoing, the partners executed a separation agreement providing for dissolution of the partnership, and they did not renew the firm's LLP registration when it expired in July, 2004. In November, 2004, the court entered a final judgment against "Chargois & Ernster, L.L.P." Dillard's was unable to collect the judgment, and Dillard's filed a complaint against the two partners of the law firm in 2008. Each partner was served, and Dillard's sought summary judgment declaring that the partners were personally liable on the judgment against the law firm. The district court granted summary judgment, and the partners appealed. The partners argued that they were protected from liability under the provisions of the Texas Revised Partnership Act. The court rejected the partners' argument that they were protected from liability under the LLP provision of the Texas Revised Partnership Act that provided a partner is not liable for a debt or obligation of the partnership incurred while the partnership is an LLP. (This provision is now found in Section 152.801 of the Business Organizations Code.) The partners argued that the law firm's debt was incurred when the infringing website was created in 2003, at which time the firm was registered as an LLP. Noting that the terms "debt" and "incurred" are not defined in the statute, the court found, however, that a plain reading of the statute supported the argument of Dillard's that the debt was incurred when the judgment was entered in 2004, at which time the LLP registration had expired. The court stated that the underlying conduct gave rise to the possibility of a future debt, but that a debt was not incurred at that time because the conduct might have gone undetected, might have been adjudged innocent, or Dillard's might have opted not to sue. The parties did not rely on another provision of the LLP statute that stated a partner was not personally liable for "errors, omissions, negligence, incompetence, or malfeasance committed" by another while the partnership is a registered LLP, but the court considered it significant that liability of a partner was limited in that provision for malfeasance "committed" while the partnership is an LLP. The court stated that the legislature's use of different language created a regime in which partners could be held liable for debts and obligations incurred when the partnership is not a registered LLP but would not bear liability for one another's "independent malfeasance" committed while it is an LLP. Thus, the court concluded that the partners in this case were not protected from personal liability because the law firm was not registered as an LLP at the time its debt was incurred. The parties apparently did not raise, and the court did not address, commentary to the LLP provision of the Revised Uniform Partnership Act stating that "[p]artnership obligations under or relating to a tort are generally incurred when the tort conduct occurs" so as to prevent a culpable partnership from engaging in wrongful conduct and then filing an LLP registration to sever vicarious liability of the partners for future injury or harm caused by conduct prior to the filing. Uniform Partnership Act (1997) (U.L.A.) § 306, cmt.3. The court also did not discuss how its interpretation squared with the provisions addressing the liability of an incoming partner or a withdrawing partner. See Tex. Bus. Orgs. Code §§ 152.304(b), 152.505(a). As noted above, the legislature amended the LLP provisions in 2011 to make clear that an obligation is incurred while the partnership is an LLP if the obligation relates to an action or omission occurring while the partnership is an LLP or the obligation arises under a contract or commitment entered into while the partnership is an LLP. Tex. Bus. Orgs. Code § 152.801(c).

In *Henry v. Masson*, 333 S.W.3d 825 (Tex. App.—Houston [1st Dist.] 2010, no pet.), Henry and Masson, who were partners in an orthopedic surgery practice organized as an LLP in 2001, became embroiled in disputes leading to litigation during which they agreed in principle to wind up the partnership and sever all ties between them. Eventually, they executed a settlement agreement, but litigation ensued over alleged breaches of the settlement agreement. Among the issues addressed in this appeal was a claim by Masson that the trial court erred in ordering Henry and Masson to make capital contributions to the partnership to allow the partnership to pay out funds it had taken in that actually belonged to two new entities formed by the parties. Masson based his argument on the liability protection provided partners in an LLP under the Texas Revised Partnership Act. The court stated that neither the partnership agreement nor the statute prevented the trial court from ordering contributions to the partnership during winding up. According to the court, the payments the trial court ordered Henry and Masson to make were capital contributions to discharge debts of the partnership during winding up, not an adjudication of individual liability for the debts or obligations as contemplated by the statute. The court relied upon the partnership agreement, which provided that if no partner agreed to lend funds needed to discharge the partnership's debts, obligations, and liabilities as they came due, each partner was required to timely contribute the partner's proportionate share of funds needed. Masson argued that this provision was not intended to apply in the winding up process and that reference elsewhere in the partnership agreement to payment of the partnership's debts upon dissolution "to the extent funds are available" evidenced the partners' intent that they would not be required to make additional capital contributions during the winding up. The court stated that the phrase relied upon by Masson appeared in a section referring to steps to be taken after the sale of partnership property, and the funds mentioned are funds received from the sale of partnership property. The court did not interpret the agreement to mean that sale of partnership property was the only source of funds to pay debts. The court also rejected Masson's argument that the reference in the capital contribution provision to payment of debts as they become "due and payable" was evidence that the parties did not intend to require capital contributions during winding up. The court stated that "due and payable" simply modified the type of debt to be paid and did not limit the provision to "operational" status of the partnership.

A few cases addressing the liability protection of partners in LLPs in other states have appeared, but there is nothing approaching a well-developed body of case law in this area. In a questionable opinion, *Ederer v. Gursky*, 881 N.E.2d 204 (N.Y. 2007), New York's highest court concluded that the liability protection provided by LLP registration under New York's partnership statute applies only to the liability of partners to third parties and not to other partners. A withdrawn partner sued the partnership and its partners for breach of contract and an accounting of funds owed the withdrawn partner under a withdrawal agreement between the partner and the partnership. The partners claimed that they did not have personal liability because the partnership was an LLP, but the court concluded that the New York LLP liability shield only applies to debts and liabilities to third parties and does not protect partners from liability for obligations of the partnership to other partners nor eliminate the right to an accounting. The New York LLP provisions state that "[e]xcept as provided by subdivisions (c) and (d) of this section, no partner of a partnership which is a registered limited liability partnership is liable or accountable, directly or indirectly (including by way of indemnification, contribution or otherwise), for any debts, obligations or liabilities of, or chargeable to, the registered limited liability partnership or each other, whether arising in tort, contract or otherwise, which are incurred, created or assumed by such partnership while such partnership is a registered limited liability partnership, solely by reason of being such a partner." Subdivision (c) excludes from the liability shield "any negligent or wrongful act or misconduct committed by [a partner] or by any person under his or her direct supervision and control while rendering professional services on behalf of" the LLP. Subdivision (d) allows partners to opt out of or limit the scope of the liability protection. The court reviewed the background and history of LLP legislation and rejected the defendants' argument that the statutory protection from liability for "any debts" applies to debts of the partnership to the partners as well as debts to third parties. The court concluded that the liability protection under the LLP provisions is restricted to liability to third parties because the phrase "any debts" is part of a provision that has always governed only a partner's liability to third parties and is part of Article 3 of the New York Uniform Partnership Act ("Relations of Partners to Persons Dealing with the Partnership") rather than Article 4 ("Relations of Partners to One Another"). The court also rejected the defendants' arguments reconciling the right to an accounting in a winding up with their interpretation of the LLP provisions. The dissenting opinion pointed out that a former partner is a third party where a partnership is concerned and argued that there is no good reason to treat him more favorably than any other third party. The dissenting opinion also points out how the majority's approach results in odd and perverse results where a withdrawn partner is able to hold remaining partners personally liable for his share when the business of a partnership goes badly after the partner withdraws and before the partner is paid his share. Among the amendments to the Business Organizations Code in the 2009 legislative session was an amendment to Section 152.801(a) making explicit the intended scope of that provision, which is to protect partners in an LLP from all liabilities and obligations of the partnership, including liabilities and obligations to the partners, unless the partners agree otherwise.

Additional LLP cases decided in jurisdictions other than Texas include: *Cooke-Zwiebach v. Oziel*, 962 N.Y.S.2d 64 (N.Y. App. Div. 2013) (holding record did not establish that partner of LLP had supervisory control over attorney who engaged in misconduct nor did record establish that partner had knowledge or reason to know of other attorney's malfeasance, as detailed in lower court's opinion at 2011 WL 6141670); *Ciecka v. Rosen*, 908 F.Supp. 2d 545 (D.N.J. 2012) (recognizing that partners in a Pennsylvania LLP are not individually liable for either the torts of another partner or the obligations of the partnership); *Largo Realty, Inc. v. Purcell*, 928 N.E.2d 999 (Mass. App. 2010) (describing protection of partners in LLP from personal liability for partnership's debts, obligations, and liabilities and concluding complaint failed to allege facts providing basis for relief against partner and employee individually); *Scarborough v. Napoli, Kaiser & Bern, LLP*, 880 N.Y.S.2d 800 (N.Y. App. Div. 4th Dept. 2009) (noting that each partner, employee, or agent of LLP may be individually liable for his or her negligent or wrongful act and holding defendant associates in LLP law firm failed to establish as matter of law that they committed no negligent or wrongful act for which they could be individually liable in legal malpractice action); *Santos v. 304 West 56th Street Realty LLC*, 862 N.Y.S.2d 435 (N.Y. Sup. 2008) (stating complaint must be dismissed as to general partner of defendant LLP in negligence action since partner of partnership which is LLP is not liable for liabilities of LLP); *Red River Wings, Inc. v. Hoot, Inc.*, 751 N.W.2d 206 (N.D. 2008) (relying upon veil-piercing provision of North Dakota LLP statute and stating evidence of participation of LLP partners in takeover of limited partnership in which LLP was limited partner supported trial court's implicit finding that it would be inequitable if LLP partners' acts were treated as those of LLP alone and trial court did not err in holding partners of LLP liable); *Kuslansky v. Kuslansky, Robbins, Stechel, and Cunningham, LLP*, 858 N.Y.S.2d 213 (N.Y.A.D. 2 Dept. 2008) (relying on *Ederer v. Gursky* (which held that LLP liability shield applies only to partner's liability to third parties) in rejecting argument of partners in LLP that they were shielded from liability for withdrawn partner's claim to recover value of withdrawn partner's interest under partnership agreement); *PCO, Inc. v. Christensen, Miller, Fink, Jacobs, Glaser, Weil & Shapiro, LLP*, 150 Cal.App.4th 384 (Cal. App. 2007) (commenting that individual partners in LLP are not vicariously liable for partnership obligations that do not arise from their personal misconduct or guarantees); *Connolly v. Napoli, Kaiser & Bern, LLP*, 817 N.Y.S.2d 872 (N.Y. Sup. 2006) (noting potential liability of LLP partners for personal participation in alleged wrongdoing); *Groth v. Ace Cash Express, Inc.*, 623 S.E.2d 208 (Ga. App. 2005) (concluding signatures of LLP partners on behalf of partnership did not bind them individually as guarantors); *Colliers, Dow and Condon, Inc. v. Schwartz*, 871 A.2d 373 (Conn. App. 2005) (holding that LLP partner did not have personal liability on agreement executed by partner on behalf of LLP); *Dow v. Jones*, 311 F.Supp.2d 461 (D. Md. 2004) (rejecting argument that attempt to hold dissolved LLP with no assets liable was disguised attempt to pierce the LLP veil, and stating that action against the LLP served purpose because LLP was required to have insurance and action could establish claim for purposes of coverage under policy); *Griffin v. Fowler*, 579 S.E.2d 848 (Ga. App. 2003) (denying LLP partners' motion for summary judgment regarding liability for another partner's alleged malpractice and breach of fiduciary duty on the basis that there were legal services performed prior to the partnership's registration as an LLP); *Dow v. Donovan*, 150 F.Supp.2d 249 (D. Mass. 2001) (refraining from deciding the "unsettled" question of what proof would be necessary to hold individual partners liable for Title VII gender discrimination claims); *Lewis v. Rosenfeld*, 138 F.Supp.2d 466 (S.D. N.Y. 2001), dism'd on other grounds on reconsideration, 145 F.Supp.2d 341 (S.D. N.Y.2001) (acknowledging that partners in New York LLP could not be held vicariously liable for liabilities of the partnership when the plaintiff had not alleged that any of the tortious acts were committed by the defendants or any individual acting under their control); *Schuman v. Gallet, Dreyer & Berkey, L.L.P.*, 719 N.Y.S.2d 864 (N.Y. A.D. 1 Dept. 2001) (holding general release of LLP and partners was sufficient to release partner in his capacity as partner but did not release partner from negligence, breach of fiduciary duty, and legal malpractice alleged against partner individually because partner is liable for any negligent or wrongful act committed by partner or under partner's supervision or control under New York LLP provisions); *Kus v. Irving*, 736 A.2d 946 (Conn. Super. 1999) (concluding that two law firm partners who did not have any supervision or control over third partner/wrongdoer were protected from liability under Connecticut LLP statute, which protects partners from liability for partnership debts and obligations except for partner's own negligence, wrongful acts, or misconduct or that of any person under partner's direct supervision or control, even if there was evidence of violation of supervisory duty under Rule 5.1, because LLP statute supersedes the rule except where the other person is under the partner's "direct supervision and control"); *Canada Life Assur. Co. v. Estate of Lebowitz*, 185 F.3d 231, 236 n. 4 (4th Cir. 1999) (noting that LLP is liable for the representation of its agent partners under Maryland law); *Middlemist v. BDO Seidman, LLP*, 958 P.2d 486 (Colo. App. 1997) (holding that LLP partner was protected from liability for wrongful termination claim and noting that a party seeking to hold a partner in a Colorado LLP liable for alleged improper actions of the partnership must proceed as if attempting to "pierce the corporate veil"). *See also Fischer v. OBG Cameron Banfill LLP*, 2010 WL 3733882 (S.D.N.Y. 2010) (holding evidence did not support piercing LLP's veil to impose liability on its "sole equity partner," but equity partner's instructing writer of libelous letter to compose letter made him jointly liable on libel claim as knowing participant); *Edlinger v. U.S.*, 2010 WL 1485951 (N.D.N.Y. 2010) (holding physician partner in LLP did not engage in wrongful act or directly supervise other partner who engaged in wrongful act); *J & J Sports Prods., Inc. v. Sunsets on Sand, LLP*, 2010 WL 1740803 (W.D. Wis. 2010) (noting that purpose of engaging in business as LLP is to limit recovery to entity's assets rather than assets of partners and requirement that LLP be represented by counsel did not preclude partner from continuing to defend herself individually); *Edlinger v. United States*, 2010 WL 1485951 (N.D.N.Y. 2010) (granting summary judgment in favor of partner in LLP because no allegation or evidence showed that partner engaged in misconduct or directly supervised errant partner or that partnership agreement limited statutory protection provided by LLP, and partners in New York LLP are not liable for partnership debt, obligation, or liability absent wrongful conduct committed by partner himself, partner's direct supervision of someone who engaged in wrongful conduct, or limitation of scope of liability protection by partnership agreement); *Vohra v. Cadigan Arbor Park*, 2010 WL 1102428 (Cal. App. 4 Dist. 2010) (relying on California statutory provisions that provide partner in LLP is not liable for debts, obligations, or liabilities of partnership