The Clash of Business Fiduciary Duties With Other Duties

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I. INTRODUCTION. The term "fiduciary duty" has come to embrace so many different obligations in so many different relationships that the term has lost a consistent meaning. This Article presents a review of legal duties arising from many different relationships, and the remedies for breach of those duties. Different types of fiduciary duties are compared to each other and to non-fiduciary duties, and possible conflicts between duties are explored.

A. WHAT IS A LEGAL DUTY? A serviceable definition of the legal term "duty" is Section 4 of the RESTATEMENT (SECOND) OF TORTS (1964): "The word 'duty' is used throughout the Restatement of this Subject to denote the fact that the actor is required to conduct himself in a particular manner at the risk that if he does not do so he may become subject to liability to another to whom the duty is owed for any injury sustained by the other, of which the actors' conduct is the legal cause."

In lay terms, duties are the obligations people owe to other people. But, duties are also the basis for people suing each other.

B. WHERE DO DUTIES COME FROM? Legal duties arise under many laws, from Federal and state constitutions, to legislation by the U.S. Congress and state legislatures, to regulations issued by Federal and state agencies, to codes and ordinances issued by local governments, and to the occasional international treaty. The language of constitutions, statutes, regulations, ordinances, and treaties must be applied by courts to the varied facts of specific cases, and in doing so courts must determine the scope of the duties based on the courts' interpretation of the written laws as they apply to the facts of the case. Appellate courts also independently create legal duties, by writing and publishing written opinions declaring duties that arise under the "common law." As to court-created duties, in *Golden Spread Council, Inc. No. 562 of Boy Scouts of Am. v. Akins*, 926 S.W.2d 287, 289-90 (Tex. 1996), the Supreme Court wrote:

> The existence of a duty is a question of law for the court to decide from the particular facts of the case. *Greater Houston Transp. Co. v. Phillips*, 801 S.W.2d 523, 525 (Tex. 1990). In deciding whether to impose a duty, the court must balance several interrelated factors. We must weigh the risk, foreseeability, and likelihood of injury against the social utility of the actor' conduct, the magnitude of the burden of guarding against the injury, and the consequences of placing the burden on the defendant. *Id*. We have also emphasized other factors, including whether one party had superior knowledge of the risk or a right to control the actor who caused the harm. *Graff v. Beard*, 858 S.W.2d 918, 920 (Tex. 1993).

C. WHERE DO FIDUCIARY DUTIES COME FROM? The law of fiduciary duties has many

fathers (and mothers and siblings). Fiduciary law is a mixture of equity concepts developed over several centuries in the chancery courts in England; mixed with Federal legislation, regulations, and case law; mixed with state legislation, regulations, and case law. Fiduciary case law is complicated by a variety of decisions that discuss what principles apply, from Federal courts "guessing" how a state court would rule on a question of first impression, to Texas courts having to apply Delaware statutes and case law in Texas lawsuits involving Texas entities that were organized under Delaware law, to Texas courts who follow Delaware law in the absence of Texas law, to Texas courts interpreting Texas statutes and Texas court opinions. This variability of fiduciary law is amplified by the ability of parties to alter fiduciary duties by agreement, which can change the way fiduciary law is applied in a particular case.

D. COMPARING DUTIES. This Article identifies the more frequently-encountered duties that arise from different relationships. These duties can arise under criminal law, property law, securities law, contract law, warranty law, tort law, business law, agency law, trust law, family law, and fiduciary law. A party acting in one or more capacities can have several different duties at the same time, duties that can be but are not necessarily consistent. Sometimes persons acting in a single capacity can have duties to different constituents, and those duties are sometimes consistent and sometimes inconsistent. The duties of business fiduciaries are often described using fiduciary terms (like duty of loyalty and duty of care), but these terms often are explained using terms borrowed from contract law (like good faith), or tort law (like intentional gross negligence, or ordinary care), or agency law (like self-dealing), with no assurance that these borrowed terms have the same meaning in new context as in the old. And sometimes the actions taken or not taken by a fiduciary can give rise to simultaneous claims under criminal law, contract law, tort law, corporate law, partnership law, trust law, or family laws; apart from fiduciary law. In this Article we first describe common legal duties, then identify the relationships in which these duties arise, and then explore how these duties can overlap and conflict.

E. OBJECTIVE VERSUS SUBJECTIVE STANDARDS. Lawyers (especially judges) place great importance on the difference between an objective standard and a subjective standard of behavior. [We have no idea whether the distinction actually affects jury verdicts, but we act like it does.] An objective standard is the reasonable person construct, which asks "what would a reasonable person do in these circumstances?" This is "ordinary care." In contrast, a subjective standard delves into the cognition of the actor - her mental state. Did she *intend* harm? Did she *knowingly* disregard a substantial risk of harm to another? Did she act in *good faith*?

The definition of gross negligence (a trigger for exemplary damages) in Texas combines the two standards: viewed objectively from the actor's standpoint, did the action involve an extreme degree of risk, coupled with an "actual subjective awareness" of the risk. Tex. Civ. Prac. & Rem. Code § 41.001(ii); *Smith v. O'Donnell*, 288 S.W3d 417, 423 (Tex. 2009) ("Malice has both an objective and a subjective prong; proof of malice involves an objective determination that the defendant's conduct involves an extreme risk of harm, and a subjective determination that the defendant had actual awareness of the extreme risk created by his conduct"). It is the Author's view that determinations by a jury of subjective intent or subjective awareness are less likely to be reversed on appeal than are verdicts based on an objective standard, which appellate courts seem to consider more susceptible to "as a matter of law" analysis where the appellate court supplants the jury's view with its own.

II. THE IMPORTANCE OF MENTAL STATE. The mental state of an actor can affect when legal responsibility is recognized, as well as the punishments imposed or the remedies available for breach of a legal duty.

A. CRIMINAL MENTAL STATES. The Texas Penal Code, like criminal law generally, ranks the severity of the crime based on the culpability, or the mental state or mens rea, of the actor at the time the offense is committed. The relative degree of criminal culpability, ranked from highest to lowest, is intentional, knowing, reckless, and criminally negligent. Tex. Penal Code § 6.02. Section 6.03 defines these culpable mental states. But the scope of a culpable mental state must be correlated to the "conduct element" to which the mental state applies: "(1) the nature of the conduct; (2) the result of the conduct; and (3) the circumstances surrounding the conduct." *Cook v. State*, 884 S.W.2d 485, 487 (Tex. Crim. App. 1994). That is, there can be culpability as to the act, or culpability as to the result, or culpability as to the surrounding circumstances. *Id.* at 487.

1. Intentional. Texas Penal Code Section 6.03(a) says: "[a] person acts intentionally, or with intent, with respect to the nature of his conduct or to a result of his conduct when it is his conscious objective or desire to engage in the conduct or cause the result." "Intent" is a subjective determination. The conduct element of "intent" involves culpability as to the act or the result, but not the surrounding circumstances.

2. Knowing. Texas Penal Code Section 6.03(b) says: "[a] person acts knowingly, or with knowledge, with respect to the nature of his conduct or to circumstances surrounding his conduct when he is aware of the nature of his conduct or that the circumstances exist. A person acts knowingly, or with knowledge, with respect to a result of his conduct when he is aware that his conduct is reasonably certain to cause the result." "Knowing" is a subjective determination. This conduct element of "knowing" is nature, result, or circumstances.

3. Reckless. Texas Penal Code Section 6.03(c) says: "[a] person acts recklessly, or is reckless, with respect to circumstances surrounding his conduct or the result of his conduct when he is aware of but consciously disregards a substantial and unjustifiable risk that the circumstances exist or the result will occur. The risk must be of such a nature and degree that its disregard constitutes a gross deviation from the standard of care that an ordinary person would exercise under all the circumstances as viewed from the actor's standpoint." "Recklessness requires the defendant to actually foresee the risk involved and to consciously decide to ignore it. Such a 'devil may care' or 'not giving a damn' attitude toward the risk distinguishes the culpable mental state of criminal recklessness from that of criminal negligence, which assesses blame for the failure to foresee the risk that an objectively reasonable person would have foreseen." *Williams v. State*, 235 S.W.3d 742, 751-52 (Tex. Crim. App. 2007) (footnote omitted). "Recklessness" is a mixed subjective and objective determinations. The conduct element of "reckless" is nature, result, and circumstances.

4. Criminally Negligent. Texas Penal Code Section 6.03(c) says: "[a] person acts with criminal negligence, or is criminally negligent, with respect to circumstances surrounding his conduct or the result of his conduct when he ought to be aware of a substantial and unjustifiable risk that the circumstances exist or the result will occur. The risk must be of such a nature and degree that the

failure to perceive it constitutes a gross deviation from the standard of care that an ordinary person would exercise under all the circumstances as viewed from the actor's standpoint." "Criminal negligence" is an objective determination. The conduct element of "criminal negligence" is nature, result, and circumstances. "Criminal negligence does not require proof of [a defendant's] subjective awareness of the risk of harm, but rather [the defendant's] awareness of the attendant circumstances leading to such a risk...The key to criminal negligence is not the actor's being aware of a substantial risk and disregarding it, but rather it is the failure of the actor to perceive the risk at all." *Montgomery v. State*, 369 S.W.3d 188, 192-93 (Tex. Crim. App. 2012). "[C]riminal negligence is different from ordinary civil negligence.... Civil or 'simple' negligence means the failure to use ordinary care, that is, failing to do that which a person of ordinary prudence would have done under the same or similar circumstances or doing that which a person of ordinary prudence would not have done under the same or similar circumstances ....Conversely, [c]onduct that constitutes criminal negligence involves a greater risk of harm to others, without any compensating social utility, than does simple negligence.... The carelessness required for criminal negligence is significantly higher than that for civil negligence; the seriousness of the negligence would be known by any reasonable person sharing the community's sense of right and wrong. ... The risk must be 'substantial and unjustifiable,' and the failure to perceive it must be a 'gross deviation' from reasonable care as judged by general societal standards by ordinary people.... In finding a defendant criminally negligent, a jury is determining that the defendant's failure to perceive the associated risk is so great as to be worthy of a criminal punishment....The degree of deviation from reasonable care is measured solely by the degree of negligence, not any element of actual awareness.... Whether a defendant's conduct involves 'an extreme degree of risk' must be determined by the conduct itself and not by the resultant harm.... Nor can criminal liability be predicated on every careless act merely because its carelessness results in death or injury to another." *Queeman v. State*, 520 S.W.3d 616, 623 (Tex. Crim. App. 2017) (citations and internal quotation marks omitted).

B. TORTIOUS MENTAL STATES. Using the RESTATEMENT (SECOND) OF THE LAW OF TORTS (1965) as a proxy for tort law generally, the gravity of a tort is affected by the culpability of the actor. In comparing tort law to criminal law it should be recognized that criminal law is designed to prohibit certain behavior, while tort law is concerned only with behavior that causes harm to another person or another's property. Stated differently, criminal law prohibits behavior, while tort law compensates injury. However, in tort law a higher degree of culpability can trigger "punitive" or exemplary damages.

1. Intent. An intentional tort is the highest level of tort culpability. Intent is an element of "malice" which is used in Tex. Civ. Prac. & Rem. Code § 41.007(7) as one of the triggers for exemplary damages.

a. Definition of Intent. RESTATEMENT (SECOND) OF THE LAW OF TORTS § 8A defines intent: "The word 'intent' is used throughout the Restatement of this subject to denote that the actor desires to cause consequences of his act, or that he believes that the consequences are substantially certain to result from it." Comment a explains: "'Intent,' as it is used throughout the Restatement of Torts, has reference to the consequences of the act rather than the act itself." Criminal intent exists either when the actor intends the harm when the actor intends to engage in the criminal conduct. Tortious intent

exists when the actor intends to cause the harm, or where the harm is substantially certain to result. Criminal intent can exist even when there is no desire to cause harm to others. Tortious intent exists only when the actor intends to harm another or intends an action that is substantially certain to cause harm to another. *In Ernst & Young, L.L.P. v. Pacific Mutual Life Ins. Co.* 51 S.W.3d 573, 578-80 (Tex. 2001), the Court said: "[a] defendant who acts with knowledge that a result will follow is considered to intend the result." In connection with a tort claim for fraud, the Texas Supreme Court said: "Intent is a fact question 'uniquely within the realm of the trier of fact because it so depends upon the credibility of the witnesses and the weight to be given to their testimony.'" *Spoljaric v. Percival Tours, Inc.*, 708 S.W.2d 432, 434 (Tex. 1986).

b. Intent vs. Recklessness or Negligence. RESTATEMENT (SECOND) OF TORTS § 8A, comment b states: "As the probability that the consequences will follow decreases, and becomes less than substantial certainty, the actor's conduct loses the character of intent, and become mere recklessness, as defined in § 500. As the probability decreases further, and amounts only to a risk that the result will follow, it becomes ordinary negligence, as defined in § 282. All three have their important place in the law of torts, but the liability attached to them will differ." The Texas Supreme Court has adopted the Restatement Second's distinction between intent and negligence. In *Reed Tool Co. v. Copelin*, 689 S.W.2d 404, 406 (Tex. 1985), the Court stated: "The fundamental difference between negligent injury, or even grossly negligent injury, and intentional injury is the specific intent to inflict injury." The Court cited RESTATEMENT (SECOND) OF TORTS § 500.

2. Recklessness. Under the RESTATEMENT (SECOND) OF TORTS, recklessness is the next lower degree of culpability below intent.

a. Definition of Recklessness. RESTATEMENT (SECOND) OF THE LAW OF TORTS § 500 defines "recklessness" by reference to the definition of negligence: "the actor's conduct is in reckless disregard of the safety of another if he does an act or intentionally fails to do an act which it is his duty to the other to do, knowing or having reason to know of facts which would lead a reasonable man to realize, not only that his conduct creates an unreasonable risk of physical harm to another, but also that such risk is substantially greater than that which is necessary to make his conduct negligent." Comment a to Section 500 explains that recklessness can consist of two different kinds of conduct. In one, the actor "knows, or has reason to know . . . of facts which create a high degree of risk of physical harm to another, and deliberately proceeds to act, or to fail to act, in conscious disregard of, or indifference to, that risk." In the other kind of conduct, the actor "has such knowledge, or reason to know, of the facts, but does not realize or appreciate the high degree of risk involved, although a reasonable man in his position would do so." In the latter situation, an objective standard is applied to the actor, who is held to have realized the "aggravated risk" to the same extent as a reasonable person in those circumstances. For a finding of recklessness, the actor must have known, or had reason to know, the facts which create the risk. According to Comment a, the risk must not be just an unreasonable one, as would be true with negligence. For recklessness, the risk must "involve a risk of harm to others substantially in excess of that necessary to make the conduct negligent. It must involve an easily perceptible danger of death or substantial physical harm, and the probability that it will so result must be substantially greater than is required for ordinary negligence."

b. Difference Between Intent and Recklessness. Comment (f) to Section 500 explains the difference between intent and recklessness: "Reckless misconduct differs from intentional wrongdoing in a very important particular. While an act to be reckless must be intended by the actor, the actor does not intend to cause the harm which results from it. It is enough that he realizes, or from facts which he knows, should realize that there is a strong probability that harm may result, even though he hopes or even expects that his conduct will prove harmless. However, a *strong probability* is a different thing from the *substantial certainty* without which he cannot be said to intend the harm in which his act results." (Italics added.)

c. Is Recklessness the Same as Gross Negligence? The RESTATEMENT (SECOND) OF TORTS does not use the terms "gross negligence." Texas Civil Practice and Remedies Code § 41.001(11) defines "gross negligence" as "an act or omission: (A) which when viewed objectively from the standpoint of the actor at the time of its occurrence involves an extreme degree of risk, considering the probability and magnitude of the potential harm to others; and (B) of which the actor has actual, subjective awareness of the risk involved, but nevertheless proceeds with conscious indifference to the rights, safety, or welfare of others." Gross negligence under Texas law thus has both an objective component (extreme degree of risk) and a subjective component (actual awareness and conscious indifference.)

3. Negligence. Negligence is the lowest level of culpability in both criminal law and tort law.

a. Definition of Negligence. "Negligence, a common law doctrine, consists of three essential elements--a legal duty owed by one person to another, a breach of that duty, and damages proximately resulting from the breach." *El Chico Corp. v. Poole*, 732 S.W.2d 306, 311 (Tex. 1987). The RESTATEMENT (SECOND) OF TORTS § 282 (1965) defines negligence in this way: "In the Restatement of this Subject, negligence is conduct which falls below the standard established by law for the protection of others against unreasonable risk of harm. It does not include conduct recklessly disregardful of an interest of others." Except for children and disabled persons, the standard established by law is the reasonable person standard -- the standard of a "reasonable man under like circumstances." *Id*. at § 283. The standard for negligence in Texas is defined as the duty of ordinary care, or the care that would be exercised by a person of ordinary prudence in a similar circumstance.

b. Contrasting Negligence and Recklessness. Comment (g) to Section 500 of the RESTATEMENT (SECOND) OF TORTS explains the difference between recklessness and negligence: "Reckless misconduct differs from negligence in several important particulars. It differs from that form of negligence which consists in mere inadvertence, incompetence, unskillfulness, or a failure to take precautions to enable the actor adequately to cope with a possible or probable future emergency, in that reckless misconduct requires a conscious choice of a course of action, either with knowledge of the serious danger to others involved in it or with knowledge of facts which would disclose this danger to any reasonable man. It differs not only from the above-mentioned form of negligence, but also from that negligence which consists in intentionally doing an act with knowledge that it contains a risk of harm to others, in that the actor to be reckless must recognize that his conduct involves a risk substantially greater in amount than that which is necessary to make his conduct negligent. The difference between reckless misconduct and conduct involving only such a quantum of risk as is necessary to make it negligent is a difference in the degree of the risk, but this difference of degree is

so marked as to amount substantially to a difference in kind."

The RESTATEMENT (THIRD) OF TORTS § 7 (2005) says that tort law imposes "a duty to exercise reasonable care" toward those whose conduct presents a risk of harm to others.

c. Negligence Per Se. "Negligence per se" is a tort concept whereby a legislatively imposed standard of conduct is adopted by the civil courts as defining the conduct of a reasonably prudent person. *Carter v. William Sommerville and Son, Inc.*, 584 S.W.2d 274, 278 (Tex. 1979); *El Chico Corp. v. Poole*, 732 S.W.2d 306, 312 (Tex. 1987). "The threshold questions in every negligence per se case are whether the plaintiff belongs to the class that the statute was intended to protect and whether the plaintiff's injury is of a type that the statute was designed to prevent." *Perry v. S.N.*, 973 S.W.2d 301, 305 (Tex. 1998). "While all "persons have a duty to obey the criminal law in the sense that they may be prosecuted for not doing so, . . . this is not equivalent to a duty in tort." *Perry v. S.N.*, 973S.W.2d 301, 304 (Tex. 1998). In determining whether to impose civil liability for the violation of a criminal statute, courts consider (1) whether the statute is the sole source of any tort duty from the defendant to the plaintiff or merely supplies a standard of conduct for an existing common law duty; (2) whether the statute puts the public on notice by clearly defining the required conduct; (3) whether the statute would impose liability without fault; (4) whether negligence per se would result in ruinous damages disproportionate to the seriousness of the statutory violation, particularly if the liability would fall on a broad and wide range of collateral wrongdoers; and (5) whether the plaintiff's injury is a direct or indirect result of the violation of the statute. *Id.* at 30.

4. Malice. The term malice is used in several areas of Texas tort law.

For a brief period of time, proof of malice was necessary to recover compensatory damages for tortious interference with contractual relations, with malice being defined as an act without excuse or just cause. *Sakowitz, Inc. v. Steck*, 669 S.W.2d 105, 107 (Tex. 1984). In *Victoria Bank & Trust Co. v. Brady*, 811 S.W.2d 931, 939 (Tex. 1991), the mental culpability for this tort was changed from malice to "willful and intentional." See Section VIII.J.9.

In Texas, exemplary damages can be assessed if the harm suffered by the plaintiff resulted from fraud, malice, or gross negligence. Tex. Civ. Prac. & Rem. Code § 41.003 (enacted in 1987). "Malice" in this context is defined as "a specific intent by the defendant to cause substantial injury or harm to the claimant." *Id*. at § 41.001(7). The Supreme Court narrowed the scope of malice from specific intent to a requirement of "outrageous, malicious, or otherwise reprehensible conduct" *coupled with* a specific intent for the victim to "suffer substantial injury that is 'independent and qualitatively different' from the compensable harms associated with the underlying causes of action." *Safeshred, Inc. v. Martinez,* 365 S.W.3d 655, 660 (Tex. 2012) (in a suit for breach of fiduciary duty, exemplary damages were affirmed against an employee who copied proprietary information from his employer's computer system to use in establishing a competing company). In *Safeshred, Inc.* the Court said: "The type of malice necessary to support punitive damages varies with the nature of the wrongful act at issue in any given category or particular type of case," citing *Continental Coffee Prod. Co. v. Cazarez,* 937 S.W.2d 444, 453 (Tex. 1996).

The Texas Medical Practices Act gives participants in a hospital peer review committee immunity from liability for state law claims if they "act []without malice and in the reasonable belief that the action or recommendation is warranted by the facts known to the person." Tex. Occ. Code § 160.010(a)(2). In this context "malice" is defined as "knowledge that an allegation is false or [constitutes] reckless disregard for whether the allegation is false." *Maewal v. Adventist Health System*, 868 S.W.2d 886, 893 (Tex. App.--Fort Worth 1993, writ denied); *Johnson v. Hosp. Corp. of America* 95 F.3d 389, 395 (5th Cir. 1996).

The term "malice" also appears in defamation law. See Section V.C below.

III. BUSINESS-RELATED CRIMES. Fiduciary law always operates against a criminal law background.

A. TEXAS CRIMINAL LAWS. Chapter 32 of the Texas Penal Code lists fraud offenses, some targeted to business activity and a few targeted specifically to fiduciaries. Offenses include: forgery, credit-related offenses, and other deceptive practices. For present purposes worthy of mention are the offenses of False Statement to Obtain Property of Credit or in the Provision of Certain Services (Section 32.32), Hindering Secured Creditors (Section 32.33), Deceptive Business Practices (Section 32.42), Commercial Bribery (Section 32.43), Misapplication of Fiduciary Property or Property of Financial Institution l(Section 32.45), Securing Execution of a Document by Deception (Section 32.46), Fraudulent Destruction, Removal or Concealment of Writing (Section 32.47), and Exploitation of Child, Elderly Individual, or Disabled Individual (Section 32.53).

1. Hindering Secured Creditors. Texas Penal Code § 32.33 prohibits a debtor under a security agreement, who does not have a right to sell or dispose of the secured property or who is required to account to the secured party for the proceeds of a permitted sale or disposition, from selling or otherwise disposing of the secured property, or failing to account to the secured party for the proceeds of a sale or other disposition as required, with intent to appropriate the proceeds or value of the secured property. There are seven grades of severity, ranging from a Class C Misdemeanor to a First Degree Felony, depending on the amount of money or value of goods in question. Tex. Pen. Code § 32.33(e).

2. Deceptive Business Practices. Texas Penal Code § 32.42 prohibits "deceptive business practices." Section 32.42 lists twelve categories of activities that are covered by the statute, including false weight or measure, selling less than or taking more than the represented quantity, passing off property or service as that of another, claiming used property as new, making a materially false or misleading statement in an advertising to buy or sell property, of making a materially false and misleading statement in connection with the purchase or sale of property or service. *Id.* § 32.42(b). The offenses are either Class C or Class A misdemeanors. *Id.* at 32.42(c).

3. Commercial Bribery. Texas Penal Code § 32.43(b) provides that "[a] person who is a fiduciary commits an offense if, without the consent of his beneficiary, he intentionally or knowingly solicits, accepts, or agrees to accept any benefit from another person on agreement or understanding that the benefit will influence the conduct of the fiduciary in relation to the affairs of his beneficiary." The offense extends to persons who offer, confer or agree to confer such a benefit to a fiduciary. *Id.* at

§ 32.42(c). As used in this statute, a fiduciary is "(A) an agent or employee; (B) a trustee, guardian, custodian, administrator, executor, conservator, receiver, or similar fiduciary; (C) a lawyer, physician, accountant, appraiser, or other professional advisor; or (D) an officer, director, partner, manager, or other participant in the direction of the affairs of a corporation or association."

4. Misapplication of Fiduciary Property. Texas Penal Code § 32.45(b) provides that "[a] person commits an offense if he intentionally, knowingly, or recklessly misapplies property he holds as a fiduciary or property of a financial institution in a manner that involves substantial risk of loss to the owner of the property or to a person for whose benefit the property is held." The offense ranges from a Class C misdemeanor to a first degree felony, depending on the value of the property misappropriated. *Id.* at § 32.45(c). If the victim is an elderly person, the offense is increased to the next higher category. *Id.* at § 32.45(d). In *Talamantez v. State*, 790 S.W.2d 33, 37 (Tex. App.-- San Antonio 1990, pet. ref'd), the court wrote that, for purposes of this statute, "a fiduciary is one in whom another has justifiably reposed confidence to act in a certain manner." In *Berry v. State*, 424 S.W.3d 579, 582-84 (Tex. Crim. App. 2014), the Court of Criminal Appeals quoted Black's Law Dictionary for the definition of "acting in a fiduciary capacity" in a situation that did not fit the named list of fiduciaries. See Section XII.J below, regarding nondischargeability in bankruptcy for fraud or defalcation "while acting in a fiduciary capacity."

5. Fraudulent Destruction, Removal, or Concealment of Writing. Texas Penal Code § 32.47 provides that "[a] person commits an offense if, with intent to defraud or harm another, he destroys, removes, conceals, alters, substitutes, or otherwise impairs the veracity, legibility, or availability of a writing, other than a governmental record."

B. FEDERAL CRIMINAL LAWS. There are Federal laws that are frequently used to prosecute business-related crimes. Federal securities laws are discussed in Section IV below. Other frequently-used Federal statutes are: obstruction of justice under U.S. Code Title 18, ch. 73 (witness tampering, retaliation, obstructing an examination of a financial institution; destroying, altering, or falsifying records with intent to impede an investigation; destruction of corporate audit work papers); the Racketeer Influenced and Corrupt Organizations (RICO) Act (for participating in an ongoing criminal organization); mail and wire fraud under 18 U.S.C. §§ 1341-1346 (using mail or wire to defraud another out of money; honest services fraud (which was limited by the Supreme Court to fiduciaries who received bribes or kickbacks in *Skilling v. United States* 561 U.S. 358, 368-69 (2010))s; and the Foreign Corrupt Practices Act of 1977 (prohibiting the payment of bribes to foreign officials to assist in obtaining or retaining business).

<u>Walmart and Foreign Bribery</u>

On June 20, 2019, the SEC and Walmart Inc. entered into an agreed cease and desist order and offer of settlement for violations of the FCPA by failing to maintain adequate anti-corruption accounting controls in Brazil, China, India, and Mexico. Walmart paid a fine of $137,955,249.[1]

<u>Herbal Life and Foreign Bribery</u>

The Clash of Business Fiduciary Duties with Other Duties

On August 28, 2020, Herbalife Nutrition, Ltd., the Los Angeles-based direct-selling company incorporated in the Cayman Islands, agreed to pay more than $67 million to resolve charges that it violated the books and records and internal accounting controls provisions of the Foreign Corrupt Practices Act arising out of a bribery scheme implemented by its China subsidiary.[2] Criminal charges and an SEC proceeding were initiated against the former managing director a Chinese national who was alleged to have bribed Chinese officials.[3] Walmart agreed to pay the U.S. Treasury disgorgement of $119,647,735 and prejudgment interest of $25,043,437, for a total payment of $144,691,172.

Goldman Sachs & Foreign Bribery

On October 22, 2020, the Department of Justice announced that Goldman Sachs admitted to conspiring to violate the Foreign Corrupt Practices Act in connection with a scheme to pay over $1 billion in bribes to Malaysian and Abu Dhabi officials in exchange for lucrative business for Goldman Sachs, including the underwriting of approximately $6.5 billion in three bond deals for a Malaysia Development authority. At a press conference announcing a deferred prosecution agreement, the Assistant U.S. Attorney involved in the case said: "Over a period of five years, Goldman Sachs participated in a sweeping international corruption scheme, conspiring to avail itself of more than $1.6 billion in bribes to multiple high-level government officials across several countries so that the company could reap hundreds of millions of dollars in fees...."[4] Goldman Sachs agreed to pay more than $2.9 billion in fines.

According to charges brought by the SEC, the participating managing director at Goldman Sachs used an intermediary to bribe foreign government officials to hire Goldman Sachs to underwrite bond offerings, and pocketed $43 million in "illicit payments" for his role in the scheme. The officer agreed to disgorge $43.7 million.[5]

IV. DUTIES UNDER FEDERAL AND STATE SECURITIES LAWS. The two major Federal statutes relating to publicly-traded stocks and bonds are the Securities Act of 1933 and Securities Exchange Act of 1934. The 1933 Act deals with the original issuance of stocks and bonds. The 1934 Act governs the resale of stock and bonds after their initial issue. A third Roosevelt era statute, the Investment Advisors Act of 1940, regulates "investment advisors" who give advice to investors for a fee. The Texas Securities Act is the state law that regulates the issuing, buying, and selling of securities and regulates investment advisers in Texas. The Federal Act governs investment advisors with funds under management above the threshold of $25 million. Smaller companies are governed by state securities laws.

A. THE SECURITIES ACT OF 1933. The Securities Act of 1933, adopted in reaction to abuses that contributed to the stock market crash of 1929, governs the original issues of corporate securities (stocks and bonds), and mandates the filing of accurate company financial statements and makes material misrepresentations or failure to disclose in connection with original issuances punishable and actionable.[6]

1. Public Offerings of Securities. The 1933 Act provides that a company making an initial offering of securities to the public must file a registration statement with the Federal Securities and Exchange

Commission (SEC) containing information about the issuer and the security, that is signed by the issuer, its officers, and a majority of its board of directors. 15 U.S.C. §§ 77f, 77g. A prospectus must be issued with similar information. Section 11 of the 1933 Act permits purchasers to sue for damages if the registration statement contained "an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." Section 12 permits a purchaser to sue for similar transgressions in a prospectus.

2. Misstatement or Omission of Material Fact. Section 17(a)(2) of the Securities Act of 1933 prohibits a party from obtaining money or property in the offer or sale of any securities by means of an untrue statement of material fact or omission to state a material fact that would make a statement not misleading. Such as untrue statement could occur in press releases or telephone conferences with interested investors. A material omission includes a failure to disclose to the public facts that make published financial statements or previous public announcements misleading. For example, in 2018, an affiliate of Walgreens Co. consented to an order that it violated Section 17(a)(2) by negligently failing to adequately disclose to the public known increases in risk that the company would not achieve financial goals. The company agreed to pay a penalty of $34,500,000 and the CEO and CFO each agreed to pay a penalty of $150,000 each.

B. THE SECURITIES EXCHANGE ACT OF 1934. The Securities Act of 1934 created the Securities and Exchange Commission to oversee the stock and bond markets, and adopted criminal sanctions and civil remedies for fraudulent practices related to the sale or purchase of previously-issued securities.

1. Material Disclosure and Non-Disclosure. Section 18(a) of the 1934 Act creates liability for any person who makes a statement related to publicly-traded securities in any document that is false and misleading with respect to a material fact. In *Indiana Public Retirement System v. SAIC, Inc.*, 818 F. 3d 85, 95-96 (2nd Cir. 2016, cert. dism's by agr.), the court held that 17 C.F.R. § 229.303(a)(3)(ii) requires a company's SEC Form 10-K filing "[d]escribe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." This decision conflicts with *In re NVIDIA Corp. Securities Litigation*, 768 F.3d 1046, 1056 (9th Cir. 2014). The U.S. Supreme Court granted certiorari but then dismissed it by agreement without ruling.

2. Insider Trading. "Insider trading, while not defined by the Federal securities laws, refers to the purchase or sale of securities while in possession of material information that is not available to the general public. Information is generally considered to be material when sufficient to induce a person to either buy or sell a security based on that information, e.g., the information is important to making an investment decision with respect to that security." FDIC Trust Examination Manual § 8.D.1. Rule l0b-5, 17 C.F.R. § 240.10b-5, under the "classical theory" requires that a corporate insider, because she owes a fiduciary duty to shareholders, either disclose material non-public information publicly or abstain from trading her own shares for personal gain. *See*, *e.g.*, *Chiarella v. United States*, 445 U.S. 222, 226-29 (1980). The SEC defines "insider trading" as "buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, on the basis of material, nonpublic information about the security. Insider trading violations may also include 'tipping' such information,

securities trading by the person 'tipped,' and securities trading by those who misappropriate such information."[7] Insiders can include corporate officers, directors, and employees, as well as employees of government, law, banking, brokerage and printing firms who trade on insider information. *Id.* The "misappropriation theory" for insider trading targets persons who trade on the basis of nonpublic information by a corporate "outsider" in breach of a duty owed not to a trading party, but to the source of the information. *United States v. O'Hagan*, 521 U.S. 642, 652 (1997). See Section IX.D.2, regarding Martha Stewart. *See* Anthony Michael Sabino &Michael A. Sabino, *From Chiarellato to Cuban: the Continuing Evolution of the Law of Insider Trading*, 16 FORDHAM J. OF CORP. & FIN. LAW 673 (2011).

Mark Cuban

In 2008, Mark Cuban, owner of the Dallas Mavericks NBA Team and regular panelist on the television show *Shark Tank*, was sued by the SEC for insider trading. Cuban was a large shareholder in Momma.com Inc. The company approached Cuban to participate in a private investment in public equity offering. As a condition to receiving information, Cuban allegedly verbally agreed to confidentiality. Cuban realized that the transaction would dilute his ownership stake in the company, so he sold his stock before the offering became public. The SEC filed a complaint, but it was dismissed by the trial judge. The Fifth Circuit Court of Appeals reinstated the case, and the case was tried to a jury in Dallas in 2014. The jury found that Cuban did not engage in insider trading.[8] *D Magazine* says that Cuban spent $8 million defeating a claim he could have settled for $2 million.[9] [Cuban could afford to stand on principle, and trust his fate to a jury. Not every individual can afford that risk.]

Congressman Chris Collins

Congressman Chris Collins served on the board of directors of a publicly-traded corporation that was developing a new treatment for multiple sclerosis. Collins' son, his son's 25-year old girlfriend and her parents and brother, had invested in the company. Collins learned from the CEO of the company that the results of the most recent phase of scientific testing indicated that the treatment had no therapeutic value. Collins immediately called his son and told him the insider information. The son calls his 25-year-old girlfriend and told her, and she told her parents and brother, and all of them start selling their shares in the company. A few days later the failure of the testing was announced to the public, and the stock lost 92% of its value. The SEC spotted the trades, and the Collins, his son and the son's girlfriend, and the girlfriend's mother, were all charged with insider trading. Congressman Collins compounded his problems by lying to the FBI during its follow-up investigation. In January of 2020, Collins pled guilty to violating Section 17(a)(1) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5, and was sentenced to 26 months in prison and fined $100,000 (his net worth was $13.8 million).[10] The tipees agree to disgorge their benefit in avoiding the stock-fall.

3. Civil Remedies. The Securities Exchange Act of 1934 does not expressly create a civil remedy for victims of false or misleading statements or omissions of material information. However, courts have long recognized an implied right of injured persons to sue for money damages for violations of the 1934 Act. The focus has been on Section 10(b) of the Act, and Rule 10b-5 promulgated by the SEC in 1977). Less-well-recognized is Section 18(a) of the 1934 Act, which expressly provides for liability

to violators to persons who rely on the statements in buying or selling a security. *See* John A. Occhipinti, *Section 18 of the Securities Exchange Act of 1934: Putting the Bite Back Into the Toothless Tiger*, 47 FORDHAM L. REV. 115 (1978).

C. THE INVESTMENT ADVISERS ACT OF 1940. The Investment Advisers Act of 1940 regulates persons who give investment advice for a fee. The primary thrust of the Act is to register investment advisors with $25 million or more under management. Another thrust is to require disclosure to the client of material information, particularly regarding potential conflicts of interest. Section 206(2) of the 1940 Act prohibits an investment advisor from employing any device, scheme or artifice, or engaging in any transaction, that defrauds a client or prospective client, or is fraudulent, deceptive or manipulative. The SEC says that investment advisors have a "duty of best execution," meaning that "[a]s a fiduciary, an adviser has an obligation to obtain 'best execution' of clients' transactions. In meeting this obligation, an adviser must execute securities transactions for clients in such a manner that the clients' total cost or proceeds in each transaction is the most favorable under the circumstances."[11]

On December 31, 2018, there were 13,299 investment advisers registered with the SEC with over $84 trillion in assets under management, plus 17,268 investment advisers registered with states with approximately $334 billion in assets under management, and 3,911 investment advisers who submit forms as exempt reporting advisers. As of that same date, there were approximately 41 million client accounts advised by SEC-registered investment advisers.[12]

According to the SEC: "Under Section 206(2), an investment adviser has a fiduciary duty to disclose to its clients all conflicts of interest which might incline an investment adviser consciously or unconsciously to render advice that is not disinterested." *Id.* at 191-92. A conflict of interest is a material fact that an investment adviser must disclose to its clients. *Id.* A violation of Section 206(2) may rest on a finding of simple negligence. *SEC v. Steadman*, 967 F.2d 636, 643 n. 5 (D.C. Cir. 1992)."[13]

Merrill Lynch and Mutual Funds That Pay Commissions

The SEC has advised that Section 206(2) requires an investment advisor to disclose when it chooses to place a client's money with a mutual fund that charges a fee for entry and pays a commission, when a no-fee alternative exists.[14] In April of 2020, Merrill Lynch, Pierce, Fenner & Smith Incorporated (ML) self-reported violations of Section 206(2), acknowledging that its advisors acquired mutual fund shares from providers who charged fees that could have been avoided by investing in a different class of mutual funds. Based on "willful" violations of Section 206(2), on April 17, 2020 the SEC announced a cease-and-desist order against ML that required the company to disgorge $325,376 and to desist from the prohibited practice.[15] The same problem arose in *Tibble v. Edison International*, 843 F. 3d 1187 (9th Circuit 2016) (en banc after remand), where an ERISA plan trustee was sued for investing 401K cash in higher priced retail-class mutual funds when materially identical lower priced institutional-class mutual funds were available.

In *Transamerican Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979), a divided Court (4-1-4) held

that the Investment Advisors Act of 1940 permitted a client to seek rescission of an investment advisors contract but not money damages.

D. SARBANES-OXLEY. The Sarbanes-Oxley Act ("SOX")of 2002 requires publicly-traded companies to have an audit committee made up of independent outside directors, including at least one financial expert. The Act also requires top managers to personally certify the accuracy of company financial reports, and the penalty for a knowingly or willfully making a false certification is up to 20 years in prison. Section 404 of the Act requires public companies to perform internal control tests and to publish an internal control report as part of the annual audits. SOX § 802 enacted 18 U.S.C. § 1519 an anti-shredding provision that makes it illegal to knowingly alter, destroy, mutilate, conceal, cover up, falsify, or make a false entry on any document with the intent to impede, obstruct or influence an investigation. [Note: in *Yates v. U.S.*, 354 U.S. 298 (2015), a divided court (4-1-4) held that an individual could not be convicted under this statute for destroying fish.] In January of 2003 the SEC issued standards of professional conduct for attorneys practicing before the SEC in the representation of companies. One standard requires the attorney to "reveal confidential information related to his or her representation to the extent the attorney reasonably believes necessary (1) to prevent the issuer from committing a material violation likely to cause substantial financial injury to the financial interests or property of the issuer or investors; (2) to prevent the issuer from committing an illegal act; or (3) to rectify the consequences of a material violation or illegal act in which the attorney's services have been used...."[16]

E. DODD-FRANK. The Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 was enacted in reaction to the "Great Recession" of 2007-2008. Dodd-Frank authorized the SEC to promulgate rules establishing a fiduciary duty between stock brokers and their clients. It also established a "bounty" program to reward whistleblowers whose disclosures lead to fines for violation of Federal Securities laws. The bounty program is discusses in Section VIII.Q.5 below.

F. MENTAL STATE UNDER FEDERAL SECURITIES LAW. Enforcement proceedings under the antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 traditionally have been based on willful violation of those securities laws. A willful violation of the securities laws means merely "'that the person charged with the duty knows what he is doing.'" *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "'also be aware that he is violating one of the Rules or Acts.'" *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)). The 2nd, 3rd, 5th, 6th, and 11th Circuits have ruled that proof of scienter is required to sue under Section 14 of the 1934 Act. However, in *Varjabedian v. Emulex Corp.*, *aff'd in part, rev'd in part and remanded*, 888 F.3d 399 (9th Cir. 2018), the Ninth Circuit Court of Appeals recognized a private right to recover for merely negligent violations of Section 14(e) of the Securities Exchange Act of 1934, for misstatements or omissions made in connection with tender offers of securities. The decision was controversial, and the U.S. Supreme Court granted certiorari and heard argument in the case. However, one week later the Supreme Court dismissed review as improvidently granted. [Comment: the questioning during oral argument reflected a concern among some justices that the complaint about a private negligence-based cause of action had not been challenged in the courts below.] The question thus remains whether a private claim can be brought for false statements or omissions under Section

14(e), where the actor was merely negligent and acted without scienter.

G. TEXAS SECURITIES LAWS. The current Texas Securities Act, Title 19 of Vernon's Texas Civil Statutes, is in effect until January 1, 2022. The Act created a State Securities Board. In Art. 581-4.F, the terms "fraud" and "fraudulent practice" are defined to include "any misrepresentations, in any manner, of a relevant fact; any promise or representation or predication as to the future not made honestly and in good faith, or an intentional failure to disclose a material fact." Under Art. 581-23, the Commissioner may, upon notice and hearing, issue a cease and desist order to stop a fraudulent practice or activities that would work a fraud or would not be "fair, just or equitable" to a purchaser. Under Art. 581-23, the Commissioner of the States Securities Board can levy administrative fines. Art. 581-29 makes fraud or fraudulent practices in selling or buying a security, or in giving investment advice, a third degree felony if the amount in question is below $10,000; a second degree felony if the amount involved is $10,000 or more but below $100,000, and a first degree felony if the amount involved is $100,000 or more. Under Art. 581-32, the Commissioner can seek an injunction to stop fraud or a fraudulent practice. The injunction is also available against any person or company who, with intent to deceive or defraud or with reckless disregard for the truth or the law, has materially aided, is materially aiding, or is about to materially aid, a fraud or fraudulent practice. Under Art. 581-33-1.A(2), an investment advisor who commits fraud or engages in a fraudulent practice can be held liable in a civil lawsuit for damages. Under Art. 581-33-1.B, damages include consideration paid less income received, any loss, plus interest, court costs, and attorney's fees. However, under Art. 581-33-1.C, liability will not be imposed for a fraudulent statement or omission where either (i) the purchaser knew of the truth or omission or (ii) the investment advisor did not know, nor in the exercise of reasonable care could not have known, of the untruth or omission.

Texas Securities Act art. 581-33F(2) provides for so-called secondary liability for a person 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...." *See In re Enron Corporation Securities, Derivative & "ERISA" Litigation, Newby v. Enron Corporation*, 540 F. Supp. 759, 769 (S.D. Texas, Houston Division 2007).

V. BUSINESS TORTS AND CLAIMS.

A. FRAUD. "Fraud is as basic a cause of action to business tort cases as negligence is to personal injury. Because in most cases where a plaintiff can prove fraud he can demonstrate malice sufficient to justify punitive damages, it is perhaps the most frequently pled and attempted business tort. ¶ Fraud comes in more than one variety: common-law or actual fraud, constructive fraud, and statutory fraud or fraud in connection with real estate and stock transactions." Dow & Smyser, 49 TEXAS PRACTICE SERIES CONTRACT LAW § 2.12 (Thomson West).

The elements of fraud are: "(1) that a material representation was made; (2) the representation was false; (3) when the representation was made, the speaker knew it was false or made it recklessly without any knowledge of the truth and as a positive assertion; (4) the speaker made the representation with the intent that the other party should act upon it; (5) the party acted in reliance on the representation; and (6) the party thereby suffered injury." *Italian Cowboy Partners, Ltd. v. Prudential*

Ins. Co. of Am., 341 S.W.3d 323, 337 (Tex. 2011). "Material means a reasonable person would attach importance to and would be induced to act on the information in determining his choice of actions in the transaction in question." *Id.* at 335. "Pure expressions of opinion are not representations of material fact, and thus cannot provide a basis for a fraud claim." *Id.* at 337-38.... Whether a statement is an actionable statement of 'fact' or merely one of 'opinion' often depends on the circumstances in which a statement is made." *Id*. at 338. "Superior knowledge by one party may also provide the occasion for fraud." *Id.* at 338, citing *Transport Ins. Co. v. Faircloth*, 898 S.W.2d 269, 276 (Tex. 1995). Where the fraud in question involved a promise to do an act in the future, the complaint must also show that, at the time of the promise, the promisor had no intention of performing the act. *Crim Truck & Tractor v. Navistar Int'l Transp. Corp.*, 823 S.W.2d 591, 597 (Tex. 1992).

Texas fraud jurisprudence does not impose a privity requirement on a fraud claim. Instead courts look at whether the defendant intended for to misrepresentation to reach a third person and induce reliance. *Ernst & Young v. Pacific Mut. Life Ins. Co.*, 51 S.W.3d 573, 578 (Tex. 2001). However, intent in this context has been broadened to include "reason to expect" reliance, "which requires a degree of certainty that goes beyond mere forseeability," meaning more than "should have known." *Id* at 579-80.

B. NEGLIGENT MISREPRESENTATION. In *Federal Land Bank Ass'n of Tyler v. Sloane*, 825 S.W.2d 439, 442 (Tex. 1991), the Texas Supreme Court adopted RESTATEMENT (SECOND) OF TORTS § 552:

> One who, in the course of his business, profession or employment, or in any transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

Note that this claim is a negligence claim involving deviation from ordinary care, whereas a fraud claim requires a showing of intent to deceive. In *McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests*, 991 S.W.2d 787, 792-794 (Tex. 1999), the Supreme Court noted that the duty regarding negligent misrepresentation has been applied to auditors, physicians, real-estate brokers, securities placement agents, surveyors, accountants, and in *McCamish* it was applied to attorneys. Courts of appeals have narrowed its application, saying that the attorney's duty is "limited" to an opinion letter furnished to a non-client. The liability arises only when the attorney is aware of the non-client and intends that the non-client rely on the representation, and the non-client justifiably relies on the attorney's representation of a material fact. *Id.* at 794. The attorney can avoid or minimize risk by including disclaimers in the opinion letter. *Id.* at 794. The non-client cannot rely on the attorney's representations unless the attorney invites that reliance. *Id.* at 795. A third party's reliance on an attorney's representation is not justified when the representation takes place in an adversarial context. *Id.* at 794. In *Blankinship v. Brown*, 399 S.W.3d 303, 308 (Tex. App.--Dallas 2013, pet. denied), the court observed that both fraud and negligent misrepresentation require proof of actual and justifiable reliance. In *Kastner v. Jenkens & Gilchrist, P.C.*, 231 S.W.3d 571, 578 (Tex. App.–Dallas 2007, no pet.), the court of appeals declined to extend the claim to a law firm that merely drafted and then

transmitted a partnership agreement for a real estate venture that failed. In *Cunningham v. Tarski*, 365 S.W.3d 179, 186-87 (Tex. App.--Dallas 2012, pet. denied), the court refused to find negligent misrepresentation for a law firm that forwarded a memorandum created by a client that allegedly was inaccurate. The court said that "courts have generally acknowledged that a third party's reliance on an attorney's representation is not justified when the representation takes place in an adversarial context." In *Grant Thornton LLP v. Prospect High Income Fund, ML CBO IV*, 314 S.W.3d 913, 920 (Tex. 2010), the Supreme Court reaffirmed its adoption of Section 552, but emphasized that the tort occurs only when the information is transferred to a *known* party for a *known* purpose. *Id.* at 920.

C. DEFAMATION.

1. Private Person Suing. A private individual suing for defamation (libel or slander) must show that "(1) the defendant published a statement, (2) the statement was defamatory concerning the plaintiff, and (3) the defendant acted with negligence regarding the statement's truth." *Neely v. Wilson*, 418 S.W.3d 52, 61 (Tex. 2013).[Comment: this is a simple negligence standard.]

2. Public Official or Public Figure Suing. Where the plaintiff is a "public official" or a "public figure," s/he must prove by clear and convincing evidence that the publisher acted with "actual malice." *Bentley v. Bunton*, 94 S.W.3d 561, 591 (Tex. 2002). [Comment: for a public figure or public official, the burden of proof rises from a preponderance of the evidence to clear and convincing evidence.] The "actual malice" standard derives from *New York Times v. Sullivan*, 376 U.S. 254, 279-80 (1964), which held that a public figure could not recover for defamation unless s/he proved that the publisher acted with "actual malice." In this context, "actual malice" means either knowledge that a statement is false or reckless disregard for the truth. *Hearst Corp. v. Skeen*, 159 S.W.3d 633, 637 (Tex. 2005) (per curiam). This is more than mere negligence, or the mere failure to investigate facts. *Bentley v. Bunton*, 94 S.W.3d at 591. The "actual malice" inquiry "focuses on the defendant's state of mind at the time of publication." *Forbes Inc. v. Granada Biosciences, Inc.*, 124 S.W.3d 167, 173 (Tex. 2003). "'Reckless disregard' means that the publisher entertained serious doubts about the publication's truth or had a high degree of awareness of the publication's probable falsity." *Bentley*, 94 S.W.3d at 591.

3. Statutory Privilege of Newpapers or Periodicals. A privilege exists for newspapers or periodicals who publish fair, true, and impartial accounts of judicial, official, or executive proceedings or who publish reasonable and fair comment or criticism of officials or official acts. Tex. Civ. Prac. & Rem. Code § 73.002. A privilege also exists for republication of a prior published report. *Id.* § 73.002(a). However, the privilege does not extend to a republication done with actual malice after the matter had ceased to be of public concern. *Id.* at § 73.002(a). Also, an aggrieved person who fails to give the publisher upon request evidence of falsity of a statement cannot recover damages unless the publication was made with "actual malice." *Id.* at § 73.056. And if the publisher corrects or retracts the libelous statement, it cannot be held liable for exemplary damages unless the publication was made with "actual malice." *Id.* at § 73.059.

4. Litigation-Related Absolute Privilege. "Communications in the due course of a judicial proceeding will not serve as the basis of a civil action for libel or slander, regardless of the negligence

or malice with which they are made.... This privilege extends to any statement made by the judge, jurors, counsel, parties or witnesses, and attaches to all aspects of the proceedings, including statements made in open court, pre-trial hearings, depositions, affidavits and any of the pleadings or other papers in the case." *James v. Brown*, 637 S.W.2d 914, 916-17 (Tex.1982).

D. BUSINESS DISPARAGEMENT. In *Hurlbut v. Gulf Atlantic Life Ins. Co.*, 749 S.W.2d 762, 766 (Tex. 1987), the Court said: "The general elements of a claim for business disparagement are publication by the defendant of the disparaging words, falsity, malice, lack of privilege, and special damages." The Court continued: "The tort is part of the body of law concerned with the subject of interference with commercial or economic relations. The Restatement identifies the tort by the name 'injurious falsehood' and notes its application 'in cases of the disparagement of property in land, chattels, or intangible things or of their quality.' Restatement (Second) of Torts § 623A, comment a (1977)." The Court continued: "the defendant in an action for business disparagement or injurious falsehood is subject to liability 'only if he knew of the falsity or acted with reckless disregard concerning it, or if he acted with ill will or intended to interfere in the economic interest of the plaintiff in an unprivileged fashion.'" *Id.*

E. CONSTRUCTIVE FRAUD. Constructive fraud is "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." *Archer v. Griffith*, 390 S.W.2d 735, 740 (Tex.1964). "Evidence supporting a breach of fiduciary duty may, in appropriate circumstances, support a constructive-fraud finding." *Saden v. Smith*, 415 S.W.3d 450, 470 (Tex. App.--Houston [1st Dist.] 2013, pet. denied). Some attorneys describe a suit for breach of fiduciary duty as a claim of constructive fraud.

F. TEXAS THEFT LIABILITY ACT. Tex. Civ. Prac. & Rem. Code ("TCP&RC") Chapter 134 sets out the Texas Theft Liability Act. Under the Act, a person who commits theft is liable for the damages resulting from the theft. TCP&RC § 134.003. The injured party can recover the amount of actual damages, plus discretionary damages up to $1,000, plus reasonable and necessary attorney's fees. TCP&RC § 134.005. Parents are vicariously liable for theft committed by a child under their control, and in that instance discretionary damages can be up to $5,000. TCP&RC § 134.005(2). In *Corley v. Hendricks*, No. 02-16-00293-CV (Tex. App.–Fort Worth April 27, 2017, pet. denied) (mem. op.), two co-owners of a closely-held corporation were sued by a third co-owner for embezzling money from the company. The defendants claimed that they had consented to the transfers in question. The court held that as interested directors and shareholders they could not consent to their own breach of fiduciary duty.

G. LIABILITY OF AGENTS, INCLUDING CORPORATE OFFICERS, FOR THEIR ACTS. In *Willis v. Donnelly*, 199 S.W.3d 262, 271 (Tex. 2006), the Court said: "A bedrock principle of corporate law is that an individual can incorporate a business and thereby normally shield himself from personal liability for the corporation's contractual obligations.[11] Avoidance of personal liability is not only sanctioned by the law; it is an essential reason that entrepreneurs like Willis choose to incorporate their businesses." However, Texas law recognizes individual liability of corporate actors

based on direct liability or piercing the corporate veil. In *Bates Energy Oil & Gas v. Complete Oilfield Servs.*, 361 F. Supp. 3d 633, 664 (W.D. Tex. 2019).

Direct Liability. The Supreme Court said: "[A] corporation's employee is personally liable for tortious acts which he directs or participates in during his employment." *Leyendecker & Assocs., Inc. v. Wechter*, 683 S.W.2d 369, 375 (Tex. 1985) (employee individually liable for a libelous letter sent in the course and scope of his employment). In *Leitch v. Hornsby*, 935 S.W.2d 114, 117 (Tex. 1996), the Court said: "unless alter ego is established, corporate officers and agents are subject to personal liability for their actions within the employment context only when they breach an independent duty of care." *Miller v. Keyser*, 90 S.W.3d 712, 717 (Tex. 2002) (holding that a corporate agent can be held personally liable for his own fraudulent or tortious acts). However, there is a significant disagreement among courts of appeals about whether Texas Business & Organizations Code (TBOC) § 21.223 (effective 2007), which restricted the availability of the remedy of piercing the corporate veil, also protects individual corporate representatives from direct liability. After a review of cases pro and con, a Federal District Judge in the Western District of Texas sided with the view that direct liability still existed in Texas. *Bates Energy Oil & Gas v. Complete Oilfield Services*, 361 F.Supp.3d 633 (W.D. Texas San Antonio Jan. 14, 2019). In *Spicer v. Maxus Healthcare Partners, LLC*, No. 02-17-00449-CV (Tex. App.–Fort Worth Oct. 1, 2020, n.p.h.), the court held that the president of a corporation could be held liable for his own fraudulent statements, even though he was acting in his capacity as president of an LLC.

Piercing the Corporate Veil. Imposing liability on corporate representatives through the doctrine of piercing the corporate veil is discussed in Section XII.I below.

VI. COMPARING THREE TYPES OF RELATIONSHIPS. For the purposes of this Article, transactions can be divided into three categories: formal fiduciary, informal fiduciary, and arm's-length. The duties vary with the type of transaction. Formal and informal fiduciary duties have similar if not identical duties. Arm's-length transactions are without special duties, but general tort duties apply.

A. FORMAL FIDUCIARY RELATIONSHIPS. There are different articulations of who is a formal fiduciary under Texas law. The Texas Supreme Court has listed attorney-client, principal-agent, partners, and joint venturers, as relationships that give rise to a formal fiduciary relationship as a matter of law. *Insurance Co. of N. Am. v. Morris*, 981 S.W.2d 667, 674 (Tex. 1998); *Texas Bank & Trust Co. v. Moore*, 595 S.W.2d 502, 507 (Tex. 1980). Texas Penal Code § 32.43, Commercial Bribery, lists as fiduciaries (A) an agent or employee, (B) a trustee, guardian, administrator, executor, conservator, receiver, or similar fiduciary, (C) a lawyer, physician, accountant, appraiser, or other professional advisor, or (D) an officer, director, partner, manager, or other participant in the direction of the affairs of a corporation or association. Texas Penal Code § 32.45(a)(1), Misapplication of Fiduciary Property, lists as fiduciaries a trustee, guardian, administrator, executors, executor, conservator, and receiver. In the Code of Ethics and Minimum Standards for Guardianship Services,[17] promulgated by the Texas Supreme Court on June 24, 2016, the term "fiduciary" is defined as "[a]n individual, agency, or organization that has agreed to undertake for another a special obligation of trust and confidence,

having the duty to act primarily for another's benefit and subject to the standard of care imposed by law or contract."

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

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

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

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

5. Guardian → Ward. On June 24, 2016, the Texas Supreme Court adopted a Code of Ethics and Minimum Standards for Guardianship Services.[18] Section 2 provides: "2. *Fiduciary Relationship.* A guardian is a fiduciary of a ward under the guardian's care and must exhibit the highest degree of loyalty and fidelity in the guardian's relations with the ward." See Section VIII.F below.

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

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

pet. denied); *Daniels v. Empty Eye, Inc.*, 368 S.W.3d 743, 750-51 (Tex. App.--Houston [14th Dist.] 2012, pet. denied). The duty of loyalty may apply to limited partners. See TBOC § 152.205. See Section VIII.G.6 below.

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

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

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

10. Spouses. Texas has long recognized that the marital relationship entails fiduciary obligations between spouses. See Section VIII.AA below.

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

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

> We have also recognized that certain informal relationships may give rise to a fiduciary duty. *See, e.g.*, *MacDonald v. Follett*, 142 Tex. 616, 180 S.W.2d 334 (1944). Such informal fiduciary relationships have also been termed "confidential relationships" and may arise "where one person trusts in and relies upon another, whether the relation is a moral, social, domestic or merely personal one". *Fitz-Gerald v. Hull*, 150 Tex. 39, 237 S.W.2d 256, 261 (1951). Because not every relationship involving a high degree of trust and confidence rises to the stature of a formal fiduciary relationship, the law recognizes the existence of confidential relationships in those cases

> "in which influence has been acquired and abused, in which confidence has been reposed and betrayed". *Texas Bank & Trust Co. v. Moore*, 595 S.W.2d 502, 507 (Tex. 1980). The existence of a confidential relationship is usually a question of fact. *See MacDonald*, 142 Tex. at 623, 180 S.W.2d at 339; *Schiller v. Lick*, 150 Tex. 363, 240 S.W.2d 997, 1000 (1951). Although we recognize that the existence of a confidential relationship is ordinarily a question of fact, when the issue is one of no evidence, it becomes a question of law. *See Thigpen v. Locke*, 363 S.W.2d 247, 253 (Tex. 1962).
>
> In *Mills v. Gray*, 147 Tex. 33, 210 S.W.2d 985 [Tex. 1948], and *Fitz-Gerald v. Hull*, 150 Tex. 39, 237 S.W.2d 256 [Tex. 1951], the Supreme Court recognized that confidential relationships may arise not only from the technical fiduciary relationships such as attorney-client, trustee-cestui que trust, partner and partner, etc. – which as a matter of law are relationships of trust and confidence–but may arise informally from "moral, social, domestic or purely personal" relationships. 54 Am. Jur. 173, § 225, "Trusts". The existence of the fiduciary relationship is to be determined from the actualities of the relationship between the persons involved.

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

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

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

There are a number of criminal cases describing what constitutes an informal "fiduciary capacity" for purposes of criminal law. A list is given in *Berry v. State*, 424 S.W.3d, 579, 585 n. 7 (Tex. Crim. App. 2013): "*Fuelberg v. State*, 410 S.W.3d 498, 502 (Tex. App.--Austin 2013) (defendant was general manager of non-profit utility cooperative who funneled cooperative's funds to his brother and a friend); *Anderson v. State*, 322 S.W.3d 401, 406-07 (Tex. App.--Houston [14th Dist.] 2010, pet. ref'd) (defendant was investment manager who received funds for sole purpose of investing funds in limited partnership but instead spent funds on personal legal fees and a car); *Head v. State*, 299 S.W.3d 414, 433 (Tex. App.--Houston [14th Dist.] 2009, pet. ref'd) (defendant was financial adviser and protector of elderly woman's two trusts who took personal and business loans from complainant's funds without

her knowledge); *Tyler v. State*, 137 S.W.3d 261, 264-66 (Tex. App.--Houston [1st Dist.] 2004, no pet.) (defendant was acting in 'fiduciary capacity' when she agreed to help manage elderly relative's financial assets and then withdrew funds from complainant's bank account without authorization); *Huett v. State*, 970 S.W.2d 119, 124-25 (Tex. App.--Dallas 1998, no pet.) (defendant used investors' money on personal expenditures unrelated to oil-lease business including house and car payments, clothing, and grocery expenses); *Starnes v. State*, 929 S.W.2d 135, 137-38 (Tex. App.–Fort Worth 1996, pet. ref'd) (defendant was hired by volunteer fire department to run charity bingo games and misappropriated money from organization); *Dwyer v. State*, 836 S.W.2d 700, 702 (Tex. App.--El Paso 1992, pet. ref'd) (defendant was accountant who received customers' payments for purpose of forwarding them to utility company but instead applied them to his own personal and business expenses); *Showery v. State*, 678 S.W.2d 103, 106 (Tex. App.--El Paso 1984, pet. ref'd) (defendant was physician who received insurance-company overpayments on patient's behalf and then failed to forward payments to patient).

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

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

C. ARM'S-LENGTH TRANSACTIONS.

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

> [W]e observe that the civil courts of Texas have generally held that everyday arms-length business transactions, including contracts to sell goods and services, do not give rise to a fiduciary relationship between the parties. *See Crim Truck & Tractor Co. v. Navistar Int'l Transp. Corp.*, 823 S.W.2d 591, 594 (Tex. 1992), superseded by statute on other grounds ("The fact that one businessman trusts another, and relies upon his promise to perform a contract, does not rise to a confidential relationship."). That is because in everyday business dealings, it is assumed that the parties interact for their mutual benefit, and, therefore, a partNovember 11, 2020y is not expected to act solely for the benefit of the other party to the contract. *See Schlumberger Tech. Corp. v. Swanson*, 959 S.W.2d 171, 177 (Tex. 1997) (declining to impose fiduciary relationship in

> contractual situation because "all contracting parties presumably contract for their mutual benefit"). To impose a fiduciary relationship in ordinary business dealings would run contrary to the principle that a fiduciary is obligated to act for the primary benefit of the other party.

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

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

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

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

In *Thigpen v. Locke* Chief Justice Calvert, joined by Justice Ruel Walker and Justice Zollie Steakley (three great Justices of the recent Texas Supreme Court),[19] wrote in dissent about the standard for when a fiduciary duty arises in a business transaction:

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

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

VII. DEFINING FIDUCIARY DUTIES. Justice Benjamin Cardozo described the fiduciary duty of co-venturers in *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545 (1928), as requiring "something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor most sensitive, is then the standard of behavior." This description is famous, partly due to Cardozo's enduring stature as a renowned jurist and important legal author[20] and partly due to the piquancy of his comment. The Texas Supreme Court similarly said in *Johnson v. Peckham*, 132 Tex. 148, 120 S.W.2d 786, 788 (1938): "When persons enter into fiduciary relations each consents, as a matter of law, to have his conduct towards the other measured by the standards of the finer loyalties exacted by courts of equity. That is a sound rule and should not be whittled down by exceptions." In the decades since Cardozo wrote, the stringency of his description of a fiduciary duty has devolved into a variety of standards that fall below his ideal. In the corporate context, and even in formal fiduciary relationships like trustees of an express trust nad partners in a partnership, legislatures and courts have articulated a variety of duties and exceptions.

A. TEXAS PATTERN JURY CHARGE. The State Bar of Texas PATTERN JURY CHARGES (BUSINESS, CONSUMER, INSURANCE & EMPLOYMENT 2018) PJC 104.2 describes the duties of a fiduciary under the common law. The liability question asks: (1) was the transaction fair and equitable to the beneficiary?;(2) did the fiduciary make reasonable use of the confidence placed in him?; (3) did the fiduciary act in the utmost good faith and exercise the most scrupulous honesty toward the beneficiary?; (4) did the fiduciary place the beneficiary's interest before his own and not use the advantage of his position to gain any benefit for himself at the expense of the beneficiary?; and (5) did the fiduciary fully disclose all important information to the beneficiary concerning the transaction? The questions are submitted in one broad form question, and the fiduciary has the burden of proof to secure a "yes" answer.

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

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

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

The Clash of Business Fiduciary Duties with Other Duties

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

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

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

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

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

D. DUTY OF GOOD FAITH. Under Texas law, a trustee of an express trust has a duty of good faith. "The trustee shall administer the trust in good faith according to its terms and this subtitle [i.e., Texas Trust Code, subtitle B]." Tex. Prop. Code § 113.051. A trustee must exercise a discretionary power in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries." Tex. Prop. Code § 113.029(a). If a trustee with full discretion to distribute the principal of a trust may distribute principal to the trustee of a second trust, but that discretion must be exercised "in good faith, in accordance with the terms and purposes of the trust, and in the interests of the beneficiaries." Tex. Prop. Code § 112.072(e).

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

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

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

E. DUTY TO DISCLOSE. In *Huie v. DeShazo*, 922 S.W.2d 920, 923 (Tex. 1996), the Court said: "[t]rustees and executors owe beneficiaries "a fiduciary duty of full disclosure of all material facts known to them that might affect [the beneficiaries'] rights.'" The broader law of the duty to disclose is discussed in Section IX.C below.

F. PROHIBITION AGAINST SELF-DEALING. The Federal Deposit Insurance Corporation's (FDIC) Trust Examination Manual defines self-dealing in these terms: "Self-dealing always involves a conflict of interest, but not all conflicts of interest involve self-dealing. Self-dealing occurs when a fiduciary is a party to a transaction with itself or its affiliates." FDIC Trust Examination Manual[21]

§ 8.B. The Manual quotes the U.S. Supreme Court in *Michoud v. Girod*, 45 U.S. 503, 555 (1846):

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

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

VIII. DUTIES ARISING FROM DIFFERENT RELATIONSHIPS.

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

B. AGENT-PRINCIPAL. An agent is duty-bound, unless otherwise agreed, to "act solely for the benefit of the principal in all matters connected with his agency." In *Johnson v. Brewer & Pritchard, P.C.*, 73 S.W.3d 193, 200 (Tex. 2002), the Court quoted the RESTATEMENT (SECOND) OF AGENCY cmt a (1958): "Among the agent's fiduciary duties to the principal is the duty to account for profits arising out of the employment, the duty not to act as, or on account of, an adverse party without the principal's consent, the duty not to compete with the principal on his own account or for another in matters relating to the subject matter of the agency, and the duty to deal fairly with the principal in all transactions

between them." The Court indicated that an agent has a duty not to divert an opportunity from the principal in a way that the agent or an entity controlled by the agent profits or benefits in some way. *Id*. at 200. In *Vogt v. Warnock*, 107 S.W.3d 778, 782 (Tex. App.--El Paso 2003, pet. denied), the court held that a power of attorney automatically creates an agency relationship along with its fiduciary duties, even if the power of attorney is not exercised. *Accord*, *Jordan v. Lyles*, 455 S.W.3d 785, 792 (Tex. App.--Tyler 2015, no pet.);

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

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

Good Faith, Statutory Rules, Common Law

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

Statutory Duty of Care in Investing and Managing Assets

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

ordinary person to the care of someone with those special skills or expertise.]

Statutory Duty to Diversify

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

Statutory Duty of Loyalty

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

Statutory Duty of Impartiality

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

Exclupation

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

Third Persons Acting With Trustee

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

2. Common Law Duties of a Trustee. The case law speaks to the duties of the trustee of an express trust. However, common law duties apply only to the extent that they do not conflict with Texas

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

Trustee's Discretion

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

No Duty to Violate Law

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

3. Terms of the Trust Document. "[I]f the trust instrument expressly limits the powers of the trustee or if it provides that the trustee has greater powers than those conferred by the Trust Code, then the language of the trust instrument will control. But if the terms of the trust instrument do not limit or

conflict with a power given to trustee, the default rules supplied by the Trust Code apply." *Myrick v. Moody Nat'l Bank*, 336 S.W.3d 795, 801 (Tex. App.--Houston [1st Dist.] 2011, no pet.). "A power given to a trustee by [the Trust Code] does not apply to a trust to the extent that the instrument creating the trust, a subsequent court order, or another provision of [the Code] conflicts with or limits the power." *Id.* § 113.001.

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

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

1. Duties Under the Code of Ethics.

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

b. Duties to Client. A lawyer's duties to the client are covered in TDRPC Sections I and II. These include the duty of competent and diligent representation (Rule 1.01), a duty to keep the client reasonably informed (Rule 1.03), a prohibition against illegal or unconscionable fees (Rule 1.04), a duty of confidentiality (Rule 1.05), a duty to avoid conflicts of interest (Rule 1.06, 1.07, 1.09 & 1.13), a prohibition of certain transactions with the client (Rule 1.08), a prohibition against successive government and private employment (Rule 1.10), a duty to safekeep the client's property (Rule 1.14), and a duty to exercise independent professional judgment (Rule 2.01).[22]

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

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

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

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

"The focus of breach of fiduciary duty is whether an attorney obtained an improper benefit from representing a client, while the focus of a legal malpractice claim is whether an attorney adequately represented a client." *Kimleco Petroleum, Inc. v. Morrison & Shelton, P.C.*, No. 2-02-278-CV (Tex. App.--Fort Worth Dec. 12, 2002, pet. denied) (mem. op.); *Goffney v. Rabson*, 56 S.W.3d 186, 193 (Tex. App.--Houston [14th Dist.] 2001, pet. denied) (giving examples of when a breach of fiduciary duty occurred); *Greathouse v. McConnell*, 982 S.W.2d 165, 172 (Tex. App.--Houston [1st Dist.] 1998, pet. denied). As to a claim of negligence, a lawyer in Texas is held to the standard of care that would have been exercised by a reasonably prudent attorney, based on information s/he had at the time of the act. *Cosgrove v. Grimes*, 774 S.W.2d 662, 665 (Tex. 1989). The courts have also recognized a claim under the Texas Deceptive Trade Practices Act. *Latham v. Castillo*, 972 S.W.2d 66 (Tex. 1998) (client can assert claim under the DTPA provisions regarding unconscionable action or course of action).

However, a claimant cannot "fracture" a case against a lawyer. "Nothing is to be gained by fracturing a cause of action arising out of bad legal advice or improper representation into claims for negligence, breach of contract, fraud or some other name. If a lawyer's error or mistake is actionable, it should give rise to a cause of action for legal malpractice with one set of issues ...." *Ersek v. Davis & Davis, P.C.*, 69 S.W.3d 268, 274-75 (Tex. App.--Austin 2002, pet. denied).

Recovery

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

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

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

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

5. Tortious Acts. "[A] lawyer's protection from liability arising out of his representation of a client is not without limits. ... For example, a cause of action could exist against an attorney who knowingly commits a fraudulent act outside the scope of his legal representation of the client.... If a lawyer participates in independently fraudulent activities, his action is 'foreign to the duties of an attorney.' ... A lawyer thus cannot shield his own willful and premeditated fraudulent actions from liability simply on the ground that he is an agent of his client." *Alpert v. Crain, Caton & James, P.C.*, 178

S.W.3d 398, 406 (Tex. App.--Houston [1st Dist.] 2005, pet. denied) (Bland, J.) (citations omitted). In *Chu v. Hong*, 249 S.W.3d 441 (Tex. 2007), the Court held that an attorney could not be held liable for conspiracy or aiding and abetting a fiduciary breach when the claimed wrong was fraud on the community estate, which is not considered to be a tort. A non-client bringing a claim against an lawyer for negligent misrepresentation is discussed in Section. V.B.

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

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

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

"Under Texas law, an executor owes a fiduciary duty to the beneficiaries of the decedent's estate. An executor has several legal obligations in that capacity, including locating and notifying beneficiaries under the will; notifying creditors of the estate; determining and paying the estate's debts; filing tax returns and paying taxes owed by the estate; identifying, valuing, accounting for, and protecting estate assets; asserting estate claims and defending the estate against claims; and distributing remaining estate assets to the beneficiaries on an equitable basis consistent with the will's provisions." Tex. Ethics Op.

No. 678 (Sep. 2018). In *Huie v. DeShazo*, 922 S.W.2d 920, 923 (Tex. 1996), the Court said: "[t]rustees and executors owe beneficiaries 'a fiduciary duty of full disclosure of all material facts known to them that might affect [the beneficiaries'] rights.'"

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

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

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

F. GUARDIAN-WARD. On June 24, 2016, the Texas Supreme Court promulgated a Code of Ethics and Minimum Standards for Guardianship Services, recognizing that a court-appointed guardian owes a fiduciary duty to the ward.[23] Section 3 and Section 7 of the Code describe a Duty of Confidentiality. Section 5 describes a duty of Competence: "5. A guardian of the person must make reasonable and informed decisions about the ward's residence, care, treatment, and services. A guardian of the estate must take care of and manage the estate as a prudent person would manage the person's own property unless relevant law imposes a higher standard of care. In either case, a guardian must exercise reasonable diligence to remain informed about options available to the ward to promote independence and self-reliance. A guardian must refrain from making decisions outside of the scope of authority granted to the guardian by law or court." Section 7 provides: "7. *Avoidance of Conflicts of Interest and*

Self-Dealing. A guardian must avoid conflicts of interest and refrain from personally engaging in transactions with the ward and other forms of self-dealing, except in a manner authorized by law." Section 15(a) prohibits even the appearance of a conflict of interest or impropriety when dealing with the needs of the ward. "Impropriety or conflict of interest arises where the guardian has some personal or agency interest that can be perceived as self-serving or adverse to the position or best interest of the ward." *Id.* "A conflict of interest may also arise where the guardian has dual or multiple relationships with a ward which conflict with each other or has a conflict between the best interests of two or more wards." *Id.* If the guardian becomes aware of a conflict of interest, s/he must immediately disclose that to the court. *Id.* Section 15(b). A guardian of the estate must maintain and manage the ward's estate as a prudent person would manage the person's own property consistent with a fiduciary's duties and responsibilities set forth in the Texas Estates Code." Section 16(a). "The guardian must manage the estate only for the benefit of the ward." Section 16(c). The guardian cannot commingle the estate's assets. Section 16 (e) & (f). "The guardian must employ prudent accounting procedures when managing the estate." Section 16(h). The standards prohibit conflicts of interest unless expressly authorized or directed by the instrument or transaction establishing the trust; commingling in the same terms as for guardians of the person. A guardian cannot profit from a transaction made on behalf of the ward or compete with the ward's estate without permission of the court. Section 19(h).

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

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

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

Court applied the law of Delaware to the remedy of constructive trust. *Id.* at 873. Texas recognizes choice-of-law clauses in agreements. *DeSantis v. Wackenhut Corp.*, 793 SW 2d 670, 678-84 (Tex. 1990) (recognizing the validity of choice-of-law clauses at stated in RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187, but applying the public-policy exception to covenants not to compete). Courts apply the law of the forum to procedural matters. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 122 (1971).

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

a. Directors. TBOC § 22.221(a) says that a corporate director must "discharge the director's duties, including duties as a committee member, in good faith [a subjective standard], with ordinary care [an objective standard], and in a manner the director reasonably [objective] believes [subjective] to be in the best interest of the corporation. Section 22.221(b) says that "[f]or a director to be liable for actions or inactions, the complainant must show that the director (i) did not act in good faith, and (ii) did not use ordinary care, and (iii) did not act in a manner that the director reasonably believed to be in the best interest of the corporation." (Underline added.) [Comment: Because the proposition is conjunctive, to be liable for damages the director must breach all three duties at the same time.] "Good faith" is not defined in the TBOC. Good faith is a subjective standard. "Ordinary care" is an objective standard, the familiar tort standard of ordinary prudence under similar circumstances. "Reasonable belief" of best interest is a mixed standard: "belief" is a subjective assessment of what was in the mind of the director, but the reasonableness of this belief is an objective standard of ordinary care. Section 22.223 says that "[a] director of a corporation is not considered to have the duties of a trustee of a trust with respect to the corporation or with respect to property held or administered by the corporation, including property subject to restrictions imposed by the donor or transferor of the property." [Comment: The trustee of an express trust is required to put the beneficiary's interest before his own. How this differs from the "duty of loyalty" owed by corporate directors is a complicated question.] Under Section 22.224 the board of directors can delegate investment authority, and if it does so "[t]he board of directors is not liable for an action taken or not taken by an advisor under this section if the board acted in good faith [subjective] and with ordinary care [objective] in selecting the advisor." [Comment: the board must meet both the subjective and objective standards for the exception to apply.] Section 22.225(a) flatly prohibits a corporation from making a loan to a director. Under Section 22.225(b), any director who votes for such a loan, or any officer who participates in making the loan, is liable to the corporation for the amount of the loan.

In *Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014), the Court said that directors must make decision about declaring dividends "in compliance with the formal fiduciary duties that they, as officers or directors, owe to the corporation, and thus to the shareholders collectively." In *Klinek v. LuxeYard, Inc.*, 596 S.W.3d 437, 453 (Tex. App.--Houston [14th Dist.] 2020, pet. denied), the court said that "[d]irectors owe fiduciary obligations to both the corporation and its shareholders, and those obligations include the fiduciary duties of care, good faith, and loyalty." [The fiduciary duty of directors to the

shareholders is a complicated question.]

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

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

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

e. Duty of Obedience. Baylor Law School Professor Elizabeth S. Miller writes that corporate directors owe a "duty of obedience" which she says forbids ultra vires acts. Miller, *Fiduciary Duties, Exculpation, and Indemnification in Texas Business Organizations*, State Bar of Texas 13th ANNUAL

ADVANCED REAL ESTATE STRATEGIES COURTS, ch. 4, p. 1 (2019) ("Miller 2019"). *Accord*, *Gearhart Industries, Inc. v. Smith International*, 741 F.2d 707, 719 (5th Cir. 1984) ("[t]he duty of obedience requires a director to avoid committing ultra vires acts, i.e., acts beyond the scope of the powers of a corporation as defined by its charter or the laws of the state of incorporation").

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

Owed to the Company. In *Hoggett v. Brown*, 971 S.W.2d 472, 488 (Tex. App.–Houston [14th Dist.] 1997, pet. denied), the court said: "[a] director's fiduciary duty runs only to the corporation, not to individual shareholders or even to a majority of the shareholders." *Accord*, *Somers v. Crane*, 295 S.W.3d 5, 11 (Tex. App.-Houston [1st Dist.] 2009, pet. denied) (citing cases that so hold). However, "officers or directors may owe a fiduciary duty to individual shareholders if a contract or confidential relationship exists between them in addition to the corporate relationship." *Opperman v. Opperman*, No. 07-12-00033-CV (Tex. App.–Amarillo Dec. 9, 2013, no pet.) (memo. op.).

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

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

h. Reliance on Others. TBOC § 3.105 says that "[i]n discharging a duty or exercising a power, an

officer of a domestic entity may, in good faith and ordinary care, rely on information, opinions, reports, or statements, including financial statements and other financial data, concerning the entity or another person and prepared or presented by: (1) another officer or an employee of the entity; (2) legal counsel; (3) a certified public accountant; (4) an investment banker; or (5) a person who the officer reasonably believes possesses professional expertise in the matter."

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

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

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

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

> In addition to any other liability imposed by law on the directors of a corporation, the directors who vote for or assent to a distribution of assets other than in payment of the corporation's debts,

> when the corporation is insolvent or when distribution would render the corporation insolvent, or during the liquidation of the corporation, without the payment and discharge of or making adequate provisions for any known debt, obligation, or liability of the corporation, are jointly and severally liable to the corporation for the value of the assets distributed, to the extent that the debt, obligation, or liability is not paid and discharged.

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

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

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

j. Environmental, Social, and Governance (ESG). In *Ritchie v. Rupe*, 443, S.W.3d 856, 869 (Tex. 2014), the Court noted "corporate officers' and directors' duty to maximize corporate returns and value of corporation's shares". Of late, a number of people have advocated tempering the principle of "shareholder primacy" with a focus on global warming, the social consequences of corporate decisions, and the idea that the interests of constituencies other than shareholders (i.e., employees, local communities, the urban poor, etc.) should be considered along with dividend income and share appreciation in making decisions about the corporation. Since these constituencies sometimes have diverging interests, adopting ESG principles could lead to directors and officers having to resolve conflicts between the interests of the shareholders, the employees, the communities where the businesses are located, and through the deteriorating global environment essentially every living thing.

<u>Climate Change</u>

The Clash of Business Fiduciary Duties With Other Duties

The environmental component of ESG traces back to the U.S. Supreme Court decision in *Massachusetts v. EPA*, 599 U.S. 497 (2007), where the U.S. Supreme Court held that the Clean Air Act, enacted to govern pollution, permitted the Environmental Protection Agency to regulate greenhouse gas emissions from new motor vehicles. The Federal Environmental Protection Agency ("EPA") issued regulations in 2011. In 2009-2013, during President Obama's terms, the EPA issued regulations aimed at curbing greenhouse gases emitted by stationary emitters that contributed to global warming. The regulations were struck down in *Utility Air Regulatory Group v. EPA*, 134 S. Ct. 2427 (2014), for deviating from the EPA's standards. Since that time, there has been a widening demand for corporations to curb the emission of greenhouse gasses.

There is an ongoing effort to use economic pressure and securities litigation to force corporate leaders to make disclosures to the public about how their companies contribute to global warming. In September of 2015, Mark Carney, then-Governor of the Bank of England and Chairman of the Financial Stability Board, gave a speech to Lloyd's of London entitled "Breaking the Tragedy of the Horizon – climate change and financial stability." In his speech, Carney discussed the threat that climate change poses for financial stability, and on insurers' risks in particular. In June of 2019, the Financial Stability Board's Task Force on Climate-Related Financial Disclosures published its second report on companies making climate-related disclosures, issuing a "call to action" for companies to make climate-related disclosures in line with its recommendations.[24] In November of 2019, the International Accounting Standards Board published standards for corporate boards to use in gauging the materiality of climate change disclosures that she believes were not adequately addressed in the proposed rule.[25]

In 2010, the SEC issued a *Guidance Regarding Climate Change Disclosure*, in which it suggested four areas of possibly necessary disclosure related to the environment: the impact of legislation and regulation, the impact of international accords, indirect consequences of regulation or business trends, and physical impacts of climate change.[26] On January 30, 2020, the SEC issued a proposed rule on reporting requirements, that would work a major change in financial disclosures.[27] The proposal does not address climate change specifically, but a new President will soon be taking office and the direction of change in reporting requirements will no doubt be influenced by his policy on climate change. The SEC Chair and two Commissioners each issued statements discussing the SEC's consideration of climate-related disclosures. Commissioner Lee's public statement heavily emphasized climate change disclosures.[28]

Having mandatory disclosures on the effects of climate change has the dual effect of bringing climate change to the attention of corporate leaders and investors, as well as permitting states or the Federal government to use the disclosure requirements of securities law as a basis to bring lawsuits for injunction or damages against greenhouse gas emitters.

Using Securities Law to Effect Environmental Policy

On October 24, 2019, the Attorney General of Massachusetts sued Exxon Mobil Corporation under state consumer protection laws for misleading Massachusetts investors about climate change. In a 205 page complaint carefully drafted to avoid claims under Federal law, the Attorney General asserted that

"Exxon Mobil Corporation ... , the world's largest publicly traded oil and gas company, systematically and intentionally has misled Massachusetts investors and consumers about climate change. In order to increase its short-term profits, stock price, and access to capital, Exxon Mobil has been dishonest with investors about the material climate-driven risks to its business and with consumers about how its fossil fuel products cause climate change – all in violation of Massachusetts law."[29] Throughout the complaint, the Attorney General drew parallels to the tobacco company litigation. Exxon Mobil removed the case to federal but it was remanded because the "well pleaded complaint" scrupulously avoided asserting claims arising under Federal law.[30] The Attorney General seeks "comprehensive injunctive relief," $5,000 per violation of the Massachusetts Consumer Protection Act, plus costs of investigation and fees. *Id.* In essence, the Attorney General of one state is asking a single judge of that state to set the climate change policy for the entire United States, using the state's securities law as the mechanism.

Stakeholderism

On August 19, 2019, the Business Roundtable published a letter[31] signed by 181 CEOs embracing a the new corporate purpose to replace "shareholder primacy." These CEOs pledged to conduct corporate business with consideration of delivering value to customer, investing in employees, dealing fairly and ethically with suppliers, supporting communities in which they work, and generating long-term value for shareholders. For all the fanfare this statement generated among people interested in corporate governance, this Statement on the Purpose of a Corporation included no concrete proposals. In the ensuing year, a number of articles were published by business school professors and researchers that offer perspectives on the effort to replace shareholder primacy with stakeholderism. A law professor from Harvard Law School and the Associate Director and Research Fellow of Harvard Law School's Program on Corporate Governance attempted to determine whether the CEOs obtained board approval before signing the Letter. Of the 173 companies contacted, ony 48 responded. 47 of those 48 indicated that the CEO did not get board approval before signing the Letter.[32] The authors also suggested that the companies these CEOs head do not actually pursue the corporate policies espoused in the Letter. There is little information on what the shareholders of these 181 companies think about refocusing efforts away from delivering income and building value for shareholders. Shareholders provide the capital to run corporations, and without this capital there would be fewer jobs for CEOs and lower-level employees. One could even argue that, if true diversity is wanted on boards of directors, a large portion of the board seats would be filled with directors who are beholden to shareholders and not to management. That diversity might cause corporate boards to reign in compensation of corporate directors and officers that are out of proportion to the compensation of lower-level employees and the rest of the working population.

k. Lack of Oversight. There are many instances where top management failed to oversee division managers resulting in injury to the company. Here are two.

Michael Milkin and Drexel Burnham & Lambert. Burnham & Company was founded in 1935 as a small brokerage company in New York City. It grew in size and stature, and in 1973 it merged with Drexel Firestone, a Philadelphia brokerage company established in 1838. In 1976, Drexel Burnham Co. merged with the American research arm of Belgium-based Groupe Bruxillas Lambert, to form

Drexel, Burnham and Lambert (DB&L). One branch of DB&L, headed by Michael Milkin, specialized in raising money through junk bonds to finance personalities (like T. Boone Pickens, Carl Icahn, and Ted Turner) in attempted and sometimes successful hostile takeovers of corporations. According to press reports, in 1986, DB&L netted $1.1 billion in 2019 dollars, and in 1987 Milken's executive compensation was $550 million. See generally Burrough & Helyar, BARBARIANS AT THE GATE (Harper & Row 1989).

In September of 1988, the SEC filed suit against DB&L, alleging insider trading, stock manipulation, and other crimes, involving activities of Michael Milkin's department. Then U.S. Attorney Rudolph Giulianni threatened to bring a RICO prosecution against the firm, based on the doctrine of respondeat superior. Under threat of a RICO indictment, DB&L pled guilty to stock parking and stock manipulation, and agreed to pay a fine of $650 million, the largest fine levied up to that time under 1930s securities laws. In 1989, DB&L – being a convicted felon – closed its retail brokerage operation. In early 1990, the SEC advised DB&L that it would seize its assets unless it filed for bankruptcy. DB&L chose to file for bankruptcy.

In the end, this storied company was brought to ruin by actions taken in one division of the company's business, which were either unknown to the firm's higher management or which higher management overlooked in the context of sky high profits. While upper-level management was not accused of criminal wrongdoing, one department's illegal behavior compromised the entire company. This is an object lesson about the importance of management's duty of oversight (duty of care).

l. Executive Private Misconduct. Sexual harassment in the workplace has been subject to Federal and state legislation and enforcement for years. See Section VIII.Q.2.c below. However, *private* misconduct of business executives can present serious risks to a company, and the duties to the company regarding executive private misconduct are not clear.

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

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

interests of the beneficiaries”).

4. Closely-Held Corporations. A closely-held corporation is defined for purposes of derivative actions as a corporation with fewer than 35 shareholders with no shares traded on a national securities exchange. TBOC § 21.563. In *Cardiac Perfusion Servs., Inc. v. Hughes*, 436 S.W.3d 790, 791 n. 1 (Tex. 2014), the Court wrote: “this Court has never recognized a formal fiduciary duty between a majority and minority shareholder in a closely held corporation.” Some Texas courts of appeals have held that no formal fiduciary relationship exists between majority and minority shareholders of closely-held corporations. *Vejara v. Levoir Int’l L.L.C.*, No. 04-11-00595-CV, *3 (Tex. App.--San Antonio Oct. 31, 2012, pet. denied) (memo. op.); *Allen v. Devon Energy Holdings, L.L.C.*, 367 S.W.3d 355, 391 (Tex. App.--Houston [1st dist.] 2012, pet. dism’d by agreement) (opinion not withdrawn). However, informal fiduciary relationships can arise between shareholders. *Flanary v. Mills*, 150 S.W.3d 785, 794 (Tex. App.--Austin 2004, pet. denied). In *Herring Bancorp, Inc. v. Mikkelsen*, 529 S.W.3d 216, 227 (Tex. App.--Amarillo 2017, pet. denied), the court said: “Even in the context of disproportionate ownership interests, the vast majority of intermediate appellate courts of this State have declined to recognize a broad formal fiduciary relationship between majority and minority shareholders that applies as a matter of law to every transaction between them.”

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

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

<u>Duty of Loyalty</u>

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

Duty of Care

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

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

Obligation of Good Faith

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

Breach of Partnership Agreement or Statutory Duty

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

Expulsion of a Partner

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

6. Limited Partnerships. The general partner of a limited partnership owes partnership fiduciary duties to the limited partners. TBOC § 153.152 (a)(2). *Hughes v. St. David's Support Corp.*, 944 S.W.2d 423 (Tex. App.--Austin 1997, writ denied); *McLendon v. McLendon*, 862 S.W.2d 662 (Tex. App.--Dallas 1993, writ denied). Limited partners do not have fiduciary duties by virtue of being

limited partners. *Strebel v. Wimberly*, 371 S.W.3d 267 (Tex. App.--Houston [1st Dist.] 2012, pet. denied); *AON Props. Inc. v. Riveraine Corp.*, No. 14-96-00229-CV, *23 (Tex. App.--Houston [14th Dist.] Jan. 14, 1999, no pet.) (unpublished); *Crawford v. Ancira*, No. 04-96-00078-CV (Tex. App.--San Antonio April 30, 1997, no writ) (unpublished).

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

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

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

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

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

8. Limited Liability Companies. The TBOC does not state fiduciary duties inside an LLC. In *Bazan v. Munoz*, 444 S.W.3d 110 (Tex. App.--San Antonio 2014, no pet.), the court held that no formal fiduciary duty was owed by majority owners to minority owners of an LLC. However the jury found

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

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

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

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

familial relation, or both."

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

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

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

3. Negligent Misrepresentation. Negligent misrepresentation is discussed in Section V.B.

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

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

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

Id. at 336.

J. CONTRACTUAL RELATIONSHIPS. Contract law governs the duties of parties arising out of a contract. The rights and duties of contracting parties are determined by the terms of the agreement. But implied contractual duties arise in some contractual relationships. Transactions between merchants grew out of the law of sales, which developed prior to the law of contracts but today can be considered

a tort-like variant of the law of contracts. See Orsinger, *170 Years of Texas Contract Law*, State Bar of Texas HISTORY OF TEXAS SUPREME COURT JURISPRUDENCE (2012) ch. 9, p. 74. And some contracts give rise to rights and duties under warranty law, which is distinct from contract law. Tort law protects victims of fraudulent or deceptive behavior in negotiating a contract. Tort law also protects existing or prospective contractual relationships from unprivileged interference. Torts committed while performing contractual duties are compensable as torts.

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

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

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

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

contract are the loss of benefit of the bargain, the claim lies in contract. *See Nagle v. Nagle*, 633 S.W.2d 796, 801 (Tex. 1982).

Disclaimer of Reliance

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

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

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

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

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

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

6. Implied Contractual Duty of Good Faith and Fair Dealing. The RESTATEMENT (SECOND) OF THE LAW OF CONTRACTS § 205 (1979) says that "every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement." Initially, the Texas Supreme Court flatly rejected the idea of a duty of good faith and fair dealing implied by law into a contract. *English v. Fischer*, 660 S.W.2d 521, 522 (Tex. 1983) ("This concept is contrary to our well-reasoned and long-established adversary system which has served us ably in Texas for almost 150 years. Our system permits parties who have a dispute over a contract to present their case to an impartial tribunal for a determination of the agreement as made by the parties and embodied in the contract itself."). In *Crim Truck & Tractor Co. v. Navistar Int'l Transp. Corp.*, 823 S.W.2d 591, 595 n. 5 (Tex. 1992), the Court "specifically rejected the implication of a general duty of good faith and fair dealing in all contracts." Later, however, the Texas Supreme Court allowed an implied duty of good faith and fair dealing to arise in "special relationships," and the breach of that duty is a tort. Examples of special relationships are: the holder of executive rights over another's mineral interest, *Manges v. Guerra*, 673 S.W.2d 180 (Tex. 1984); insurers, *Arnold v. National County Mut. Fire Ins. Co.*, 725 S.W.2d 165 (Tex. 1987) (duty of good faith and fair dealing arises from the "special relationship" between insurer and insured); *Aranda v. Insurance Co. of North America*, 748 S.W.2d 210, 215 (Tex. 1988) (duty of good faith and fair dealing imposed on workers' compensation insurers, later overruled in 2012);[33] *Universe Life Ins. Co. v. Giles*, 950 S.W.2d 48 (Tex. 1997) ("an insurer will be liable if the insurer knew or should have known that it was reasonably clear that the claim was covered"). The Supreme Court restricted the implied duty of good faith and fair dealing to parties in contractual privity with the claimant in *Natividad v. Alexsis, Inc.*, 875 S.W.2d 695, 697-98 (Tex. 1994) ("The duty of good faith and fair dealing emanates from the special relationship between the parties and not from the terms of the

contract, therefore its breach gives rise to tort damages and not simply to contractual liability"). The Supreme Court rejected an implied duty of good faith and fair dealing between employers and employees in *City of Midland v. O'Bryant*, 18 S.W.3d 209, 216 (Tex. 2000), and between a secured creditor and a co-guarantor, in *FDIC v. Coleman*, 795 S.W.2d 706, 708-09 (Tex. 1990). Texas Courts of Appeals have rejected an implied duty of good faith and fair dealing for: a developer, in *Affiliated Capital Corp. v. Southwest, Inc.*, 862 S.W.2d 30, 34 (Tex. App.--Houston [1st Dist.] 1993, writ denied); a franchisor, in *Barrand, Inc. v. Whataburger, Inc.*, 214 S.W.3d 122, 139 (Tex. App.--Corpus Christi--Edinburg 2006, writ denied); a lender, in *UMLIC VP LLC v. T&M Sales*, 176 S.W.3d 595, 612 (Tex. App.--Corpus Christi--Edinburg 2005, writ denied); and between an insurance company and a broker, in *Casteel v. Crown Life Ins. Co.*, 3 S.W.3d 582, 590 (Tex. App.--Austin 1997), *rev'd in part on other grounds and aff'd in part*, 22 S.W.3d 378 (Tex. 2000). Good faith and fair dealing is succinctly and admirably covered by T. Ray Guy, in *Good Faith Revisited: Extra-Contractual Duties in Texas*.[34] Guy concludes: "The duty of good faith and fair dealing remains an outlier in Texas common law, imposed only in specific relationships deemed by our Supreme Court as 'special' and therefore appropriate for the implication of such a duty for the protection of the disadvantaged party."

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

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

8. Preexisting Fiduciary Duties Between Contracting Parties. "[W]hile a fiduciary or confidential relationship may arise from the circumstances of a particular case, to impose such a relationship in a business transaction, the relationship must exist prior to, and apart from, the agreement made the basis

of the suit." in *Schlumberger Technology Corp. v. Swanson*, 959 S.W.2d 171, 177 (Tex. 1997).

9. Tortious Interference With Contract or Prospective Business Relations. In *Raymond v. Yarrington*, 73 S.W. 800, 803 (Tex. 1903), the Court wrote: "We are of opinion that the rule that, where one knowingly induces another to break his contract with a third person, such third person has a right of action against the one so causing the breach for any damages resulting to him by such breach, is supported by a decided preponderance of authority and by the better principle." In *Clements v. Withers*, 437 S.W.2d 818, 822 (Tex. 1969), the Supreme Court said that "[a]ctual malice need not be shown to recover compensatory damages for the tort of interference with an existing contractual relationship. Intentional and knowing interference must be shown, but there may be liability even though the interferer's motive be to save money for himself or another. On the other hand, to support the recovery of punitive damages in such a case, there must be a finding of actual malice: ill-will, spite, evil motive, or purposing the injuring of another.... The existence of such malice may not be necessary in a case where the defendant's acts are accompanied by fraud or other aggravating circumstances."

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

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

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

In *Southwestern Bell Telephone Co. v. John Carlo Texas, Inc.*, 843 S.W.2d 470, 472 (Tex. 1992), the

Court wrote: "Interference with contract is tortious only if it is intentional." The Court further noted that "intentional interference does not require intent to injure, only that 'the actor desires to cause the consequences of his act, or that he believes that the consequences are substantially certain to result from it.'" (Citing RESTATEMENT (SECOND) OF TORTS § 8A.)

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

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

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

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

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

K. WARRANTIES. Warranties are transactional and arise from a sale of real or personal property

or the delivery of services, or an agreement for either. Some breaches of warranty are treated as a tort, some as a breach of contract, and some as a violation of public policy that is neither a tort nor a breach of contract. Warranties can be express or implied. To be express, a warranty must be communicated in some way to the buyer, whereby it becomes part of the transaction. An implied warranty is not expressly communicated between the parties and instead arises by operation of law from the circumstances. In his famous article *Assault on the Citadel: Strict Liability to the Consumer*, 69 YALE L. J. 1099, 1126 (1960), Dean William L. Prosser wrote about warranty: "The adoption of this particular device was facilitated by the peculiar and uncertain nature and character of warranty, a freak hybrid born of the illicit intercourse of tort and contract." In *Medical City Dallas, Ltd. v. Carlisle Corporation*, 251 S.W.3d 55, 60 (Tex. 2008), the Court wrote that "breach of warranty and breach of contract are distinct causes of action with separate remedies."

1. Express Warranties. An express warranty was defined by William Story[35]: "Any positive affirmation, or representation, made by the vendor, at the time of the sale, with respect to the subject of sale, which operates, or may operate, as inducement, unless it be the expression of mere matter of opinion, in a case where the vendee had no right to rely upon it, or be purely matter of description, or identification, without fraud, and not intended as a warranty, constitutes a warranty." William Wetmore Story, A TREATISE ON THE LAW OF SALES OF PERSONAL PROPERTY § 357 (1853) (cited in *Blythe v. Speake*, 23 Tex. 429 (1859). The earliest appearance of express warranty in Texas law was *Henderson v. San Antonio & M.G.R. Co.*, 17 Tex. 560 (Tex. 1856), where Justice Wheeler wrote: "The representations as to what the defendants would do, when used as inducements to others to contract with them, became assurances and undertakings which they were bound to fulfill. They were obligatory upon them, and must be so held, or the contract would be void for the want of mutuality. If such assurances were not binding, there could be no binding promise to perform an act in future." In *Blythe v. Speake*, the Supreme Court recognized a description of the condition of personal property as a warranty of soundness. Today several express warranties are described in the Uniform Commercial Code ("U.C.C."), adopted as the Texas Business & Commerce Code, including a warranty of title, Section 2.312; a warranty by affirmation of fact, Section 2.313(a)(1); a warranty by description, Section 2.313(a)(2); and a warranty by sample or model, Section 2.313(a)(3).

2. Implied Warranties. An implied warranty is a duty from a seller to a buyer, or from a service-provider to a consumer, that arises by operation of law and not by express agreement of the parties. "Implied warranties are created by operation of law and are grounded more in tort than in contract. . . . Implied warranties are derived primarily from statute, although some have their origin at common law." *La Sara Grain Co. v. First Nat. Bank of Mercedes*, 673 S.W.2d 558, 565 (Tex. 1984). In *Brantley v. Thomas*, 22 Tex. 270 (Tex. 1858), the Supreme Court established an implied warranty of merchantability:

> If goods are sent, upon order, by a New York merchant, to a Texas merchant, the law will imply a warranty, that the goods sent are such as were ordered; or, if goods are sent by a New York merchant, to a Texas merchant, without a special order, but upon a general engagement to forward goods, the law will imply a warranty, that all goods sent are valuable and merchantable.

In *Walker v. Great Atlantic & Pacific Tea Co.*, 112 S.W.2d 170, 172 (Tex. 1938), the Supreme Court

ruled that the sale of food carried with it an implied warranty that the food was safe, and that the seller could be sued if a consumer was harmed by bad food. In *Jacob E. Decker & Sons v. Capps*, 139 Tex. 609, 618 164 S.W.2d 828, 832 (Tex. 1942), the Court held that a manufacturer could be held liable to a consumer for bad food, even though there was no contractual privity between the consumer and the manufacturer, based on an implied warranty that food sold is wholesome and fit for consumption. In *Humber v. Morton*, 426 S.W.2d 554 (Tex. 1968), the Supreme Court established an implied warranty of habitability and good and workmanlike construction for newly-built homes. In *Melody Home Manufacturing Co. v. Barnes*, 741 S.W.2d 349, 355 (Tex. 1987), the Court established a non-waivable implied warranty of good workmanship in the repair or modification of tangible goods or property. However, in *Nobility Homes of Texas, Inc. v. Shivers*, 557 S.W.2d 77, 78 (Tex. 1977), the Supreme Court ended implied warranty as a foundation for further expansion of liability for defective products, and redirected attention to Section 402A of the RESTATEMENT (SECOND) OF TORTS, Special Liability of Seller of Product for Physical Harm to User or Consumer, and the warranty sections of the Uniform Commercial Code. In *Centex Homes v. Buecher*, 95 S.W.3d 266 (Tex. 2002), after a lengthy analysis of implied warranty law, the Supreme Court held that the implied warranty of good workmanship in new home construction could be disclaimed, but only when the parties agree on the terms for the manner, performance, or quality of desired construction. *Id.* at 268. The Court also held that the implied warranty of habitability cannot be disclaimed generally. *Id.* at 268. In *Gonzales v. Southwest Olshan Foundation Repair Company LLC*, 400 S.W.3d 52, 56 (Tex. 2013), the Court held that the implied warranty of good and workmanlike repair of tangible goods or property recognized in *Melody Home* could not be disclaimed but it could be superseded by an agreement that sufficiently describes the manner, performance or quality of the services.

The U.C.C. prescribes an implied warranty of merchantability, Tex. Bus. & Comm. Code § 2.314, an implied warranty of fitness for a particular purpose, Tex. Bus. & Comm. Code § 2.315.

L. GOOD FAITH. As noted by Ray Guy in his excellent piece on *Good Faith Revisited* (see Endnote 34), violation of the duty of good faith and fair dealing in special relationships that we know from *Arnold*, *Aranda*, and *O'Bryant*, is a *tort*, while the duty to maintain reasonable commercial standards of fair dealing is a factor in determining whether a promise was breached. *See* TEX. BUS. & COMM. CODE § 1.304 cmt. 1. However, "good faith" is mentioned in discussions of fiduciary duties in many other types of relationships. See Section VII.D. Good faith also appears as a factor in the TBOC § 152.206(c)'s presumption of care in a partner's actions. See Section VIII.G.8 above. "Good faith" also appears in TBOC ch. 21 with regard to for-profit corporations.

M. BETWEEN MERCHANTS. The Uniform Commercial Code (1962) ("U.C.C."), adopted in Texas in 1966 as the Texas Business and Commerce Code, establishes standards for the duties between merchants. Under Section 2.104(a), "'[m]erchant' means a person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction or to whom such knowledge or skill may be attributed by his employment of an agent or broker or other intermediary who by his occupation holds himself out as having such knowledge or skill." Section 2.104(c) states: "'Between merchants' means in any transaction with respect to which both parties are chargeable with the knowledge or skill of merchants." *See Nelson v. Union Equity Co-op. Exchange*, 548 SW 2d 352, 355 (Tex. 1977) (holding a wheat

farmer to be a merchant).The U.C.C. implies a duty of good faith in the performance and enforcement of every contract or duty governed by the U.C.C. *See* Tex. Bus. & Comm. Code § 1.304. "Good faith" in this context is defined as "honesty in fact and the observance of reasonable commercial standards of fair dealing." Tex. Bus. & Comm. Code §1.201(b)(20). "Honesty in fact" seems to be a straightforward standard, but presumably it applies only to material misstatements of fact, and it is unclear if it imposes a duty to disclose. It is also unclear whether the U.C.C.'s requirement to observe "reasonable commercial standards of fair dealing" is an objective standard of ordinary care or is a subjective standard involving the intentions of the acting party. "In the absence of a specific duty or obligation in the contract to which the good-faith standard can be tied, the obligation of good faith under the U.C.C. will not support a claim for damages." *Apache Corp. v. Dynegy Midstream Services*, 214 S.W.3d 554, 563 (Tex. App.--Houston [14th Dist.] 2006), *aff'd in part and rev'd in part on other grounds*, 294 S.W.3d 164 (Tex. 2009) (quoted in T. Ray Guy, *Good Faith Revisited: Extra-Contractual Duties in Texas*, n. 24).

N. INSURERS. Duties arise in connection with both selling insurance and paying claims of and against the insured. The Texas Supreme Court has held that, with respect to claims, the insurer is in a special relationship with the insured such that insurer owes the insured duty of good faith and fair dealing on coverage issues. *Universal Life Ins. Co. v. Giles*, 950 S.W.2d 48 (Tex. 1997). The law has long been inclined to protect insureds from insurers. In Texas, the types of coverage and essential terms of insurance contracts are largely determined by the Office of the Texas Commissioner of Insurance. In determining coverage questions, the courts have construed an insurance policy against the insurer. "It is a settled rule that policies of insurance will be interpreted and construed liberally in favor of the insured and strictly against the insurer." *Ramsay v. Maryland Am. Gen. Ins. Co.*, 533 S.W.2d 344, 349 (Tex.1976); *Brown v. Palatine*, 89 Tex. 590, 35 S.W. 1060, 1061 (1896). A choice-of-law clause in an insurance contract payable to a person in Texas, or wit an insurance company doing business in Texas, is preempted by TIC art. 21.42 which makes Texas law apply.

1. Selling Insurance Policies. Texas Insurance Code ("TIC") § 541.002 prohibits "a trade practice that is defined in this chapter as or determined under this chapter to be an unfair method of competition or an unfair or deceptive act or practice in the business of insurance." Violation of this provision can result in treble damages. TIC § 541.152.

Misrepresentation of Insurance Policy, TIC § 541.061, says that

> is an unfair method of competition or an unfair or deceptive act or practice in the business of insurance to misrepresent an insurance policy by: (1) making an untrue statement of material fact; (2) failing to state a material fact necessary to make other statements made not misleading, considering the circumstances under which the statements were made; (3) making a statement in a manner that would mislead a reasonably prudent person to a false conclusion of a material fact; (4) making a material misstatement of law; or (5) failing to disclose a matter required by law to be disclosed, including failing to make a disclosure in accordance with another provision of this code.

TIC art. 21.21 § 1(a) prohibits persons from engaging in unfair methods of competition or unfair or deceptive acts or practices in the business of insurance. This stricture applies to persons "engaged in the business of insurance, including agents, brokers, adjusters and life insurance counselors." TIC art. 21.21, § 2(a).

Apart from administrative penalties, TIC § 541.151 permits a person who sustains actual damages to sue for an unfair method of competition or an unfair or deceptive act or a deceptive trade practice under Tex. Bus. & Comm. Code § 17.46 (b). TIC § 541.151. A plaintiff who prevails can recover actual damages, court costs, and reasonable and necessary attorney's fees. TIC § 541.152.

2. Settlement of Claims With the Insured. An implied duty of good faith and fair dealing impliedly applies to the payment of the insured party's claims. In *Arnold v. National County Mutual Fire Ins. Co.*, 725 S.W.2d 165 (Tex. 1987), the Supreme Court recognized the insurer's implied duty of good faith and fair dealing because of unequal bargaining power. *Id*. at 167. The duty requires making prompt, fair and equitable settlement of claims once the insurer's liability has become clear. *Universal Life Ins. Co. v. Giles*, 950 S.W.2d 48, 55 (Tex. 1997); State Bar of Texas PATTERN JURY CHARGES BUSINESS, CONSUMER & EMPLOYMENT PJC 103.1 (2020). However, in *Republic Ins. Co. v. Stoker*, 903 S.W.2d 338 (Tex. 1995), the Supreme Court held that the duty of good faith and fair dealing is not breached by the erroneous denial of a claim if the insurer had a reasonable basis for denial. The common law duty of good faith and fair dealing in resolving insurance claims has been at least partially subsumed into the Texas Insurance Code § 541.060, Unfair Settlement Practices.

3. The Settlement of Liability Claims of Third Parties. The case of *G.A. Stowers Furniture Co. v. American Indemnity, Co.*, 15 S.W.2d 544 (Tex. Comm'n App. 1929, holding approved), established a rule that in settling claims against its insured, an insurer is "held to that degree of care and diligence which a man of ordinary care and diligence would exercise in the management of his own business." The Court based its decision in part on the insurer's control over settlement. *Rocor Int'l v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA,,* 77 S.W.3d 253, 263 (Tex. 2002). *Stowers* created a negligence claim by an insured against an insurer who had the opportunity to settle within policy limits and negligently refused to do so, and the eventual liability determination exceeded policy limits. In order to trigger the duty to settle, the plaintiff's demand must be within policy limits and must offer a full and final release. *Trinity Universal Ins. Co. v. Bleeker*, 966 S.W.2d 489 (Tex. 1998). The *Stowers* duty is based on a duty of ordinary care and not a duty of good faith.

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

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

P. HEALTHCARE PROVIDERS. a physician is listed as a fiduciary for purposes of Texas' commercial bribery statute, Tex. Penal Code § 32.43(b). See Section III.A.3 above. For tort law purposes in Texas, ordinarily there is no fiduciary duty between a health care provider and the patient, and recovery for medical malpractice is based on negligence. However, "[b]ecause the physician-patient relationship is one of trust and confidence, Texas recognizes a duty on the part of the physician to disclose a negligent act or fact that an injury has occurred." *Borderlon v. Peck*, 661 S.W.2d 907, 908 (Tex. 1983) (discussing fraudulent concealment delaying the start of the statute of limitations for medical malpractice). In *Wheeler v. Yettie Kersting Mem'l Hosp.*, 866 S.W.2d 32 (Tex. App--Houston [1st Dist.] 1993, no writ), the court refused to find a special relationship between a doctor, a hospital, or a nurse, and a patient that would give rise to a duty of good faith and fair dealing. In *Kelsey-Seybold Clinic v. Maclay*, 466 S.W.2d 716, 720 (Tex. 1971), the Court held that a medical partnership owed a duty to "families of its patients to exercise ordinary care to prevent a tortious interference with family relations," where one of the physicians allegedly alienated the affections of a patient from her husband. In *Bird v. W.C.W.*, 868 S.W.2d 767, 770 (Tex. 1994), the Court rejected a health care provider's duty to third parties, saying that a "mental health professional owes no professional duty of care to a third party not to misdiagnose the condition of a patient." *Accord*, *Van Horn v. Chambers*, 970 S.W.2d 542, 545 (Tex. 1998). In *Texas Home Management, Inc. v. Peavy*, 89 S.W.3d 30 (Tex. 2002), the Court held that an "intermediate care facility for the mentally retarded" owed a duty of care to a person murdered by a resident of that facility. *See Golden v. Tips*, 651 S.W.2d 364 (Tex. App.--Tyler 1983, no writ) (physician may owe duty to motoring public to warn patient of drug side effects).

"Texas authorizes mental anguish damages as an element of recoverable damages in the following categories of cases: (1) as the foreseeable result of a breach of duty arising out of certain special relationships, such as the relationship between a physician and a patient ...." *Verinakis v. Med. Profiles, Inc.*, 987 S.W.2d 90, 95(Tex. App.--Houston [14th Dist.] 1998, pet. denied).

As far back as the Hippocratic Oath, sexual relations between healers and patients have been prohibited. The American Association, the American Psychiatric Association, the American Psychological Association, and the National Association of Social Workers all consider professional -patient sexual relations to be unethical.

Texas Penal Code § 22.011, Sexual Assault, make it an offense for a "mental health service provider" or a "health care service provider" to engage in sexual relations with a patient or former patient "by exploiting the other person's emotional dependency on the actor...." The statute applies to a physician chiropractor, physician's assistant, registered nurse, social worker, chemical dependency counselor, licensed professional counselor, marriage and family therapist, member of the clergy, or psychologist,

etc. Tex. Penal Code § 22.011(c).

Texas Civil Practice & Remedies Code Chapter 81 creates a private cause of action for a patient or former patient of a mental health services provider who suffers physical, mental, or emotional injury caused by or resulting from, or arising out of sexual contact, sexual exploitation, or therapeutic deception relating to sexual relations with the service provider. The provider's employer can be held liable for failing to inquire with the therapist's employer or prior employer within the preceding five years, or who knows or has reason to know that the service provider engaged in sexual exploitation of a patient or prior patient and fails to report that to the county prosecutor and state licensing board. Texas Civil Practice & Remedies Code § 81.006. A successful plaintiff can recover actual damages, including mental anguish without other injury, plus exemplary damages and attorney's fees. Texas Civil Practice & Remedies Code § 81.004. It is a defense that the sexual exploitation began more than two years after the termination of mental health services and the patient was not emotionally dependent on the service provider. Texas Civil Practice & Remedies Code § 81.005.

Q. EMPLOYER AND EMPLOYEE.

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

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

a. Safe Working Environment. "An employer is not an insurer of its employees' safety at work; however, an employer does have a duty to use ordinary care in providing a safe work place.... For decades, this Court has recognized that this duty is an implied part of the employer employee relationship." *Leitch v. Hornsby*, 935 S.W.2d 114, 117 (Tex. 1996); *Kroger Co. v. Elwood*, 197 S.W.3d 793, 795 (Tex. 2006) ("An employer has a duty to use ordinary care in providing a safe workplace"). An employer has a "duty to exercise ordinary care to select careful and competent fellow servants or co-employees." *Hammerly Oaks, Inc. v. Edwards*, 958 S.W.2d 387, 391-92 (Tex. 1997). In *Kesner v.*

Pneumo Abex, LLC, 384 P.3d 283 (Cal. 2016), the Supreme Court of California ruled that employers can be held liable for secondary exposure of family members of workers who may have taken asbestos home on their clothing.

OSHA. The Occupational Safety and Health Act of 1970 § 5(a)(1), General Duty Clause, requires employers to provide their employees with a workplace free from recognized hazards likely to cause death or serious physical harm. The Act also established the Occupational Safety and Health Administration ("OSHA") to promulgate regulations for preserving the health and safety of workers. OSHA standards predominate the domain of workplace safety without displacing workers' compensation statutes and tort duties.

COVID-19. OSHA has promulgated a Guidance on Preparing Workplaces for COVID-19. It provides that "this guidance is not a standard or regulation, and it created no new legal obligations." OSHA has been citing employers for COVID-related violations of pre-COVID OSHA standards. Although workers' compensation systems could preclude general personal injury suits for sickness or death from COVID-19, class actions relating to COVID-19 are being filed. Early examples include *Ornelas v. Central Valley Meat Co.*, No. 20-cv-01017 (E.D. Cal. July 22, 2020), which asserts tort and statutory claims based on alleged failure to implement proper safety protocols at the defendant's facilities.[36] Another is *Esco v. Dollar Tree Stores, Inc.*, No. 2020-00280479 (Superior Court of Sacramento County, California), a class action for violations of California's Unfair Business Practices Act and public nuisance for failing to protect employees from COVID-19 exposure.

b. Unlawful Employment Practices. Title VII of the Civil Rights Act of 1964 provides that "[i]t shall be an unlawful employment practice for an employer ... to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin." 42 U.S.C. § 2000e-2(a)(1). An unlawful employment practice is established if a suspect category is a motivating factor for an employment practice, even when there are other motivating factors. The Texas Commission on Human Rights Act ("TCHRA") was enacted in Chapter 21 of the Texas Labor Code. Texas Labor Code § 21.051 prohibits an employer from refusing to hire, firing, or discriminating in any other manner against a person "because of race, color, disability, religion, sex, national origin, or age." In 2019, the accounting firm of Deloitte LLP published a survey of bias in the workplace, involving 3,000 respondents from companies with more than 1,000 employees. They found that 42% of women, 38% of men, 56% of LGBT, 54% of persons with disabilities, 54% of Hispanics, 44% of Asians, and 44% of African Americans, reported that they had experienced discrimination at work at least once a month.[37]

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

Racial Discrimination. The Department of Justice explains: "Discrimination on the basis of race involves denying equal employment opportunity to any person because that person is of a particular race or has personal characteristics associated with a particular race (e.g., hair texture, facial features). Discrimination on the basis of color involves denying equal employment opportunity to any person

because of that person's skin color or complexion. Race or color discrimination also may include treating a person unfavorably because of his or her association with someone or some group generally associated with a particular race or color (e.g., marriage)."[38]

National Origin. The Department of Justice explains: "Discrimination on the basis of national origin involves denying equal employment opportunity to any person because that person is from a different country or part of the world, or because of ethnicity or accent, or because that person is perceived to be of a particular ethnicity. In some circumstances, national origin discrimination may involve discrimination based on unjustified English-fluency requirements and English-only rules and policies. It also may include treating a person unfavorably because of his or her association with someone or some group generally associated with a particular national origin (e.g., civic or cultural organization)."[39]

Gender Discrimination. The Department of Justice explains: "Discrimination on the basis of sex involves denying equal employment opportunity to any person because of that person's sex. Sex discrimination also involves treating a woman unfavorably because she is pregnant or based on gender stereotype."[40] Federal Regulations on sexual harassment are set out at 29 CFR Part 1604.11 (7-1-2016). In *Price Waterhouse v. Hopkins*, 490 U.S. 228, 251 (1989), the U.S. Supreme Court said "we are beyond the day when an employer could evaluate employees by assuming or insisting that they matched the stereotype associated with their group, for [i]n forbidding employers to discriminate against individuals because of their sex, Congress intended to strike at the entire spectrum of disparate treatment of men and women resulting from sex stereotypes." (Internal quotations marks omitted). To be actionable, gender discrimination must play a motivating part in making an employment decision. The Supreme Court explained: "In saying that gender played a motivating part in an employment decision, we mean that, if we asked the employer at the moment of the decision what its reasons were and if we received a truthful response, one of those reasons would be that the applicant or employee was a woman." *Id.* at 250.The employer can present objective evidence as to its probable decision in the absence of an impermissible motive. *Id.* at 252. Texas Labor Code § 21.051 prohibits "sex discrimination." Texas Labor Code § 21.106 includes in "sex discrimination" consideration of pregnancy, childbirth or a related medical condition. It is not unlawful employment discrimination when a prohibited activity is not intended to contravene prohibited practices and "is justified by business necessity." Texas Labor Code § 21.115. Employment discrimination laws do not apply to employees who are a parent, spouse, or child of the employer. Texas Labor Code § 21.117.

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

Labor Code does not cap the trial court's awards for front pay and for future mental anguish.

Retaliation. The Department of Justice explains: "Discrimination on the basis of retaliation involves taking an adverse action against a person because he or she has opposed a discriminatory employment practice (e.g., race discrimination, military status discrimination), has complained about discrimination, or has assisted in the investigation of a complaint of discrimination. Retaliation could take the form of refusing to hire, discharging, failing to promote, harassing, or discriminating against a person with respect to any other term, condition or privilege of employment."[41] An employer cannot retaliate against an employee who engages in a "protected activity," which is voicing opposition to any practice made an unlawful employment practice under 42 U.S.C. § 2000e-3(a). A plaintiff must prove that: (1) s/he engaged in protected activity; (2) an adverse employment action occurred; and (3) a causal link exists between the protected activity and the adverse employment action. *Turner v. Baylor Richardson Medical Center*, 476 F.3d 337, 348 (5th Cir. 2007). One Federal district court in Texas ruled that an informal complaint is protected activity. *Eura v. The Sage Corporation*, Cv. No. 5:12-CV-1119-DAE (U.S. Dist. Ct., W.D. Texas, Nov. 19, 2014) ("Although neither the Supreme Court nor the Fifth Circuit have ruled definitively as to whether informal complaints can constitute opposition, the majority of circuits find that informal complaints come within the opposition clause requirements"). For retaliation protections to apply, the employee must have a reasonable belief that unlawful employment practices were occurring. *Long v. Eastfield Coll.*, 88 F.3d 300, 304 (5th Cir. 1996). [Comment: "Reasonable belief" is a mixed objective and subjective standard.] Retaliation against an employee for engaging in a protected activity is also prohibited by Texas Labor Code § 21.055. Section 21.056 prohibits "aiding and abetting discrimination." The Texas Supreme Court has said: "A retaliation claim is related to, but distinct from, a discrimination claim, and one may be viable even when the other is not. Unlike a discrimination claim, a retaliation claim focuses on the employer's response to an employee's protected activity, such as making a discrimination complaint. The TCHRA's prohibition against retaliation does not protect employees from all ostracism, discipline, or even termination following a discrimination complaint. Rather, a remedy exists only when the evidence establishes that a materially adverse employment action resulted from the employee's protected activities." *Alamo Heights Ind. Sch. Dist. v. Clark*, 544 S.3d 755 (Tex. 2018).

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

Family Medical Leave. The Federal Family and Medical Leave Act ("FMLA") applies to private sector employers with 50 or more employees who have worked 20 or more work weeks in the current or prior years. 29 U.S.C. § 2601. The FMLA also applies to public agencies and elementary and secondary public or private schools. The FMLA applies to employees who have worked for the employer for more than 12 weeks and have at least 1,250 hours of service during the 12 months prior to taking medical leave.[42] The FMLA "entitles eligible employees of covered employers to take unpaid, job-protected leave for specified family and medical reasons, with continuation of group health insurance coverage under the same terms and conditions as if the employee had not taken leave."[43] The employee can take up to 12 weeks of unpaid job-protected leave per year. The protection extends to one year after the birth or adoption of a child. It also applies to an employee who is unable to perform the functions of the position, or who must miss work to recevie medical treatment for a serious health condition. An

employee can take FMLA leave to care for a spouse, child, or parent with a serious health condition. *Id.* An employer can refuse to restore a "key" employee, meaning that the employee is salaried and among the highest-paid 10% of the employer's employees within 75 miles, if restoring employment would cause substantial and grievous economic injury to its operations.[44] On September 1, 2020, a class action was filed against Deloitte Touche Tohmatsu, Ltd. for refusing to reinstate former employees who were offered and took FMLA leave for more than 12 weeks. *Knight v. Deloitte Touche Tohmatsu Ltd.*, No. 1:20-cv-07114 (S.D.N.Y., Sept. 1, 2020).

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

CBS. In 2018, in advance of the expected publication of details in *The New Yorker* magazine by author Ronan Farrow, the CBS board of directors forced CEO Leslie Moonves to resign, later saying this action was based on evidence that he had destroyed evidence and misled investigators to cover up sexual misconduct with employees. Moonves was denied $120 million in severance pay. At about this time, a number of Directors resigned from the Board. In March of 2019 a lawsuit was filed in Delaware to compel inspection of books and records, based on the allegation that the CBS Board of Directors recklessly disregarded Moonves's wrongdoing. On January 15, 2020, a Federal District Court in New York denied a motion to dismiss a Section 10(b) shareholder class action based on Moonves's public statements suggesting that he was unaware of sexual misconduct in the company.[45]

McDonald's. In November of 2019, the independent directors of McDonald's fired its CEO Steve Easterbrook for having a short-term consensual non-physical relationship with an employee over text and video. Easterbrook denied having a sexual relationship with other McDonald's employees.[46] The Board had to decide whether to fire Easterbrook with cause (no severance benefits) or without cause (with severance benefits). According to McDonald's Form 8-K filed with the SEC, the directors feared that termination with cause would lead to lengthy litigation. Form 8-K, p. 8.[47] According to a press report, Easterbrook received an estimated $40 million in severance benefits. The severance agreement provided that McDonald's could recover the severance benefits if later investigations established that cause for termination of employment existed. The Board's action was publicly lauded. However, an

anonymous report led to photographic and video evidence of more extensive wrongdoing, including (says McDonald's) financial reward for sexual activities. So on August 10, 2020, McDonald's sued Easterbrook in Delaware Chancery Court for breach of fiduciary duties of candor, due care, and loyalty, as well as fraud in the inducement by misrepresentation. *Id.* at p. 15-17. The company is seeking to claw back most of the $40 million.

Houston Fire Department. On October 26, 2020, the City of Houston settled claims brought by the Department of Justice under Title VII of the Civil Rights Act of 1964, relating to a hostile work environment and retaliation claims asserted by three female fire fighters, consisting of a sustained campaign of harassment that affected their ability to work and even their safety. Under the consent decree, the City must provide training to supervisory staff and pay $275,000 to one claimant and $67,500 to another.[48]

d. Overtime. The Federal Fair Labor Standards Act (FLSA) governs claims for overtime pay. The FLSA applies to (a) employers with two or more employees engaged in interstate commerce and annual gross sales of at least $500,000, or (b) an employee who engages in interstate commerce. The FLSA requires employers to pay hourly workers at least the minimum wage and provides that employers must pay time-and-a-half for work beyond 40 hours per week. The overtime requirement does not apply to salaried employees who manage at least two full-time employees, with authority to hire, fire, and promote. And it does not apply to administrative employees or learned professionals or creative professionals. It is reported that in 2016 FLSA overtime lawsuits were settled for just over $400 million. Overtime FLSA settlements included: FedEx, $240 million; Walmart and Sam's Club, $62.2; Los Angeles Children's Hospital, $27 million; Bank of America, $14 million; Avis Budget Car Rental, $7.8 million.[49] In 2007, Walmart was ordered to pay more than $62 million. Under the FLSA, a jury found that Walmart saved $1 million by refusing to allow employees to record their time in a computerized pay system and saved $48 million by denying rest breaks. This is one of may lawsuits filed against Walmart for worker-related claims. In *Fast v. Cash Depot Ltd.*, No. 16-C-1637 (U.S. Dist. Ct. E.D. Wisconsin Nov. 6, 2018), the court ruled that the attorney for the class-action plaintiffs could not recover attorneys' fees when before class certification the employer voluntarily paid all that was owed and no judgment was rendered for the plaintiffs.

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

animals in the workplace.

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

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

However, Justice Bland continued:

> "'[a]n at-will employee may properly plan to go into competition with his employer and may take active steps to do so while still employed'" and may secretly do so with other employees, without disclosing his plans to his employer. *Id.* (quoting *Augat v. Aegis*, Inc., 409 Mass. 165, 565 N.E.2d 415, 419 (1991)). An employee also may use his general skills and knowledge obtained through employment to compete with the former employer. *Sharma v. Vinmar Int'l, Ltd.*, 231 S.W.3d 405, 424 (Tex. App.--Houston [14th Dist.] 2007, no pet.). Thus, an employee's duty to his employer does not require an employee to disclose his plans to compete; he may secretly join with other employees to plan a competing company without violating any duty to his employer. *Abetter Trucking*, 113 S.W.3d at 511.

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

4. Covenant Not to Compete. "An agreement not to compete is in restraint of trade and will not be enforced unless it is reasonable." *Frankiewicz v. National Comp. Assoc.*, 633 S.W.2d 505, 507 (Tex. 1982). "The fundamental legitimate business interest that may be protected by such covenants is in preventing employees or departing partners from using the business contacts and rapport established during the relationship of representing the [former] firm to take the firm's customers with him." *Peat Marwick Main & Co. v. Haass*, 818 S.W.2d 381, 387 (Tex. 1991). Texas Business & Commerce Code §§ 15.50-52 apply to covenants not to compete that relate to employment. An employment-related covenant not to compete is enforceable only if it is ancillary to or part of an otherwise enforceable agreement that contains "limitations as to time, geographical area, and scope of activity to be restrained that are reasonable and do not impose a greater restraint than is necessary to protect the goodwill or

other business interest of the promisee." Section 15.50(a). Special factors apply to the practice of medicine. Section 15.50(b). "Whether an agreement not to compete is a reasonable restraint of trade is a question of law for the court." *Martin v. Credit Protection Ass'n, Inc.*, 793 S.W.2d 667, 668-69 (Tex. 1990). "Under Texas law, covenants not to compete that extend to clients with whom the employee had no dealings during her employment or amount to industry-wide exclusions are overbroad and unreasonable." *D'Onofrio v. Vacation Publications, Inc.*, 888 F.3d 197, 211–12 (5th Cir. 2018) (brackets and quotation marks omitted). Section 15.51 requires the court to reform a covenant that is overbroad as to time, area, or scope of activity, to make it reasonable, but the reformed agreement is enforceable by injunction. That rule of reform-and-enforce does not apply where the claim is for damages. *Juliette Fowler Homes, Inc. v. Welch Assocs., Inc.*, 793 S.W.2d 660, 663 (Tex. 1990) (in a suit for damages for breach of a covenant not to compete, the contract is taken as written). "Customer lists and names need not be specifically proved in evidence or stated in the permanent injunction." *Safeguard Bus. Sys., Inc. v. Schaffer*, 822 S.W.2d 640, 644 (Tex. App.--Dallas 1991, no writ). The court can simply reform an agreement into one "generally restraining solicitation of customers and not specifically listing the individual customers[.]" *Bertotti v. C.E. Shepherd Co., Inc.*, 752 S.W.2d 648, 656 (Tex. App.—Houston [14th Dist.] 1988, no writ).

Violating a covenant not to compete is considered to be a breach of contract, not a breach of fiduciary duty.

5. Whistleblowers.

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

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 established "bounty" provisions that allow the SEC to reward whistleblowers with an "award amount" ranging from 10% to 30% of monetary sanctions imposed on wrongdoers whose bad actions were revealed by the whistleblower. According to the summary accompanying new final rules issued by the SEC on September 23, 2020, "information provided by whistleblowers has led to enforcement actions in which the Commission has obtained more than $2.5 billion in financial remedies, including more than $1.4 billion in disgorgement of ill-gotten gains and interest, of which almost $750 million has been or is scheduled to be returned to harmed investors. In recognition of the important contributions of whistleblowers, the Commission has ordered over $523 million paid to 97 individuals in 80 enforcement actions whose original information led to the success of Commission actions and, in some instances, related actions brought by other enforcement authorities against wrongdoers." On October 22, 2020, the SEC announced a new award of over $114 million to a whistleblower.[50] On November 3, 2020, an award of $28 million was approved.[51] On November 6, 2020, an award of $3.6 million was approved.[52]

Qui Tam. The Federal False Claims Act, passed in 1863 in response to fraud by vendors supplying the

Union Army during the Civil War, as amended throughout the years, permits private persons to sue government contractors for fraud on the government and to keep a portion of any recovery ("qui tam"). In 2009, an individual was awarded $51.5 million in connection with his False Claims Act complaint against Pfizer Inc. for illegal practices in marketing four drugs. Pfizer pleaded guilty to various civil and criminal charges and paid $2.3 billion to the government.[53]

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

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

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

b. Negligent Hiring, Training, and Supervision. The Texas Supreme Court has "not ruled definitively on the existence, elements, and scope of [torts such as negligent retention and supervision

of an employee by an employer] and related torts such as negligent training and hiring." *Waffle House, Inc. v. Williams*, 313 S.W.3d 796, 804 n. 27 (Tex. 2010). However, the Supreme Court has reviewed the sufficiency of the evidence regarding such claims. *JBS Carriers, Inc. v. Washington*, 564 S.W.3d 830, 842 (Tex. 2018). Texas courts of appeals have written that "[n]egligent hiring, retention, and supervision claims are all simple negligence causes of action based on an employer's direct negligence rather than on vicarious liability." *Dangerfield v. Ormsby*, 264 S.W.3d 904, 912 (Tex. App.--Fort Worth 2008, no pet.); *Morris v. JTM Materials, Inc.*, 78 S.W.3d 28, 49 (Tex. App.--Fort Worth 2002, no pet.). "The basis of responsibility for negligent hiring is the employer's own negligence in hiring an incompetent individual whom the employer knows, or by the exercise of reasonable care, should have known to be incompetent or unfit, thereby creating an unreasonable risk of harm to others." *Castillo v. Gulf Coast Livestock Market, LLC*, 392 S.W.3d 299, 306 (Tex. App.--San Antonio 2012, no pet.).

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

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

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

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

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

In *Mitchell v. Zimmerman*, 4 Tex. 75, 1849 WL 3970, *3 (Tex. 1849), the Court addressed a lease for

real estate where the lessor misrepresented that 140 acres were suitable for cultivation, when in truth it was less than fifty acres. Justice Wheeler made a number of broad and important statements regarding the duties attending the creation of contracts. He wrote:

> If the party, says Story, intentionally misrepresents a material fact or produces a false impression by words or acts, in order to mislead or obtain an undue advantage, it is a case of manifest fraud. (1 Story Eq., sec. 192.) It is a rule in equity that all the material facts must be known to both parties to render the agreement just and fair in all its parts. (2 Kent Com., 491.) And if there be any intentional misrepresentation or concealment of material facts in the making of a contract, in cases in which the parties have not equal access to the means of information, it will vitiate and avoid the contract. (2 Kent Com., 482; 2 Bail. R., 324.) It is immaterial whether the misrepresentation be made on the sale of real or personal property, or whether it relates to the title to land or some collateral thing attached to it. (7 Wend. R., 380.)

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

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

S. ACCOUNTANTS AND AUDITORS.

1. Are Accountants Fiduciaries? The relationship between accountant and client traditionally has not been considered to be a formal fiduciary duty. However, Texas Penal Code § 32.43, Commercial Bribery, lists accountants as a fiduciary for purposes of that statute. The American Institute of Certified Public Accountants says that the "AICPA Professional Code of Conduct embodies standards of conduct which are closely analogous to a fiduciary relationship—objectivity, integrity, free of conflicts of interest and truthfulness."[54] But a March 2020 article in THE CPA JOURNAL notes that accounting firms no longer limit themselves to accounting, attestation, and tax services. The article continues: "The major firms are well-run, widespread conglomerates performing investment advisory, wealth management, personal financial planning, mergers and acquisitions, divestiture, strategic planning, forensic, business risk management, brand and reputation, and other advisory services. Even smaller CPA firms perform variations of these services, often on a limited, 'informal' basis." Vincent J. Love, and John H. Eickemeyer, *Fiduciary Duty, Due Care, and the Public Interest: A Practical Dilemma for CPAs*.[55] So while the CPA-client relationship itself is not generally recognized as a formal fiduciary relationship, the CPA can easily be in a formal or an informal fiduciary relationship with the client depending on his/her role.

The difficulty in applying fiduciary principles to the accountant-client relationship is reflected in the "Public Interest Principle" contained in the AICPA's Code of Professional Conduct. Section 0.300.030, The Public Interest, says:

> .01 Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate a commitment to professionalism.
>
> .02 A distinguishing mark of a profession is acceptance of its responsibility to the public. The accounting profession's public consists of clients, credit grantors, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity of members to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on members. The public interest is defined as the collective well-being of the community of people and institutions that the profession serves.
>
> .03 In discharging their professional responsibilities, members may encounter conflicting pressures from each of those groups. In resolving those conflicts, members should act with integrity, guided by the precept that when members fulfill their responsibility to the public, clients' and employers' interests are best served.
>
> .04 Those who rely on members expect them to discharge their responsibilities with integrity, objectivity, due professional care, and a genuine interest in serving the public. They are expected to provide quality services, enter into fee arrangements, and offer a range of services–all in a manner that demonstrates a level of professionalism consistent with these Principles of the Code of Professional Conduct.
>
> .05 All who accept membership in the American Institute of Certified Public Accountants commit themselves to honor the public trust. In return for the faith that the public reposes in them, members should seek to continually demonstrate their dedication to professional excellence.

The Texas Administrative Code, Part 22, ch. 501, sets out ethical standards for Texas CPAs. Responsibilities to clients include independence, competence, and confidentiality. Responsibilities to the public include licensing, advertising, and forms of accounting business entities, but no mention is made of duties owed to the public relating to accounting work.

2. Do Auditors Owe a Duty to Clients or to the Public? AICPA says that auditors are not considered to have fiduciary duties to the client because of their duty to the public.[56] The emphasis the profession places an auditor's duty to the public recognizes that many times an accountant's financial reporting work or tax work will be offered to and relied on by investors, lenders, or the IRS as being accurate. "The attest service is part of the practice of public accountancy. That service provides assurance to the public, especially the public markets, that the management of commercial entities has reasonably described the financial status of those entities. That assurance contributes to the strength of the economy and public markets of this state and to the soundness and reliability of the financial system. The strength of the financial system in this state is supported by the competence, integrity, and expertise of the persons who attest to financial statements in this state." Public Accountancy Act, Texas Occupation Code ("TOC") § 901.005(b). Speaking of the auditing function in particular, in *U.S. v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984), the Supreme Court said: "By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public

accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. To insulate from disclosure [to the IRS] a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations."

3. Accountants' Liability to Clients. Like any professional, accountants have owe a duty of ordinary care to their clients, and the breach of this duty is a tort claim based on negligence. *See Atkins v. Crosland*, 417 S.W.2d 150, 153 (Tex. 1967) ("the plaintiffs cause of action for accounting negligence did not arise until the tax deficiency was assessed by the IRS); *Murphy v. Campbell*, 964 S.W.2d 265, 272-73 (Tex. 1997) (refusing to recognize an implied warranty regarding accounting services since a claim for accounting malpractice and under the DTPA sufficed).

4. Accountants' Liability to Others. In *Murphy v. Campbell*, 964 S.W.2d 265 (Tex. 1997), the Court considered a claim brought by shareholders of a corporation against an accounting firm for accounting malpractice relating to tax advice. The firm argued that the shareholders had no standing, since the wrong was to the corporation and not to its shareholders. The Court rejected that contention, saying that the accounting firm advised both the corporation and its shareholders, thus permitting the shareholders to sue in their own right. The Court therefore did say whether the doctrine of privity limits an accountant's duty of care just to clients.

5. Auditing Standards. The duties of auditors are reflected in Generally Accepted Auditing Standards ("GAAS") issued by the Auditing Standards Board of the AICPA. The auditing standards provide for adequate training and proficiency, an independence in mental attitude, due professional care, adequate planning and supervision, sufficient understanding of internal control, and gathering sufficient evidence. The audit report must state whether the financial statements are based on Generally Accepted Accounting Practices (GAAP), if not then how they deviate from GAAP, give reasonably adequate informative disclosure, and give a clear expression of auditor's opinion of the financial statement, in whole or in part. See AU Section 150, Generally Accepted Auditing Standards.[57]

Auditing standards for Federal government agencies, offices, etc. are set by the U.S Govenment Accounting Office. See TOC § 901.005(b). The Sarbanes–Oxley Act of 2002 created the Public Company Accounting Oversight Board (PCAOB), a nonprofit corporation that oversees audits of publicly-traded companies and broker-dealers. The PCAOB has issued auditing standards that reflect SEC determinations as to auditing practices,[58] and these are required for registered public accounting firms. The AICPA still recognizes its Auditing Standards Board as the authority for auditing privately-owned companies.

In its August 18, 2015 Annual Report,[59] the PCAOB said that out of 106 audits inspected, 92 (87%) had deficiencies and only 14 did not have deficiencies. In its August 20, 2020 Annual Report[60] of inspections of broker-dealers, the PCAOB said: "There were 411 public accounting firms (firms) registered with the PCAOB that performed audits of broker-dealers registered with the U.S. Securities

and Exchange Commission (SEC) this inspection period, and we selected 66 of these firms for inspection. Our inspections assess firms' compliance with professional standards and applicable rules and regulations, with a focus on risks to customers of broker-dealers. ¶ While our 2019 inspections revealed modest improvement in the rate of deficiencies, we continue to see a high rate of deficiencies in certain areas of engagement performance." *Id.* at 1.

6. Auditors' Liability to Third Parties. The Texas Supreme Court addressed auditors' liability for the tort of negligent misrepresentation in *Grant Thornton LLP v. Prospect High Income Fund*, 314 S.W.3d 913 (Tex. 2010). Chief Justice Jefferson related the history of the question, noting at p. 918 Justice Cardozo's New York Court of Appeals Opinion in *Ultramares Corp. v. Touche, Niven & Co.*, 174 N.E. 441, 445 (N.Y. 1931), in which Cardozo rejected "the assault upon the citadel of privity" that would subject auditors to claims of an indeterminate amount for an indeterminate time to an indeterminate class. *Ultramares* at 444. The Texas Supreme Court reaffirmed its earlier reliance on RESTATEMENT (SECOND) OF TORTS § 552, in the *McCamish* case which said that a "cause of action is available only when information is transferred by an attorney to a *known* party for a *known* purpose." *Grant Thornton*, p. 920, citing *McCamish* at 794. In other words, the professional must be aware of the nonclient and intend that the non client rely on the information. *Id.* at 920. See Section V.B. for a discussion of negligent misrepresentation. The Court in *Grant Thornton* rejected the plaintiffs' claim of fraud due to the failure to prove intent to deceive. *Id.* at 921.

7. Problems in the Auditing World. All is not well in the auditing world. Some of the biggest financial scandals in the past decades have involved the neglectful or conscious ignoring of problematic activities of the client who is being audited.

Currently, one major focus of the SEC is auditor independence. The SEC believes that a lack of independence between the auditor and the client being audited can threaten an auditor's objectivity and impartiality. On October 16,2020, the SEC issued final rules respecting auditor independence.[61]

In February of 2018 the SEC fined Deloitte Touche Tohmatsu LLC $2 million for performing an audit on a company whose financial subsidiary had money on deposit from 89 of Deloitte Touche's employees. The SEC said that this violated the principle of auditor independence.[62]

<u>Enron & Arthur Andersen</u>

The collapse of Enron in 2001 and the ensuing scandal was a large auditing failure. The Government alleged in its complaint that: "1. Enron Corp.'s ('Enron') senior executives engaged in and presided over a wide-ranging scheme to defraud the investing public by materially overstating the company's earnings and cash flows, and concealing debt in periodic reports filed with the [SEC]. The fraudulent scheme was carried out through a variety of complex structured transactions, off-balance sheet financings, related party transactions, misleading disclosures, and a widespread abuse of generally accepted accounting principles ('GAAP').[63] 2. Arthur Andersen LLP ("Andersen") served as Enron's auditor, and for each year during the relevant time period, issued an auditor's report stating the opinion that Enron's financial statements were presented fairly, in all material respects, in conformity with GAAP, and that Andersen had conducted its audit of those financial statements in accordance with

generally accepted auditing standards ('GAAS''). David B. Duncan ('Duncan') served as the global engagement partner responsible for the Enron audits. As the global engagement partner for the Enron audits, Duncan was ultimately responsible for determining whether an unqualified opinion should be issued within the auditor's report. For years ended December 31,1998 through 2000, Duncan was reckless in not knowing that the unqualified auditor's reports he signed on behalf of Andersen were materially false and misleading. These auditor's reports were part of Enron's annual reports on Forms 10-K filed with the [SEC] for years 1998, 1999 and 2000. Based on this, the [SEC] alleges that Duncan violated Section 10(b) of the Securities Exchange Act of 1934 ('Exchange Act') and Rule 10b-5 promulgated thereunder. Accordingly, the Commission requests that this Court permanently enjoin Duncan from any future violation of Section 10(b) of the Exchange Act and Rule l0b-5 promulgated thereunder."[64] The SEC alleged, and the accountant neither agreed not disagreed, "that, for the years 1998 through 2000, [the accountant] was reckless in not knowing that the unqualified audit reports he signed on behalf of Andersen were materially false and misleading." The Settlement Action said that Duncan "failed to exercise due professional care and the necessary skepticism required under Generally Accepted Auditing Standards ('GAAS') to ensure Enron's financial statements were presented in conformity with Generally Accepted Accounting Principles ('GAAP')." The SEC alleged that the auditor's report attached to Enron's financial statement violated Section 10-(b) of the Securities and Exchange Act of 1934 and Rule 10b-5. The SEC also procured Settlement Orders from Bauer, Lowther, and Odom, who were Arthur Anderson accountants involved in the Enron audits.[65] In 2009, Arthur Anderson LP agreed to pay $16 million to creditors of Enron for claims that Arthur Anderson did not properly perform their duties as auditors of Enron.

<u>The Bernie Madoff Ponzi Scheme</u>

On December 11, 2008, the SEC filed a complaint in federal court in Manhattan, alleging that Bernie Madoff had committed a $50 billion fraud and violated Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and Sections 206(1) and 206(2) of the Advisers Act of 1940.[66] The Madoff Ponzi scheme was perpetuated from 19991 to 2008 based on "audits" by an accountant who flagrantly violated accepted auditing standards. On March 18, 2009, the SEC charged CPA David G. Friehling of fraudulently purporting to perform audits of Bernard L. Madoff Investment Securities LLC (BMIS) in accordance with GAAS, when in reality "Friehling merely pretended to conduct minimal audit procedures of certain accounts to make it seem like he was conducting an audit, and then failed to document his purported findings and conclusions as required under GAAS. If properly stated, those financial statements, along with BMIS related disclosures regarding reserve requirements, would have shown that BMIS owed tens of billions of dollars in additional liabilities to its customers and was therefore insolvent."[67] Frieling pled guilty and was sentenced to one year of home detention and one year of supervised release. Total loss of principal was estimated by the New York Times to amount to $17.5 billion.[68]

<u>KPMG Cheating on Audit Reviews</u>

In 2013, nearly half of KPMG's audits inspected by the PCAOB were found deficient. According to charges filed in 2018, the SEC discovered that KPMG had hired a succession of employees who left the PCAOB and informed KPMG about planned inspections of KPMG audits, permitting KPMG to

shore up the work papers in order to avoid negative findings. The illicit disclosures were allegedly encouraged by KMPG's national managing partner for audit quality along with the national partner in charge of inspections.[69] Five KPMG officers were charged with conspiring to interfere with the PCAOB's ability to detect audit deficiencies. The SEC also found that KPMG audit professionals who passed SEC mandated training exams shares answers with colleagues who took the test at a later time. The tests had been imposed by the SEC due to deficiencies in past KPMG audits. The SEC also charged that KPMG audit professional manipulated computer software by embedding a formula in a hyperlink that altered the minimum passing score on the SEC-mandated audit-training exams. In June of 2019, KPMG admitted these allegations in a settlement order and agreed to pay a $50 million fine.

T. APPRAISERS. Historically, the appraisal field was self-regulated. Appraisal standards were promulgated by the American Institute of Real Estate Appraisers, the Society of Real Estate Appraisers, the Appraisal Institute (a merger of the foregoing two organizations, the American Society of Appraisers, and the American Institute of Certified Public Accountants. As a result of the 1980s Savings and Loan crisis, the U.S. Congress established the Appraisal Foundation to establish real property appraisal standards affecting federally-insured lenders. In 1987, the Appraisal Foundation promulgated the Uniform Standards of Professional Appraisal Practice (USPAP). The Ethics Rule provides that "[a]n appraiser must perform assignments with impartiality, objectivity, and independence, and without accommodation of personal interests." The Standard goes on to say that an appraiser must act without bias, must not advocate the interests of any party or issue; must not agree to meet predetermined positions, must not misrepresent his role, must not communicate results with the intent to mislead or defraud, must not use of communicate a report known to be misleading or fraudulent, must not engage in bias based on race, color, religion, gender and other suspect categories, must not engage in criminal conduct, must not violate the record-keeping rule, and must not perform an assignment in a grossly negligent manner. The American Society of Appraisers has promulgated standards for the appraisal of businesses.

U. REAL ESTATE BROKERS AND AGENTS. Real estate brokers and salespersons in Texas fall under Texas Occupations Code ch. 1101. Section § 1101.652, Grounds for Suspension or Revocation of License, lists 33 behaviors that can result in a loss license, including negligence, incompetence, dishonesty, bad faith, material misrepresetation or failure to disclose, false promises, receiving commissions from more than one party without disclosure, commingling monies, and more. Causes of action against real estate brokers and agents include breach of contract, negligence, and breach of fiduciary duty. The contractual obligations generally are listed in the listing agreement. Claims for negligence are based on failure to use ordinary care. Breach of fiduciary duty claims are based on violations of the agency relationship.

V. ADVERTISERS. The Federal Trade Commission Act of 1914, 15 U.S.C. §§ 41-58, established the Federal Trade Commission ("FTC"). The Commission is empowered to "a) prevent unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce; (b) seek monetary redress and other relief for conduct injurious to consumers; (c) prescribe rules defining with specificity acts or practices that are unfair or deceptive, and establishing requirements designed to prevent such acts or practices; (d) gather and compile information and conduct investigations relating to the organization, business, practices, and management of entities engaged in commerce; and (e) make

reports and legislative recommendations to Congress and the public."[70] Section 57b(a) permits the FTC to file a civil action against anyone who engages in unfair or deceptive acts or practices. Section 57b(b) permits the FTC to seek rescission or reformation of contracts, the refund of money or rreturn of property, the payment of damages, and public notification respecting the rule violation or the unfair or deceptive act or practice, but not exemplary or punitive damages. The Lanham Act, 15 U.S.C. § 1125 permits any person who engages in false advertising to be sued by any person who believes s/he is likely to be damaged by such act. "To establish a prima facie case of liability for false advertising under the Lanham Act, the plaintiff must show that (1) the defendant made a false statement of fact[36] about its product in a commercial 630
*630 advertisement; (2) the statement actually deceived or has a tendency to deceive a substantial segment of its audience; (3) the deception is likely to influence a purchasing decision; (4) the defendant caused the false statement to enter interstate commerce; and (5) the plaintiff has been or is likely to be injured as a result." *Astoria Indus. of Iowa, Inc. v. SNF, Inc.*, 223 S.W.3d 616, 629-30 (Tex. App.–Fort Worth 2007, pet. denied).

W. LANDLORD-TENANT. The landlord-tenant relationship is not a fiduciary one. The landlord has duties specified in the lease. And a landlord has duties defined in tort law. For example, when "a landlord retains possession or control of a portion of the leased premises, the landlord is charged with the duty of ordinary care in maintaining the portion retained." *Exxon Corp. v. Tidwell*, 867 S.W.2d 19, 21 (Tex. 1993).

X. STOCK BROKERS AND DEALERS. The Securities Exchange Act of 1934 defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others." 15 U.S.C.A. § 78c(a)(4)(A). A "dealer" is "any person engaged in the business of buying and selling securities (not including security-based swaps, other than security-based swaps with or for persons that are not eligible contract participants) for such person's own account through a broker or otherwise." 15 U.S.C.A. § 78c(a)(5)(A). The broker or dealer relationship with the client is considered to be an agency relationship, not an arm's length relationship. As are result fiduciary duties arise.

In 2007, the stock brokerage profession created the Financial Industry Regulatory Authority, Inc. ("FINRA"). The stock brokerage industry normally requires its brokers and dealers and customers to sign an arbitration agreement to arbitrate disputes with a FINRA panel of arbitrators. As a result, many broker/dealer/customer disputes do not make their way to a court system. FINRA itself says: "FINRA is, for all practical purposes, the sole arbitration forum in the United States for resolving disputes between broker -dealers, associated persons, and customers. FINRA requires arbitration of disputes between customers and broker-dealers and associated persons at the request of the customer."[71] With FINRA, the stock brokerage industry has essentially moved litigation involving brokers, dealers, and customers into a private justice system that is outside the public eye. FINRA says this about its arbitration justice syste: "FINRA sponsors a forum for securities dispute resolution. Our arbitration program administers claims involving customers of brokerage firms and disputes between brokerage firms and their employees."[72]

FINRA promulgates rules for broker/dealers to follow. Rule 2020, Use of Manipulative, Deceptive or Other Fraudulent Devices, which provides: "No member shall effect any transaction in, or induce the

purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance." FINRA Rule 2010(d), Communications with the Public, provides:

> (A) All member communications must be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service. No member may omit any material fact or qualification if the omission, in light of the context of the material presented, would cause the communications to be misleading.
>
> (B) No member may make any false, exaggerated, unwarranted, promissory or misleading statement or claim in any communication. No member may publish, circulate or distribute any communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading."

Merrill Lynch and "Masking."

In 2018, the SEC charged Merrill Lynch, Pierce, Fenner & Smith Incorporated (ML) with willful violations of Federal securities laws by sustained efforts to hide from brokerage customers its practice of routing some customer orders to other broker-dealers for execution (a process ML called "masking"). ML programmed a system that generated automated messages to customers regarding each trade, thereby falsely indicating that the trade had been effected by ML. ML stopped the practice in 2013 but did not inform its clients of past practices. ML was charged with violating Section 17(a)(2) (untrue statement in the sale of securities) and Section 17(a)(3) (fraud or deceit upon the purchaser) of the Securities Act of 1933. In June of 2019, ML accepted an SEC Order censuring ML, and imposing a civil penalty of $42 million.[73]

On June 5, 2019, the SEC issued *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, "establishing a standard of conduct for broker-dealers ... when they make a recommendation to a retail customer of any securities transaction or investment strategy involving securities..." This new standard requires broker-dealers to "act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker-dealer ahead of the interests of the retail customer" and addressed "conflicts of interest by establishing, maintaining, and enforcing policies and procedures reasonably designed to identify and fully and fairly disclose material facts about conflicts of interest, and in instances where we have determined that disclosure is insufficient to reasonably address the conflict, to mitigate or, in certain instances, eliminate the conflict." In setting these standards, the SEC says that it drew on key principles underlying fiduciary obligations.[74]

Y. INVESTMENT ADVISORS. The Investment Advisers Act of 1940 is discussed in Section IV.C above. It applies to investment advisors with $25 million or more of assets under management. Section 206(2) makes it illegal for an investment advisor to defraud a client or prospective client, or engage in a transaction or practice that operates as a fraud or deceit, or to engage in a course of business that is fraudulent, deceptive, or manipulative. The Supreme Court has said that Section 206(2) places on an investment adviser a fiduciary duty to disclose to the client all conflicts of interest which might incline an investment adviser consciously or unconsciously to render advice that is not disinterested.

SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-92 (1963). A conflict of interest is a material fact that an investment adviser must disclose to its clients. *Id.* A violation of Section 206(2) may rest on a finding of simple negligence. *SEC v. Steadman*, 967 F.2d 636, 643 n. 5 (D.C. Cir. 1992).] On June 5, 2019, the SEC issued an "Interpretation" of the 1940 Act to define the fiduciary duties of financial advisors.[75] Broadly speaking, the SEC identified a duty of care and a duty of loyalty. The duty of care requires the investment advisor (i) to provide advice that is in the best interest of the client, (ii) to seek best execution of transactions; and (iii) to provide advice and monitoring over the course of the relationship. *Id.* at 12. The duty of loyalty requires the investment advisor not to subordinate its clients' interest to its own. *Id.* at 21. [Comment: apparently equal treatment of the fiduciary's and beneficiary's interest is acceptable. The duty of loyalty requires "full and fair disclosure to its clients of all material facts relating to the advisory relationship," including "all conflicts of interest which might incline and investment advisor – consciously or unconsciously – to render advice that is not disinterested." *Id*. at 21-23. The Interpretation gave an example of inadequate disclosure when an investment adviser said that it *may* receive compensation for services when in fact there actually was a compensation arrangement in place. *Id.* at 25. The SEC also criticized failure to disclose a policy of unequal treatment between clients in allocating expenses. *Id*. at 26. The 1940 Act permits both SEC enforcement and criminal prosecution, but makes no mention of a private cause of action. In *Transamerica Mortgage Advisors, Inc v. Lewis*, 444 U.S. 11, 25 (1979), a divided Court (4-1-4) held that under the 1940 Act an investment advisor client can bring an equitable claim of rescission of the investment adviser's contract, but not a claim for money damages. In *United States v. Tagliaferri*, 648 F. App'x 99 (2d Cir. 2016), the court held that the 1940 Act does not require intent to harm, but only intent to deceive. In *Western Reserve Life Assurance Company of Ohio v. Graber*, 233 S.W.3d 360, 374 (Tex. App.--Ft. Worth 2007, no pet.), the court held that a financial manager has a fiduciary relationship with his client.

Z. ERISA PLAN TRUSTEES. "Before ERISA's enactment in 1974, the measure that governed a transaction between a pension plan and its sponsor was the customary arm's-length standard of conduct. This provided an open door for abuses such as the sponsor's sale of property to the plan at an inflated price or the sponsor's satisfaction of a funding obligation by contribution of property that was overvalued or nonliquid." *Commissioner v. Keystone Consol. Indus., Inc.*, 508 U. S. 152, 160 (1993). Congress enacted the Employee Retirement Income Security Act of 1974 ("ERISA"), 29 U.S.C. §§ 1001 - 1461, in order to protect the deferred compensation promised by employers to employees. ERISA was designed to reduce administration risk and default risk in pension plans. *Massachusetts v. Morash*, 490 U.S. 107, 115 (1989) ("In enacting ERISA, Congress' primary concern was with the mismanagement of funds accumulated to finance employee benefits and the failure to pay employees benefits from accumulated funds.") Default risk arises because a defined benefit plan's payments are payable over a period of time in the future. ERISA, along with the Pension Benefit Guarantee Corporation, have greatly reduced default risk. *See* John H. Langbein, *What ERISA Means By "Equitable": The Supreme Court' Trail of Error in Russell, Mertens, and Great-West*, 103 COLUM. L. REV. 1317, 1323 (2002).

ERISA authorizes participants and beneficiaries to bring a civil action "for appropriate relief" against fiduciaries of employee benefit plans who violate their duties, responsibilities, and obligations under ERISA. Under ERISA § 1109, the only right to recover a money judgment is to the plan.

Massachusetts Mutual Life Insurance Co. v. Russell, 473 U.S. 134 (1985). The only relief available to a plan participant is "appropriate equitable relief." ERISA § 1132(a)(3); *Mertens v. Hewitt Assocs.*, 508 U.S. 248, 255 (1993) (equitable relief does not include money damages). There are two kinds of ERISA plans: defined contribution plans and defined benefit plans. 29 U.S.C. 1–2(34) & (35). Section 502(a) allows nine types of claims to be brought against trustees. Section 502(l) permits civil penalties. *See LaRue v. DeWolff, Boberg & Associates, Inc.*, 552 U.S. 248 (2008) (holding that a participant in a defined contribution plans can sue an ERISA fiduciary under § 501(a)(2)).

1. Duties of ERISA Trustees. Under ERISA, the term "fiduciary" includes a fiduciary named in the plan instrument, § 1102(a), or as a person who has or exercises discretionary authority or control respecting management of a plan or management or disposition of plan assets, or who renders, or has the authority or responsibility to render, investment advice for compensation regarding money or property of the plan. 29 U.S.C. 1002(21)(A). However, a person is a plan fiduciary only to the extent of the fiduciary tasks she assumes. *Pegram v. Herdrich*, 530 U.S. 211, 225-26 (2000); *Livick v. The Gillette Co.*, 524 F.3d 24, 29–30 (1st Cir. 2008). Fiduciaries of ERISA plans are subject to the duties set out in 29 U.S.C. 1104(a), which include a duty of prudence, a duty to diversify to avoid large losses, while acting in accordance with the Plan documents provided they are consistent with ERISA. Section 502(a)(3) authorizes a "participant, beneficiary, or fiduciary" of a plan to bring a civil action to obtain "appropriate equitable relief" to redress violations of ERISA. Section §1109(a) says that "[a]ny person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter shall be personally liable."

a. Prohibited Transactions. ERISA fiduciaries are "categorically" barred from certain "prohibited transactions" with a "party at interest" that are "likely to injure the pension plan." 29 U.S.C. 1104(a), 1106(a)(1); *Commissioner v. Keystone Consol. Indus., Inc.*, 508 U.S. 152, 155, 160 (1993). The term "party in interest" includes a fiduciary, counsel, or employee of a plan; a person providing services to the plan; an employer or employee organization any of whose employees or members are covered by the plan; a corporation or other entity that is owned by such a person; an employee, officer, or director of, or owner of a specified financial interest in, such a person; and a partner or joint venturer of such a person. 29 U.S.C.1002(14). Section 1106 prohibits a trustee from causing a plan to engage in "(A) sale or exchange, or leasing, of any property between the plan and a party in interest; (B) lending of money or other extension of credit between the plan and a party in interest; (C) furnishing of goods, services, or facilities between the plan and a party in interest; (D) transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan; or(E) acquisition, on behalf of the plan, of any employer security or employer real property in violation of section 1107(a)." All five of these *per se* transactions are "commercial bargains that present a special risk of plan underfunding because they are struck with plan insiders, presumably not at arm's length." *Lockheed Corp. v. Spink*, 517 U.S. 882, 893 (1996).

b. Duty of Loyalty. While ERISA does not specifically mention a "duty of loyalty," courts have interpreted ERISA's requirement that the fiduciary make all decisions regarding ERISA plan solely in interests of participants and beneficiaries and for exclusive purpose of providing benefits or defraying costs as a duty of loyalty. *Gregg v. Transp. Workers of Am. Int'l*, 343 F.3d 833, 840-41 (6th Cir. 2003). However, ERISA allows a plan fiduciary to wear "two hats," although not in the same

transaction. *Pegram v. Herdrich*, 530 U.S. 211, 225 (2000).

c. Duty of Care. Under the "Prudent Man Standard of Care" of ERISA, the fiduciary of an ERISA plan must discharge his/her duties with respect to the plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan. 29 U.S.C. § 1104(a)(1), Fiduciary Duties. The fiduciary must discharge his duties "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims" "by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so"; and "in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter and subchapter III." *Id.* at 29 U.S.C. §1104(a)(1) (B), (C) & (D). "[ERISA's] test of prudence is one of conduct, and not a test of the result of performance of the investment. The focus of the inquiry is how the fiduciary acted in his selection of the investment, and not whether his investments succeeded or failed." *Laborers National Pension Fund v. Northern Trust Quantitative Advisors, Inc.*, 173 F.3d 313, 317 (5th Cir. 1999). The prudent man standard is an objective standard, not subject to a defense of good faith. *Reich v. Lancaster*, 55 F.3d 1034, 1046 (5th Cir. 1995); *Donovan v. Cunningham*, 716 F.2d at 1467 ("this is not a search for subjective good faith--a pure heart and an empty head are not enough").

ERISA Section 1104(a)(1)(C) requires ERISA fiduciaries to diversify plan assets. *Massachusetts Mut. Life Ins. Co. v. Russell*, 473 U.S. 134, 143, n. 10.

In *Tibble v. Edison Int'l*, 135 S. Ct. 1823, 1827-28 (2015), beneficiaries of a defined-contribution 401(k) retirement savings plan governed by ERISA sued the plan trustees for breach of an ongoing duty to monitor investments. The U.S. Supreme Court held that the duty to monitor investments is continuing in nature, and that each new breach begins a six-year limitations period. Imprudently retaining an asset thus has a rolling limitations period.

d. Duty to Disclose. An ERISA fiduciary cannot give misleading material information to plan participants. Materiality is a mixed question of law and fact, *Gregg v. Transp. Workers of Am. Int'l*, 343 F.3d 833, 844 (6th Cir. 2003), but a misstatement is material if the statement would induce a reasonable person to rely on it. *Ballone v. Eastman Kodak Co.*, 109 F.3d 117, 122–23 (2nd Cir. 1997). In *Varity Corp. v. Howe*, 516 U.S. 489, 506 (1996), the Supreme Court chose not to "reach the question whether ERISA fiduciaries have any fiduciary duty to disclose truthful information on their own initiative, or in response to employee inquiries." Courts of Appeals have differed on the question. In *Watson v. Deaconess Waltham Hosp.*, 298 F.3d 102, 115 (1st Cir. 2002), the court held that there is no general duty to provide individualized, unsolicited advice. In *Bins v. Exxon Co. U.S.A.*, 220 F.3d 1042, 1048-49 (9th Cir. 2000) (en banc) the court said: "We believe that once an ERISA fiduciary has material information relevant to a plan participant or beneficiary, it must provide that information whether or not it is asked a question."

e. Exculpatory Provisions. Some ERISA plan documents include exculpatory provisions that limit

the liability of plan trustees. However, "trust documents cannot excuse trustees from their duties under ERISA." *Central States, Se. & Sw. Areas Pension Fund v. Central Transp., Inc.*, 472 U.S. 559, 568 (1985).

2. Trustees of an ESOP. An Employee Stock Option Plan ("ESOP") is an ERISA plan that primarily invests in shares of stock of the employer that creates the plan. "Congress intended ESOPs to function as both an employee retirement benefit plan and a technique of corporate finance that would encourage employee ownership. . . Because of these dual purposes, ESOPs are not designed to guarantee retirement benefits, and they place employee retirement assets at much greater risk than the typical diversified ERISA plan." *Chao v. Hall Holding Co., Inc.*, 285 F.3d 415, 425 (6th Cir. 2002), *cert. denied*, 123 S. Ct. 966 (2003) (internal quotations omitted). ERISA's traditional duties of loyalty, prudence, and care under Section 404 apply to the fiduciary of ESOPs, but the fiduciary is not bound by the requirement of diversification of plan assets under ERISA §404(a)(2), or by the prohibited transaction rules of ERISA § 406. The U.S. Supreme Court ruled in *Bancorp v. Dudenhoeffer*. 134 S. Ct. 2459, 2463 & 2467 (2014), that a "presumption of prudence" does not apply to ESOP trustees, and that "ESOP fiduciaries are subject to the same duty of prudence that applies to ERISA fiduciaries in general, except that they need not diversify the fund's assets. §1104(a)(2)." The Court in *Dudenhoeffer* upheld the right of ERISA plan beneficiaries to sue plan trustees who failed to sell and continued to buy company stock when publicly-available information reflected that subprime mortgages were risky and insider information indicated that corporate officers "had deceived the market by making material misstatements about the company's financial prospects." *Id.* at 2464. The Supreme Court specified: "[t]o state a claim for breach of the duty of prudence on the basis of inside information, a plaintiff must plausibly allege an alternative action that the defendant could have taken that would have been consistent with the securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it." *Id.* at 2472.

<u>Insider Information.</u> The U.S. Supreme Court faced the issue of insider information and ESOP trustees (who have no duty to diversify) in *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459, 2471 (2014). The Court wrote:

> The potential for conflict arises because ESOP fiduciaries often are company insiders and because suits against insider fiduciaries frequently allege, as the complaint in this case alleges, that the fiduciaries were imprudent in failing to act on inside information they had about the value of the employer's stock.
>
> This concern is a legitimate one.... While ESOP fiduciaries may be more likely to have insider information about a company that the fund is investing in than are other ERISA fiduciaries, the potential for conflict with the securities laws would be the same for a non-ESOP fiduciary who had relevant inside information about a potential investment. And the potential for conflict is the same for an ESOP fiduciary whose company is on the brink of collapse as for a fiduciary who is invested in a healthier company. (Surely a fiduciary is not obligated to break the insider trading laws even if his company is about to fail.)
> * * *
> A fiduciary usually "is not imprudent to assume that a major stock market . . . provides the best

> estimate of the value of the stocks traded on it that is available to him."" *Id.* at 2472.... To state a claim for breach of the duty of prudence on the basis of inside information, a plaintiff must plausibly allege an alternative action that the defendant could have taken that would have been consistent with the securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it. *Id.* at 2472. Additionally, the Court said that "courts should consider the extent to which an ERISA-based obligation either to refrain on the basis of inside information from making a planned trade or to disclose inside information to the public could conflict with the complex insider trading and corporate disclosure requirements imposed by the federal securities laws or with the objectives of those laws." *Id* at 2472. Thirdly, "lower courts faced with such claims should also consider whether the complaint has plausibly alleged that a prudent fiduciary in the defendant's position could not have concluded that stopping purchases -- which the market might take as a sign that insider fiduciaries viewed the employer's stock as a bad investment -- or publicly disclosing negative information would do more harm than good to the fund by causing a drop in the stock price and a concomitant drop in the value of the stock already held by the fund." *Id.* at 2473.

During oral argument in *Dudenhoeffer*, Justice Breyer said that he "would like to know directly, not indirectly, what the SEC thinks." In response, the SEC filed an amicus curiae brief in No. 15-20282, *Whitley v. BP, P.L.C.*, 838 F.3d 523 (5th Cir. 2016),[76] that "set[] forth alternative actions available to managers or administrators ... of an employee stock ownership plan ('ESOP') who are aware that the employer's publicly traded securities are materially overvalued due to an undisclosed fraud." SEC Brief, p. 1. The options are: 1. disclose the fraud to the public; 2. suspend ESOP transactions; 3. urge the wrongdoers to disclose the fraud; 4. report the fraud to the SEC. *Id.* at pp. 5 & 6. The SEC brief says the first two are required by securities law, and the last two are not required but are not inconsistent with securities laws. The U.S. Supreme Court in *Retirement Plans Comm. of IBM v. Jander*, No. 18-1165 (U.S. Jan. 14, 2020) (an ESOP case), had the opportunity to address a claim that "a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it," as well as the SEC's and Department of Labor's view that "an ERISA-based duty to disclose inside information that is not otherwise required to be disclosed by the securities laws would 'conflict' at least with 'objectives of' the 'complex insider trading and corporate disclosure requirements imposed by the federal securities laws ....'" *Id.* at 3. The Court of Appeals had not addressed those points, so the Supreme Court remanded to the lower court to rule on those contentions.

3. Non-Qualified Plans. So-called "non-qualified plans" are not governed by ERISA. They are essentially contractual relationships, or could be set up as a trust under state law.

4. Liability of Third Parties. In *Harris Trust and Savings Bank v. Salomon Smith Barney*, 530 U.S. 283 (2000), the U.S. Supreme Court unanimously held that ERISA authorizes suits against third parties who engage in prohibited transactions with trustees.

AA. SPOUSES. Spouses have fiduciary duties to each other. Speaking generally, the fiduciary obligation arises from the inherent trust between spouses, but a fiduciary duty also emanates from a position of exclusive control over sole management community property. The most frequently-litigated fiduciary duty is the duty of a spouse who manages or disposes of the other spouses's undivided one-

half ownership interest in community property. Additionally, courts have applied fiduciary standards to transactions between spouses. Occasionally the fiduciary obligation arises from one spouse's acting as the other spouse's financial advisor or legal representative.

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

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

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

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

S.W.2d 110, 115 (Tex. App.--Houston [1st Dist.] 1989, no writ), the court said that, "[b]ecause of the confidential relationship between a husband and a wife, courts have imposed the same duties of good faith and fair dealing on spouses as required of partners and other fiduciaries."

Ends Upon Filing Divorce and Hiring Independent Professionals. Several Texas appellate courts have said that the fiduciary relationship between spouses ends at the start of a contested divorce in which the spouses each hire independent attorneys or financial advisors. *Bass v. Bass*, 790 S.W.2d 113, 119 (Tex. App.--Fort Worth 1990, no writ) ("Although marriage may bring about a fiduciary relationship ..., such a relationship clearly does not continue when a husband and wife hire numerous independent professional counsel to represent them respectively in a contested divorce proceeding"); *Parker v. Parker*, 897 S.W.2d 918, 924 (Tex. App.--Fort Worth 1995, writ denied) ("While marriage may bring about a fiduciary relationship, such a relationship terminates in a contested divorce when a husband and wife each have independent attorneys and financial advisers"); *Boyd v. Boyd*, 67 S.W.3d 398, 405 (Tex. App.--Fort Worth 2002, no pet.) ("The fiduciary duty arising from the marriage relationship does not continue when a husband and wife each hire independent professional counsel to represent them in a contested divorce proceeding"); *Toles v. Toles*, 113 S.W.3d 899, 916 (Tex. App.--Dallas 2003, no pet.) ("A fiduciary duty exists between spouses.... However, that relationship terminates in a contested divorce when a husband and wife each have independent attorneys."); *Ricks v. Ricks*, 169 S.W.3d 523, 526 (Tex. App.–Dallas 2005, no pet.) ("The fiduciary duty arising from the marital relationship ceases in a contested divorce when the husband and wife each hire independent attorneys to represent them"); *Boaz v. Boaz*, 221 S.W.3d 126, 133 (Tex. App.--Houston [1st Dist.] 2006, non pet.) ("adverse parties who have retained professional counsel, including husbands and wives in a suit for divorce, do not owe fiduciary duties to one another"). The Austin Court of Appeals, however, in *Sheshunoff v. Sheshunoff*, 172 S.W.3d 686, 701 n. 21 (Tex. App.--Austin 2005, pet. denied), rejected a categorical rule that hiring separate counsel in a divorce always eliminates fiduciary obligations. It makes sense that the duty of disclosure that exists between spouses would be supplanted, at least to some extent if not entirely, by the discovery rules of procedure that govern the disclosure of information in a lawsuit. However, if the relationship giving rise to a fiduciary obligation between spouses exists independent of the marriage, like a partnership relationship or an agency relationship, one would think that those duties are not altered by the filing of a divorce. And in instances where a spouse convinces the other spouse to enter into a settlement unbeknownst to his or her attorneys, the rule might not apply.

Ends Upon Granting of Divorce. Several cases sensibly hold that the fiduciary duty between spouses ends upon the granting of a divorce. *Grossnickle v. Grossnickle*, 935 S.W.2d 830, 846 (Tex. App.--Texarkana 1996, writ denied) (no fiduciary duty after divorce); *In re Marriage of Notash*, 118 S.W.3d 868, 872 (Tex. App.--Texarkana 2003, no pet.) ("The fiduciary duty between husband and wife terminates on divorce"); *Camacho v. Montes*, 2006 WL 2660744, *3 (Tex. App.--Amarillo 2006, no pet.) (mem. op.) ("The formal fiduciary relationship between Frances and Delfino as husband and wife terminated on their divorce"). However, Texas Family Code Section 9.001 creates a post-divorce fiduciary duty with regard to a former spouse who receives property awarded in the decree of divorce to the other spouse.

2. The Duty to Disclose. Several cases identify a spouse's duty to disclose. In *Buckner v. Buckner*,

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

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

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

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

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

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

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

PJC 206.1 Confidence and Trust Relationship between Spouses

> A relationship of confidence and trust exists between a husband and wife with regard to that portion of the community property that each controls. This relationship requires that the spouses use the utmost good faith and frankness in their dealings with each other.
>
> Because of the nature of the spousal relationship, conduct of a spouse affecting the property rights of the other spouse may be fraudulent even though identical conduct would not be fraudulent as between nonspouses.

PJC 206.2A Actual Fraud by Spouse against Community Estate—Instruction

> A spouse commits fraud if that spouse transfers community property or expends community funds for the primary purpose of depriving the other spouse of the use and enjoyment of the assets involved in the transaction. Such fraud involves dishonesty of purpose or intent to deceive.

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

> A spouse may make moderate gifts, transfers, or expenditures of community property for just causes to a third party. However, a gift, transfer, or expenditure of community property that is capricious, excessive, or arbitrary is unfair to the other spouse. Factors to be considered in determining the fairness of a gift, transfer, or expenditure are—
>
> 1. The relationship between the spouse making the gift, transfer, or expenditure and the recipient.
> 2. Whether there were any special circumstances tending to justify the gift, transfer, or expenditure.
> 3. Whether the community funds used for the gift, transfer, or expenditure were reasonable in proportion to the community estate remaining.

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

IX. OTHER DUTIES.

A. GOVERNMENT OFFICIALS. Texas Government Code ch. 572 contains duties owed by state government officials. Section 572.001 says that a state officer or employee cannot "have a direct or indirect interest, including financial and other interests, or engage in a business transaction or professional activity, or incur any obligation of any nature that is in substantial conflict with the proper discharge of the officer's or employee's duties in the public interest." State officers are required to file financial statements revealing income and ownership of assets. Sec. 572.023. Standards of conduct are set out in Subchapter C. They prohibit income or investments that "might reasonably tend to influence the officer or employee in the discharge of official duties ...." Section 572.051. Legislators must file a notice before they vote on a bill where a relative is a lobbyist. Section 572.0531.

B. JUDGES. Judges are generally immune from liability for their judicial actions.

1. Judicial Immunity. Judges enjoy a common law immunity from liability for judicial acts. *Turner v. Pruitt*, 342 S.W.2d 422, 423 (1961). The immunity extends not just to being held liable, but also being immune to having to defend lawsuits. *Bradt v. West*, 892 S.W.2d 56, 69 (Tex. App.--Houston [1st Dist.] 1994, writ denied). The immunity extends only to actions that are intimately associated with the judicial process. *Imbler v. Pachtman*, 424 U.S. 409, 430-31 (1976). Immunity is excluded for acts that "fall clearly outside the judge's subject matter jurisdiction." *Spencer v. City of Seagoville*, 700 S.W.2d 953, 957-58 (Tex. App.--Dallas 1985, no writ). *See* Ryan Henry, *Immunity; So You Think You Can't Be Sued?* (2013).[77] "Derived judicial immunity" applies to non-judges who are intimately associated with the judicial process and who exercise discretionary judgment comparable to that of a judge. *Davis v. West*, (Tex. App.--Houston [1st Dist.] Dec. 31, 2009, no pet.) (granting derived judicial immunity to a court-appointed receiver).

2. Texas Statutory Probate Judges. Texas statutory probate judges are required to provide a $500,000 bond, payable to the country treasury, "conditioned on the faithful performance of the duties of the Office." Tex. Gov't Code § 25.00231(b). Texas Estates Code § 401.007, provides that a probate judge cannot be held liable for misdeeds or the failure to act on the past an independent executor absent proof of fraud or collusion on the part of a judge. Under Texas Estates Code § 1201.003, Judge's Liability, "[a] judge is liable on the judge's bond to those damaged if damage or loss results to a guardianship or ward because of the gross neglect of the judge to use reasonable diligence in the performance of the judge's duty under this subchapter [to review the guardianship]." Federal Judge Lee Rosenthal of the Southern District of Texas ruled that "[t]he subchapter imposes duties on probate judges, including the 'use of reasonable diligence to determine whether an appointed guardian is performing the required duties,' annual inspection of the well-being of each ward, and ensuring that guardians have posted solvent bonds.... The immunity waiver is limited. It applies only to actions on the judge's bond for gross neglect of the duties imposed in the subchapter, and only to the extent of the bond's value. It does not open judges to generalized liability for violations of other statutes or common-law duties" *Johnston v. Dexel*, 373 F. Supp.3d 764 (S.D. Tex. 2019).[78]

3. The Duty to Recuse. A judge *must* recuse in any proceeding in which the judge's impartiality might reasonably be questioned, or where the judge has a personal bias or prejudice concerning the subject matter or a party. Tex. R. Civ. P. 18b(b)(1) & (2). (These are two out of the eight listed grounds to recuse.)

4. Canons of Judicial Ethics. Prior to 1974, Texas judges had no separate set of rules governing their official conduct. In 1974, the Texas Supreme Court adopted the American Bar Association's Code of Judicial Conduct. *In re Rio Grande Valley Gas Company*, 987 S.W.2d 167 (Tex. App.--Corpus Christi 1999, orig. proceeding); *see* John C. Domino, *the Origins and Development of Judicial Recusal in Texas*, 5 BR. J. AM. LEG. STUDIES 149, 156 (2016). Canon 2 requires that a judge avoid impropriety and the appearance of impropriety in all of his activities. Tex. Jud. Ethics Op. No. 45 (1979) said that, under Canon 3b(3) (now Canon 3D(2)), a judge has a duty to "initiate appropriate disciplinary measures"" against a lawyer who presented false information to the court in order to obtain the entry of a judgment. The judge cannot remove a retained attorney for ineffective assistance of counsel. Tex. Jud. Ethics Op. No. 78 (1985).

5. Standards of Appellate Conduct. The Supreme Court of Texas and the Texas Court of Criminal Appeals adopted the Standards of Appellate Conduct on February 1, 1999. The Standards cover lawyers' duties to clients, lawyers' duties to the court, lawyers' duties to lawyers, and the court's relationship with counsel. The Standards admonish: "Judges must practice civility in order to foster professionalism in those appearing before them." Considerations listed for judges include: "3. The court will be courteous, respectful, and civil to counsel. 4. The court will not disparage the professionalism or integrity of counsel based upon the conduct or reputation of counsel's client or co-counsel. 5. The court will endeavor to avoid the injustice that can result from delay after submission of a case. 6. The court will abide by the same standards of professionalism that it expects of counsel in its treatment of the facts, the law, and the arguments. 7. Members of the court will demonstrate respect for other judges and courts."

C. THE DUTY TO DISCLOSE. "As a general rule, a failure to disclose information does not constitute fraud unless there is a duty to disclose."" *Bradford v. Vento*, 48 S.W.2d 749, 755 (Tex. 2000). "Generally, no duty of disclosure arises without evidence of a confidential or fiduciary relationship." *Ins. Co. of N. Am. v. Morris*, 981 S.W.2d 667, 674 (Tex. 1998).

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

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

Texas Property Code § 5.008 requires the seller of a single home to make a disclosure to the buyer of a list of of items set out in that section.

1. When Does the Duty to Disclose Arise? A duty to disclose has been recognized: (i) in a formal

or informal fiduciary relationship; (ii) when a partial disclosure leads to a duty to fully disclose; (iii) when new information causes an earlier disclosure to become misleading or untrue; (iv) when a partial disclosure conveys a false impression; (v) in connection with estoppel by silence; and (vi) when a person "by force of circumstances is under a duty to another to speak." *A. R. Clark Investment Co. v. Green*, 375 S.W.2d 425, 435 (Tex. 1964) (involving estoppel by silence).

Under Securities Act of 1933 § 17(a)(2), issuers of publicly-traded securities have a duty to disclose material facts that, if omitted, would make disclosures in a registration or prospectus misleading. See Section IV.A above. The Supreme Court "repeatedly has described the "fundamental purpose" of the 1934 Act as implementing a "philosophy of full disclosure." *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 477-78 (1977).

2. Trustee's Duty to Disclose. "[T]he duty to inform is a constant thread in the relationship between beneficiary and trustee; it entails not only a negative duty not to misinform, but also an affirmative duty to inform when the trustee knows that silence might be harmful." *Bixler v. Central Pa. Teamsters Health-Welfare Fund*, 12 F.3d 1292, 1300 (3d Cir. 1993) (internal quotation marks omitted). The RESTATEMENT (SECOND) OF TRUSTS § 173 (1959), said that a trustee is under a duty to the beneficiary to give him *upon his request* at reasonable times complete and accurate information as to the nature and amount of the trust property and to permit him or a person duly authorized by him to inspect the subject matter of the trust and the accounts and vouchers and other documents related to the trust. However, comment d to § 173, says that "[t]he trustee is under a duty to communicate to the beneficiary material facts affecting the interest of the beneficiary which he knows the beneficiary does not know and which the beneficiary needs to know for his protection in dealing with a third person with respect to his interest." When a plan administrator speaks, it must speak truthfully. *Mullins v. Pfizer, Inc.*, 23 F.3d 663, 668 (2d Cir. 1994) (discussing the duty of an ERISA plan trustee). Tex. Prop. Code § 111.035(c) provides that "the terms of a trust may not limit any common law duty to keep a beneficiary of an irrevocable trust who is 25 years of age or older informed at any time during which the beneficiary: (1) is entitled or permitted to receive distributions from the trust; or (2) would receive a distribution from the trust if the trust were terminated." So a trust instrument can eliminate the duty to disclose to a beneficiary under age 25 when that beneficiary is entitled to a distribution.

D. THE DUTY TO PRESERVE INFORMATION. Speaking of the Watergate scandal, it was said that the cover-up was worse than the crime. If not worse than the crime, the destruction of evidence in advance of a Federal investigation can certainly add one more paragraph to the SEC compliant on the grand jury indictment. In some instances, destruction of information becomes the focus of prosecution where no other crime was committed or where the underlying crime is too complex to explain to a jury.

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

> Whoever knowingly uses intimidation or physical force, threatens, or corruptly persuades another person, or attempts to do so, or engages in misleading conduct toward another person, with intent

> to ... cause or induce any person to ... withhold testimony, or withhold a record, document, or other object, from an official proceeding [or] alter, destroy, mutilate, or conceal an object with intent to impair the object's integrity or availability for use in an official proceeding ... shall be fined under this title or imprisoned not more than ten years, or both.

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

Arthur Anderson. In 2000, the accounting firm of Arthur Anderson earned $58 million from its client Enron, and was projected to earn $100 million in 2001. *United States v. Arthur Anderson, LLP*, 374 F.3d 281, 284 (5th Cir. 2004), *rev'd*, 544 U.S. 696, 698 (2005). "As Enron Corporation's financial difficulties became public in 2001, petitioner Arthur Andersen LLP, Enron's auditor, instructed its employees to destroy documents pursuant to its document retention policy." So begins Chief Justice Rehnquist's Opinion for a unanimous Supreme Court reversing accounting firm Arthur Anderson's conviction for obstruction of justice. *Id*. at 698. A jury found Arthur Anderson guilty of violating 18 U. S. C. §§ 1512(b) (2)(A) and (B), which criminalizes corruptly persuading another to withhold or alter documents for use in an official proceeding. As the Enron scandal was bubbling to the surface, a manager at Arthur Anderson spoke in a training meeting to 89 employees, urging everyone to comply with the firm's document retention policy, saying: "[I]f it's destroyed in the course of [the] normal policy and litigation is filed the next day, that's great.... [W]e've followed our own policy, and whatever there was that might have been of interest to somebody is gone and irretrievable." Two days later an in-house counsel emailed this manager to "remin[d] the engagement team of our documentation and retention policy" and emailed the crisis team a copy of the firm's document policy. *Id.* at 700–701. Four days later, the in-house attorney reminded everyone on the crisis team to ensure that team members should comply with the document policy. *Id.* at 701. Employees began shredding documents on a large scale. One Arthur Anderson partner saw a partner shredding documents and said "this wouldn't be the best time in the world for you guys to be shredding a bunch of stuff." *Id*. at 701 n. 6. The evidence shows that a few days later this same shredding partner picked up a document with the words "smoking gun" on it and shredded it saying "we don't need this." *Id.* The jury had difficulty reaching a verdict. After seven days it was deadlocked. The court submitted an "*Allen* charge" and after three more days of deliberating the jury returned a verdict of guilty. Arthur Anderson appealed. In the meantime, Duncan, the partner in charge of the Enron account, pleaded guilty to obstruction of justice by impeding an SEC investigation by shredding documents. *United States v. Arthur Anderson*, LLP, 374 F.3d 281, 287 (5th Cir. 2004), *rev'd*, 544 U.S. 696, 698 (2005). In 2005, after the reversal of the Arthur Anderson conviction, prosecutors agreed to allow Duncan to withdraw his guilty plea and dismissed charges against him.

As a result of the conviction, Arthur Anderson wound up operations. Most of the firm's active accountants found jobs elsewhere, but former retired employees with non-qualified deferred compensation benefits, who had no part in any wrongdoing, lost some or all of their deferred benefits when Arthur Anderson became defunct. Arthur Anderson was not brought down by questionable auditing or reporting practices, but by document destruction during a Federal investigation.

1. Martha Stewart. In 2006, television and home-making icon Martha Stewart and her broker Peter Bacanovic settled an insider trading case with the SEC brought under Section 17(a) of the Securities Act of 1933, and Section 10(b) of the Securities Exchange Act of 1934, and SEC Rule 10b-5. The claim was that Bacanovic, a broker at Merrill Lynch, tipped Stewart of an impending rejection of a license for an anti-cancer drug, and Stewart sold her stock in the company one day before the announcement of the rejection caused the stock to drop 16%, avoiding a loss of $45,673. Stewart also altered the wording of a text. Stewart and Bacanovic were convicted by a jury of making false statements in the follow-up investigation and each was sentenced to five months in prison.[79]

2. Volkswagen. When Volkswagen decided to admit its pollution defeat-device wrongdoing to the United States government, its in-house attorney advised engineers that a litigation hold was imminent and recommended that they check what documents they had, and advised them not to keep new potentially harmful records on thumb drives and to save final versions on the company's computer network only if necessary. Reportedly at least 40 people subsequently destroyed documents.[80] Based on these events, the eventual indictment of the company and guilty plea included one count of obstruction of justice.[81]

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

E. VICARIOUS LIABILITY.

1. A Principal's Liability for Acts of the Agent. The RESTATEMENT (THIRD) OF AGENCY, ch. 7 suggests that a principal is directly liable to third parties if its agent commits a tort and the principal was negligent in selecting, training, retaining, supervising, or otherwise controlling the agent. *Id.* §§ 7.031 & 7.05(1). The Restatement suggests that a principal is vicariously liable to third parties if

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

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

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

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

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

2. Respondeat Superior. "Respondeat superior imposes liability on the employer that is responsible for the acts of his employee, acting in the scope of his employment, where the negligence of the employee is shown to have been the proximate cause of injury." *DeWitt v. Harris County*, 904 S.W.2d 650, 654 (Tex. 1995). "In order to impose liability upon an employer for the tort of his employee under the doctrine of respondeat superior, the act of the employee must fall within the scope of the general authority of the employee and must be in furtherance of the employer's business and for the accomplishment of the object for which the employee was hired." *Dieter v. Baker Service Tools*, 739 S.W.2d 405, 407 (Tex. App.--Corpus Christi 1987, writ denied). Because the basis for respondeat

superior is the employer's right to control the employee's activities, one who hires an independent contractor is generally not vicariously liable for the tort or negligence of the contractor, because the independent contractor has sole control over the means and methods of the work. *Baptist Mem'l Hosp. Sys. v. Sampson*, 969 S.W.2d 945, 947 (Tex. 1998).

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

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

Under the "intracorporate conspiracy doctrine," a corporation cannot conspire with itself. *Wilhite v. H.E. Butt Co.*, 812 S.W.2d 1, 5 (Tex. App.--Corpus Christi 1991, no writ); *Christopher v. General Computer Sys., Inc.*, 560 S.W.2d 698, 709 (Tex. Civ. App.--Dallas 1977, writ ref'd n.r.e.). "This is

because the acts of a corporation's agents are deemed to be the acts of the corporation itself." *Vosko v. Chase Manhattan Bank, N.A.*, 909 S.W2d 95, 100 n. 7 (Tex. App.--Houston [14th Dist.] 1995, writ denied). "Nor can a parent and subsidiary corporation, or their employees or agents acting within the scope of their employment, conspire." *Id.*

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

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

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

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

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

Restatement Section 448 thus recognizes liability based on knowing or negligent culpability as to the risk of a third peson committing a tort or crime. In *Centeq Realty, Inc. v. Siegler*, 899 SW 2d 195,197 (Tex, 1995), the Court said that "[g]enerally, a person has no legal duty to protect another from the

criminal acts of a third person." However, "a landlord who retains control over the security and safety of the premises owes a duty to a tenant's employee to use ordinary care to protect the employee against an unreasonable and foreseeable risk of harm from the criminal acts of third parties." *Id.* at 197. That duty extends to guests and others. *Id.*

F. STRICT LIABILITY IN TORT. In contract law, the requirement of privity limits the persons to whom contractual duties are owed. RESTATEMENT (SECOND) OF THE LAW OF TORTS § 402A eliminates the privity barrier between manufacturers and consumers, giving rise to products liability. Section 402A was adopted as to food products in *Decker & Sons v. Capps*, 164 S.W.2d 828 (Tex. 1942), and in *McKisson v. Sales Affiliates, Inc.*, 416 SW 2d 787, 789 (Tex. 1967), it was extended to all defective products which cause physical harm to persons.

G. THE DUTY TO MITIGATE DAMAGES. The doctrine of mitigation of damages "prevents a party from recovering for damages resulting from a breach of contract that could be avoided by reasonable efforts on the part of the plaintiff." *Great American Ins. Co. v. N. Austin Utility*, 908 S.W. 2d 415, 426 (Tex. 1995). A defense of failure to mitigate damages in a tort case was rejected in *Moulton v. Alamo Ambulance Service, Inc.*, 414 S.W. 2d 444, 449 (Tex. 1967), on the ground that it was already included in the requirement that the plaintiff's damages be proximately caused by the defendant.

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

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

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

The SEC fined a company $180,000 for including a provision in its non-disclosure agreements with departing employees that they could not disclose company information to the SEC.[82]

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

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

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

C. LIMITED LIABILITY COMPANIES. The liability of a governing person may be limited or eliminated in a limited liability company by its certificate of formation or company agreement as to monetary damages for an act or omission by the person in the person's capacity as a governing person, except that liability cannot be limited or eliminated for breach of loyalty to the organization or its

owners or member, or an action not in good faith that constitutes a breach of duty of the person to the organization; or involves intentional misconduct or a knowing violation of law. TBOC § 7.001(d)(3). However, TBOC § 101.401 allows "[t]he company agreement of a limited liability company [to] expand or restrict any duties, including fiduciary duties, and related liabilities that a member, manager, officer, or other person has to the company or to a member or manager of the company."

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

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

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

Texas Property Code § 114.007 provides:

> (a) A term of a trust relieving a trustee of liability for breach of trust is unenforceable to the extent that the term relieves a trustee of liability for:
>
> > (1) a breach of trust committed:
> >
> > > (A) in bad faith;
> > > (B) intentionally; or
> > > (C) with reckless indifference to the interest of a beneficiary; or

(2) any profit derived by the trustee from a breach of trust.

(b) A term in a trust instrument relieving the trustee of liability for a breach of trust is ineffective to the extent that the term is inserted in the trust instrument as a result of an abuse by the trustee of a fiduciary duty to or confidential relationship with the settlor.

(c) This section applies only to a term of a trust that may otherwise relieve a trustee from liability for a breach of trust. Except as provided in Section 111.0035, this section does not prohibit the settlor, by the terms of the trust, from expressly:

(1) relieving the trustee from a duty or restriction imposed by this subtitle or by common law; or

(2) directing or permitting the trustee to do or not to do an action that would otherwise violate a duty or restriction imposed by this subtitle or by common law.

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

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

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

XI. NECESSITY AND JUSTIFICATION. "Private Necessity" is a defense recognized in criminal prosecutions and to a limited degree in tort claims. Texas Penal Code § 9.22 recognizes the defense of necessity where a person charged with an offense proves that s/he reasonably believed that the illegal conduct was immediately necessary to avoid imminent harm, and avoiding the harm clearly outweighs the harm to be prevented, and there is no legislation excluding the justification. Oliver Wendell Holmes, Jr. wrote: "Suppose that, acting under the threats of twelve armed men, which put him in fear of his life, a man enters another's close and takes a horse. In such a case, he actually contemplates and chooses harm to another as the consequence of his act. Yet the act is neither blameworthy nor punishable. But it might be actionable, and Rolle, C.J. ruled that it was so in *Gilbert v. Stone*, Alen, 35; Style, 72; A.D. 1648." Holmes, THE COMMON LAW 148 (Boston: Little, Brown, 1881). The roots of the necessity defense were explored in John P. Finan and John Ritson, *Tortious*

Necessity; the Privileged Defense, 26 AKRON L. REV. 1 (1992). The focus of many discussions of this esoteric topic is the case of *Vincent v. Lake Erie Transportation Co.*, 124 N.W. 221 (Minn. 1910), where the captain of a ship in Lake Erie lashed his ship to the dock to ride out a storm rather than cast off and subject the boat and crew to the perils of the storm. The dock was damaged, and the Captain was held liable for the damages. There are few cases and few articles on the private necessity defense, and its use in tort cases has so far been limited to trespass or conversion claims, although the criminal defense in Texas applies to any criminal offense. There is no inherent reason why the doctrine of private necessity would not apply to other torts, including breach of fiduciary duty. The REINSTATEMENT (THIRD) OF TORTS (2005) recognized necessity as a defense to a claim for "negligence per se" (i.e., violation of a statute when "the actor's compliance with the statute would involve a greater risk of physical harm to the actor or to others than noncompliance." *Id.* § 15. See Stephen D. Sugarman, *the "Necessity" Defense and the Failure of Tort Theory: The Case Against Strict Liability for Damages Caused While Exercising Self-Help in an Emergency*, 5 ISSUES IN LEGAL SCHOLARSHIP 10 (2005).

"Justification" is a defense in criminal and tort law, where the defendant argues that wrongful activity is justified by a public interest or a superior right that outweighs the transgression. Professor John C. P. Goldberg wrote: "To plead a justification is to claim that one's conduct was permissible, all things considered, even though it meets the definition of a wrong." Goldberg, *Inexcusable Wrongs*, 103 CAL. L. REV. 467 (2015). In *Sterner v. Marathon Oil Co.*, 767 S.W.2d 686, 689-90 (Tex. 1989), in connection with the tort of interference with a contract the Court explained that "legal justification or excuse is treated as a type of privilege. The party asserting this privilege does not deny the interference but rather seeks to avoid liability based upon a claimed interest that is being impaired or destroyed by the plaintiff's contract."

XII. REMEDIES FOR BREACH OF FIDUCIARY DUTY.

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

B. DAMAGES. To prevail on a breach-of-fiduciary-duty claim, a party must prove the existence of a fiduciary duty, a breach of the duty, causation, and damages. *Las Colinas Obstetrics-Gynecology-Infertility Ass'n v. Villalba*, 324 S.W.3d 634, 645 (Tex. App.--Dallas 2010, no pet.). An injured party can sue for damages, and "courts may fashion equitable remedies such as profit disgorgement and fee

forfeiture to remedy a breach of fiduciary duty." *ERI Consulting Engineers, Inc. v. Swinnea*, 318 SW 3d 867, 873 (Tex. 2010). Under Tex Prop. Code § 114.008(a)(3), a trustee who breaches his trust can be ordered to pay money or restore property. In *Frost Nat'l Bank of San Antonio v. Kayton*, 526 S.W.2d 654, 665-66 (Tex. App.–San Antonio 1975, writ ref'd n.r.e.), the appellate court applied the law of damages for reasonable cost of repairs for the administrator of an estate negligently failing to insure against loss from a hurricane.

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

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

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

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

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

should be awarded to victims and not to the government-at-large. *Id.* at 15-17. The SEC has sought disgorgement for violations of the Foreign Corrupt Practices Act ("FCPA") since 2004.

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

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

G. CONSTRUCTIVE TRUST. ""Whenever the legal title to property is obtained through means or under circumstances 'which render it unconscientious for the holder of the legal title to retain and enjoy the beneficial interest, equity impresses a constructive trust on the property thus acquired in favor of the one who is truly and equitably entitled to the same, although he may never, perhaps, have had any legal estate therein; and a court of equity has jurisdiction to reach the property either in the hands of the original wrongdoer, or in the hands of any subsequent holder, until a purchaser of it in good faith and without notice acquires a higher right and takes the property relieved from the trust.'" *Moore v. Crawford*, 130 U. S. 122, 128 (1889) (quoting 2 J . Pomeroy, Equity Jurisprudence §1053, pp. 628–629 (1886))" "[I]t has long been settled that when a trustee in breach of his fiduciary duty to

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

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

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

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

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

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

H. DERIVATIVE ACTIONS. In *Wingate v. Hajdik*, 795 S.W.2d 717, 719 (Tex. 1990). the Court said: "Ordinarily, the cause of action for injury to the property of a corporation, or the impairment or destruction of its business, is vested in the corporation, as distinguished from its stockholders, even though it may result indirectly in loss of earnings to the stockholders. Generally, the individual stockholders have no separate and independent right of action for injuries suffered by the corporation which merely result in the depreciation of the value of their stock. This rule is based on the principle that where such an injury occurs each shareholder suffers relatively in proportion to the number of shares he owns, and each will be made whole if the corporation obtains restitution or compensation

from the wrongdoer. Such action must be brought by the corporation, not alone to avoid a multiplicity of suits by the various stockholders and to bar a subsequent suit by the corporation, but in order that the damages so recovered may be available for the payment of the corporation's creditors, and for proportional distributions to the stockholders as dividends, or for such other purposes as the directors may lawfully determine." (Citations omitted.) Where the claim belongs to the corporation, and the corporate managers will not pursue the claim, shareholders can seek to do so by bringing a derivative proceeding. Shareholder derivative proceedings are governed by TBOC §§ 21.551 et seq. These statutory provisions include a requirement to make demand on the corporation, discovery limited to independence and disinterestedness, good faith, and reasonableness, and dismissal if the court finds that the corporate managers decide in good faith, after reasonable inquiry, that continuing the proceeding is not in the best interest of the corporation. However, procedural barriers are relaxed for closely-held corporations. TBOC § 21.563.

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

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

Id. at 272. [Footnotes omitted.]

A post-*Castleberry* statute, TBOC § 21.233, Limitation for Liability for Obligations, eliminated piercing for contractual obligations (subject to an exception), and eliminated piercing for any type of claim based upon the failure to observe a corporate formality. The statute recognizes an exception "if

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

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

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

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

2. Actual Fraud. The term "actual fraud" is not defined in TBOC § 21.223. In *Castleberry* the Supreme Court described actual fraud as "involv[ing] dishonesty or purpose or intent to deceive." *Id.* at 273. The fraud must relate to the transaction in issue. *Viajes Gerpa, S.A. v. Fazeli*, 522 S.W.3d 524, 533-35 (Tex. App.--Houston [14th Dist.] 2016, pet. denied) (an alter ego case). In *Stover v. ADM Milling Co.*, No. 05-17-00778-CV (Tex. App.–Dallas Dec. 28, 2018, pet. denied) (memo. op.), the court said: "In the context of piercing the corporate veil, ... actual fraud is not equivalent to the tort of fraud").

3. Direct Personal Benefit. A shareholder can be held liable for a corporate contractual obligation if s/he "caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit of the holder." TBOC § 21.233(b). In *Hong v. Harvey*, 551 S.W.3d 875, 887 (Tex. App.–Houston [14th Dist.] 2018, no pet.) (finding no direct personal benefit), the court said: "In cases in which the direct personal benefit showing has been met, evidence showed that funds derived from the corporation's allegedly fraudulent conduct were

pocketed by or diverted to the individual defendant.... In contrast, evidence showing that fraudulently procured funds were used to satisfy a corporation's financial obligations cuts against the notion that the fraud was perpetrated primarily for the direct personal benefit of an individual."

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

5. LLCs Are Protected as Well. TBOC § 101.002 extends the protection of TBOC § 21.233 to LLCs and their members, owners, etc.

6. Limited Partnerships. "Texas courts have uniformly declined to apply the alter-ego theory to pierce a limited partnership's 'veil' to impose the entity's liabilities on a limited partner. The need for any equitable veil-piercing doctrine is fundamentally dubious as applied to the liabilities of a limited partnership. Unlike a person doing business with a corporation, a person doing business with a limited partnership always has recourse against any general partner in the same manner as partners are liable for the liabilities of a partnership without limited Partners." *Peterson Group, Inc. v. PLTQ Lotus Group*, 417 S.W.3d 46, 56 (Tex. App.–Houson [1st Dist.] 2013, pet. denied) (footnote omitted).

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

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

1. Fraud or Defalcation. The Section 523(a)(4) exception to dischargeability requires that the debt

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

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

XIII. BUSINESS-RELATED FRAUD. It is disappointing but perhaps not surprising that fraud is far too common in the business world and especially in the financial realm, in the United States. Fraud is worse in many other countries. For over 20 years the accounting firm of Pricewaterhouse Coopers ("PwC") has conducted an annual global economic survey on crime and fraud. Their 2020 survey[83] garnered 5,000 respondents from 99 countries. *Id.* at 3. The survey showed that 47% of companies experienced fraud in the previous 24 months, that the average number of frauds reported per company was six, and in the United States $42 billion in fraud losses were reported, and 13% reported fraud

losses in excess of $50 million. *Id.* at 7. The top five types of fraud – listed in order of frequency -- were customer fraud, cybercrime, asset misappropriation, bribery and corruption, and accounting/financial statement fraud. For internal fraud, middle management accounted for 34%, operations staff accounted for 31%, and senior management accounted for 26%. Nearly half of incidents resulting in losses of $100 million or more were committed by insiders. Only 56% of companies investigated their worst incident of fraud, and only one-third reported them to the board of directors. *Id.* at 9. The PwC report indicated that "perhaps most importantly, regulators are paying more attention to compliance programmes – some are starting to request companies to provide evidence showing that their compliance programmes are effective." *Id.* at 12.

The Association of Certified Fraud Examiners has conducted an annual global fraud survey since 1996. The 2020 edition of its *Report to the Nations*[84] analyzed "2,504 cases of occupational fraud that were investigated between January 2018 and September 2019." *Id.* at 6. The largest group of employee frauds, constituting 86% of cases, was asset misappropriation, but median losses were only $100,000. Corruption, including bribery and conflicts of interest, constituted 43% of frauds with a median loss of $200,000. Financial statement fraud schemes constituted only 10% of frauds but the median loss was $954,000. *Id.* at 10. The top four concealment methods were: creating fraudulent physical documents, 40%; altering physical documents, 36%; altering electronic documents, 27%; and creating fraudulent electronic documents, 26%. *Id.* at 17. Where fraud was detected, 43% resulted from tips, 15% from internal audit, 12% from management review, and 5% were discovery by accident. *Id.* at 19. 50% of the tips were from employees, 22% from customers, 15% anonymous, 11% from vendors, 2% from competitors, and 2% from shareholders. *Id.* at 17. Fraud detected by management review led to the lowest losses and a shorter period of nondetection. Fraud detected by tips had somewhat higher losses, but shorter periods of non-detection. External audits had slightly higher losses, and nearly twice the period of undetected fraud. *Id.* at 20. The ACFE Report noted that nonprofit organizations are more susceptible to fraud due to having fewer resources, lack of internal controls, lack of management review, and the overriding of internal controls. *Id.* at 29. The most frequent anti-fraud controls in large businesses are: external audit of financial statements, 83%; Code of Conduct, 81%; internal audits, 74%, management certification of financial statements, 73%; external audits of internal controls over financial reporting, 68%; management review, 65%; hotline, 64%; an independent audit committee, 62; an anti-fraud policy, 56%; employee support programs, 55%; fraud training for employees, 55%; fraud training for managers/executives, 55%; etc. *Id.* at 31. Rated for effectiveness, a code of conduct cut fraud cases by 51%, an internal audit department by 50%, management certification of financial statements by 50%, an external audit of internal controls over financial reporting by 50%, management review by 50%, hotline by 49%, an external audit of financial statements by 46%, and fraud training for employees by 38%. Interestingly, the Report projected that rewards for whistleblowers reduced cases by only 2%. *Id.* at 33. Another interesting point: in the U.S.A., 59% of perpetrators in the study were males and 41% were females. *Id.* at 43. By age, the bell curve is weighted to older ages, with the highest class being 36-40 years of age, falling off as you move to the younger or older ends of the curve. *Id.* at 45. The median losses, however, increased with age, taking a significant jump starting at age 56. The Report noted: "Most occupational frauds are committed by employee-level or manager-level personnel. But frauds by owners/executives are much more harmful." *Id.* at 46.

A. SPECIFIC INSTANCES.

Madoff. The biggest known business fraud of all time was perpetrated by Bernie Madoff, facilitated by his auditor/accountant, several employees, and an outside IT firm, operate a Ponzi scheme for many years. The fraudulent scheme is discuss in Section VIII.S.6 above. The SEC was warned repeatedly about the fraud, but ignored the warning signs. The SEC's Inspector General's report concluded: "[D]espite numerous credible and detailed complaints, the SEC never properly examined or investigated Madoff's trading and never took the necessary, but basic, steps to determine if Madoff was operating a Ponzi scheme. Had these efforts been made with appropriate follow-up at any time beginning in June of 1992 until December 2008, the SEC could have uncovered the Ponzi scheme well before Madoff confessed."[85]

Cheating on Pollution Emissions Testing. A "defeat device" is hardware or software that permits a vehicle to pass emissions testing in the laboratory but downgrades the controls when a vehicle is being driven on the road, thus secretly increasing pollution beyond permitted levels. In the 1970s, major car makers installed hardware that disabled pollution controls at low outside temperatures. The EPA ended that practice without an admission of wrongdoing by car manufacturers. In 1973, the U.S. Environmental Protection Agency accused Volkswagen of installing pollution control defeat devises on 25,000 1973 Volkswagens.[86] Volkswagen paid a $120,000 fine, saying that it was a matter of failed reporting and not a scheme to circumvent the Clean Air Act. In 1996, General Motors agreed to pay a fine of $11 million, and to recall 470,000 vehicles, to remove defeat devices on some of its cars. Also in 1996, Ford was caught installing defeat devices on Econoline vans. In 1998, the EPA levied $83.4 million in penalties on makers of truck diesel engines, including Cummins, Mack Trucks, Caterpillar, Renault, and Volvo, for using computerized controls built into the diesel engines to run cleanly during testing but to run more fuel efficient on the road while doubling the emission of pollutants. In 2015, the EPA found out that Volkswagen had installed a defeat device on hundreds of thousands of vehicles it sold in the United States that passed emission control tests but exceeded pollution admission standards while in normal use. On January 11, 2017, the Justice Department announced that Volkswagen AG agreed to plead guilty conspiracy to defraud the U.S. government, as well as obstruction of justice for destroying documents, and pay $4.3 billion in criminal and civil penalties.[87] In an unusual move, criminal charges were filed in the USA against higher-ups in the Volkswagen organization, many of whom still remain unextradited in Germany. The SEC sued Volkswagen and its chief executive Martin Winterkorn for issuing $13 billion in bonds and asset-backed-securities in U.S. markets while knowing but not disclosing that 500,000 vehicles it had sold in the USA "grossly exceeded legal vehicle emissions limits."[88] German authorities finally filed criminal charges against Winterkorn in April of 2019.[89] Prosecutors are seeking to have Winterkorn forfeit up to $12 million in bonuses he received upon resigning from the company after records reflected that he received a memo (which he denied reading) detailing the fraud up to a year before the story broke. According to a Forbes magazine article, VW has lost more than $20 billion in the scandal, including fines, lost production, retrofitting vehicles, and compensating owners.[90]

Merrill Lynch Meets Enron. The Enron fraud is discussed in Section VIII.S.7 above. In May of 2010, the SEC settled with four former Merrill Lynch executives for aiding and abetting Enron's earnings manipulation. According to the SEC's litigation release, "on December 29, 1999, Enron entered into a sham 'sale' of its interest in certain Nigerian barges so as to fraudulently record over $12 million in income. The 'sale' was a sham since the risk and rewards of ownership in the barges never passed to

Merrill Lynch because Enron's then Chief Financial Officer, Andrew Fastow, guaranteed Merrill Lynch that it would not lose money and that it would be taken out of the deal within six months." In a second transaction, "on December 29, 1999, Enron agreed to pay Merrill Lynch a $17 million fee to enter into a virtually offsetting energy trade.... [T]he transaction was essentially risk free to Merrill Lynch and had the purpose and effect of inflating Enron's reported income by approximately $50 million in 1999, and ... such earnings were necessary for Enron to meet earnings and award bonuses to senior management. Furst also knew that Enron was contemplating unwinding the energy trade transaction after obtaining its earnings benefit. After the transaction was completed and Enron reported its inflated earnings, Enron and Merrill Lynch unwound the transaction on June 30, 2000, and Enron received $8.5 million, half of its original fee." These two transaction inflated Enron's income for the fourth quarter of 1999 by over $60 million.[91]

Enron's In-House Counsel. Two in-house attorneys for Enron were charged with failure to disclose "in Enron's 2000 proxy statement millions of dollars paid to the former Chief Financial Officer, Andrew Fastow. The complaint further allege[d] that Rogers failed to disclose $16 million realized through insider stock sales by Enron's former Chairman, Kenneth Lay, in Enron's 2000 Proxy Statement, and aided and abetted Lay's failure to disclose an additional $70 million in stock sales in Lay's Form 4 filings with the Commission."[92]

Allen Stanford's Ponzi Scheme. In February of 2009, the SEC charged R. Allen Stanford with running a multi-billion Ponzi scheme involving the sale of over $8 billion of certificates of deposit at a bank in Antigua that promised higher rates of return than CDs at other banks, along with other scams. Stanford loaned much of the money to himself through various entities. Stanford was indicted on July 18, 2009, for mail, wire and securities fraud, obstruction of an SEC investigation, and other charges. On March 6, 2012, Stanford was convicted by a jury on 13 of 14 counts, and on June 14, 2012, Federal Judge David Hittner of the Southern District of Texas sentenced Stanford to eleven 20-year terms to run concurrently. Hittner also imposed a judgment against Stanford of $5.9 billion.[93] The fraud spawned class-action lawsuits against law firms, stock brokers, and financial services companies.

XIV. EXAMPLES OF CONFLICTING DUTIES.

1. Necessity. A hiker on a mountain is caught in a storm. She enters an unoccupied cabin and eats some food and burns some wood, thereby saving her life. Under the defense of necessity, the hiker is not guilty of the crime or liable for the tort of trespass, but she must pay for the value of the food and wood she used. Stephen D. Sugarman, *The "Necessity" Defense and the Failure of Tort Theory: The Case Against Strict Liability for Damages Caused While Exercising Self-Help in an Emergency*, ISSUES IN LEGAL SCHOLARSHIP (2005).[94]

2. Agent - Principal. A real estate broker agrees to help a client purchase a house in a particular neighborhood. There are number of houses that could meet the client's desires, several that are listed for sale by the broker and several that are not. The broker gets a 6% commission if the client buys a house he has listed, but only 3% if the client buys a house listed with another broker. The broker shows the client only houses listed by his office. Is this a breach of fiduciary duty? "Yes." Damages? "Hard to prove." Disgorgement? "Possibly."

3. Trustee's Transaction With Beneficiary. The trustee of an express trust invests trust funds in a business start-up in which he is the only other investor. The action is not mentioned as a permitted transaction in the trust agreement. Is this a breach of fiduciary duty? "Probably." If the investment loses money, the trustee will likely have to make the trust whole. If the investment makes money, the trustee may be made to disgorge some or all of his profits.

4. Trustee's Duty to Diversify. The trustee of an express trust invests 50% of the trust assets in Tesla Inc. and 50% in cash. Has the Trustee violated his duty to diversify under Tex. Prop. Code §117.005? "Possibly." If the Tesla stock goes up and the trustee sells for a big gain, he is a hero. If Tesla stock goes down and the trustee sells for a big loss, he may be sued for failure to diversify.

5. Trustee's Duty to Sell. A new U.S. President has been elected. He ran on a campaign to double the capital gain tax. The same party may control both houses of Congress, making a tax increase more likely. Should the trustee of a private trust liquidate assets with large built-in capital gains before year-end? Should an investment advisor recommend liquidation? What if their company earns a broker's commission on sales?

6. Duties of Corporate Directors and Officers. Directors must act in good faith, with ordinary care, and in a manner the director reasonably believes is in the best interest of the corporation. TBOC § 22.221(a). To be held liable, a director must violate all three duties at the same time. TBOC § 22.221(b). But directors are not held to the duties of a trustee. TBOC § 22.223. The same three-part test applies to officers. TBOC § 22.235. Can a director avoid liability for negligence as long as she acts in good faith?

7. Partner's Obligation of Good Faith. A partner in a real estate partnership steers the partnership toward borrowing money from a bank of which he is a part-owner and a member of the board of directors. The terms are similar to what could be obtained from other lenders. Is this a breach of the partner's duty of loyalty or obligation of good faith? "No." The partnership was not harmed. "A partner does not violate a duty or obligation under this chapter or under the partnership agreement merely because the partner's conduct furthers the partner's own interest." TBOC §152.204(c).

8. Contracts with Corporate Officers. A closely-held corporation owns several pieces of real estate. One director is a licensed real estate broker. The Board decides to list three of the properties for sale with this director. The properties are marketed and sold for the standard brokerage fee and a good price. A minority shareholder threatens to sue for the director to return his commission. What happens? "It depends." Under TBOC § 22.230, contracts with directors and others are OK if disclosed to the board and a majority of disinterested directors vote to approve the contract, in good faith and with ordinary care, or if the contract is fair to the corporation. If those criteria are not met, the director must prove fairness. However, the shareholder has to bring a derivative proceeding which the board will undoubtedly reject.

9. Environmental, Social & Governance. You are advising the Board of Directors of a privately-held corporation. Some shareholders are not board members. Some directors want to adopt a policy that the corporation will buy only electricity identified as coming from renewable energy

sources, even though that costs appreciably more than ordinary electricity. Would that policy breach any of the Board's duties to the corporation? Directors must act in a manner that they reasonably believe is in the best interest of the corporation. TBOC § 22.221(a). But directors are liable only if they do not act in good faith, and do not use ordinary care, and do not act in a manner they reasonably believe is in the best interest of the corporation. TBOC § 22.221(b).

10. LLC as a General Manager. John is the sole manager of an LLC that is the general partner of a limited partnership. The fiduciary duties that John owes to the LLC are governed by LLC law, while the duties John as manager of the general partner owes to the partnership and other partners are governed by partnership law. Hopefully, these duties will never conflict. If they do, which prevails? Because the LLC is a general partner and owes fiduciary duties to the partnership, the partnership duties should come first.

11. When a Corporation is Insolvent. When a corporation is insolvent and has ceased normal business, the directors cause the corporation to pay loans due to shareholders without paying outside creditors first. What are the creditor's remedies? Sue the transferee to set aside the transfer based on the fraudulent transfer statute. Another remedy is to sue the directors directly under the trust fund theory. TBOC § 22.226.

12. Privacy of Health Information. Personal health information is generally considered to be private information. An employee in an office tests positive for COVID-19. DHHS has issued guidelines about disclosure of the identity of COVID-positive persons to first responders, without mentioning disclosure to co-employees. The employer has a duty to provide a safe workplace. The better approach is to disclose that an unnamed employee tested positive. The illness must be recorded and reported to OSHA if it was contracted at work.

13. Executive Rights Over Minerals. You hold executive rights over the minerals of royalty interest owners. You also own the surface rights to the property. No drilling has occurred and the primary term of the oil and gas lease is rapidly approaching. You agree to extend the mineral lease in exchange for an agreement with the operator to pay above-market rates to purchase water from a water well on the property which belongs to you as owner of the surface rights. Does this breach your fiduciary duty to the royalty owners? "Yes."

14. Spouse's Duties Regarding Community Property. The husband has sole management and control over his salary and bonuses, which are community property. The husband transfers half of a large bonus to his girlfriend. In the divorce, the wife sues to recover the gift based on actual and constructive fraud on the community. Can the wife sue the girlfriend for the return of the money? The law is not crystal clear. Most likely the wife must first seek compensation out of the community estate or the husband's separate property, and if that is inadequate then seek to invalidate the transfer to the girlfriend as a fraudulent transfer or by imposing a constructive trust. *Chu v. Hong* (Tex. 2008).

15. Attorney Representing a Trustee. You are hired by the trustee of an express trust to defend the trust in litigation. One of the trust beneficiaries calls you saying that she disagrees with trustee's intention to settle the case by paying a substantial sum to the plaintiff. The beneficiary asks you not

to go forward with the settlement. You talk to the trustee who is determined to settle. What do you do? Do what the trustee wants. The trustee is your client. *Huie v. DeShazo*, 922 S.W.2d 920, 925 (Tex. 1996).

16. Attorney Representing the Executor of an Estate. You are the attorney for the independent executor of a decedent's estate. One of the beneficiaries under the will calls complaining about the executor's bias against her, and asks you about private conversations you had with the executor about the estate. Can you reveal your discussions with the executor? "No." Your conversations with the executor are subject to the attorney-client privilege. *Huie v. DeShazo*, 922 S.W.2d 920, 923 (Tex. 1996).

17. Drafting a Demand Letter That Could be Defamatory. You are drafting a demand letter in a case alleging misapplication of fiduciary property, which is an offense under Penal Code § 32.45(b). Your letter is accusing the other party of committing a crime. Are you at risk of being held liable for defamation? "No." Attorneys are immune from civil liability to non-clients for actions taken in connection with representing a client in litigation. *Cantey Hanger, LLP v. Byrd*, 467 S.W.3d 477, 481-82 (Tex. 2015). See Section VIII.D.1.f.

18. Pleading Claims That Could be Defamatory. You are drafting a pleading in a case alleging misapplication of fiduciary property, which is an offense under Penal Code § 32.45(b). You are accusing the defendant of committing a crime. Are you or your client at risk of being sued for defamation? "No." Every participant in a court proceeding has an absolute privilege against being sued for libel or slander for what they say in court. See Section V.C.4.

19. Opinion Letter To Third Party. You draft a letter for a corporation saying that taking out a loan has been ratified by the board of directors and is in compliance with the corporate charter and by-laws. You say this solely in reliance on what the corporation's CEO told you. The letter is submitted to a bank in support of the loan. Turns out that the CEO did not obtain the required board approval of the loan. The loan goes into default, the bank sues and the corporation pleads that that the loan was an ultra vires act. The bank joins you in the suit claiming negligent misrepresentation. Can you be held liable? "Yes." See Section VIII.I.3.

20. Reporting a Law Partner's Suspected Overbilling. You are a junior partner in a law firm and you suspect that an older partner is recording more time than he is working. You report that to the senior partner. The senior partner investigates and determines that not all recorded time is being billed to the client and no overbilling has occurred. Within a short time, you are expelled as a partner. What is your legal recourse? "You have none." Because partnership is an at-will relationship, a partner can be expelled for any reason. *Bohatch v. Butler & Binion*, 977 S.W.2d 543, 545-46 (Tex. 1998). The Court's rationale would seem to apply even if the client had been overbilled.

21. Duty to Report Neglect or Abuse of a Child. "A person having cause to believe that a child's physical or mental health or welfare has been adversely affected by abuse or neglect by any person shall immediately make a report as provided by this subchapter." Tex. Fam. Code § 261.101. An attorney learns in representing a client that a child in the client's family likely was a victim of child

abuse. Under Tex. Disc. Rule of Prof. Conduct 1.05(c)(4), a lawyer can reveal confidential client information when the lawyer has reason to believe it is necessary to do so in order to comply with the law.

22. Insider Trading. You serve on the board of directors of a publicly-traded corporation that is developing a new treatment for an inherited disease. One evening the CEO of the company calls with the new that the results of the most recent phase of scientific testing indicate that the treatment has no therapeutic value. You have invested in the company, and so have members of your family. You know that you can't sell the shares you own, but you immediately call and inform your son. He tells his girlfriend who tells her parents. The next morning they all sell their shares in the company. A few days later the failure of the testing was announced to the public, and the stock loses 92% of its value. The SEC spotted the trades, and charges everyone with insider trading. The FBI investigates and the Justice Department files criminal charges. What happens? Everyone disgorges their savings, and someone likely will go to jail. Change the facts so that the director is the trustee of an express trust for the benefit of his son, and stock in the company is held in trust. The trustee has a duty of care in managing the trust's investments. Can the director sell the stock held in trust based on his insider knowledge? No, it would violate the 1933 and 1934 Securities Acts. Can the trust beneficiary sue the trustee for failing to sell trust-held stock before its value collapsed? "No." Selling the stock based on insider knowledge would be illegal. Can the director tip his spouse, who owns company stock as community property? "No." Can the director tip his spouse, who owns company stock as her separate property? "No."

23. ERISA Plan Trustees With Insider Knowledge. You are a trustee of Enron's ERISA pension plan. You receive information that inaccurate accounting has caused the company to overstate its income. You have a fiduciary duty to the trust fund and its members to make prudent investment decisions for the plan, including a duty to diversify, and a duty to disclose information to the plan beneficiaries, but the information you have is insider information that would be illegal for you to trade on or to pass on secretly to others for them to trade on. What do you do? Nothing. A trustee of an ERISA plan has no duty to violate Federal securities laws. The smart thing to do is consult with corporate general counsel, and if she has no plan of action then call the SEC Whistleblower program.

24. Investment Advisor Investing in Mutual Funds. You are a stock broker and investment advisor for multiple clients. You recommend to all your clients that they maintain at least 10% of their invested wealth in mutual funds. Your company has a policy of investing in mutual funds that charge a fee for admission and pay a commission for making the investment, even though there are similar mutual funds that do not charge an admission fee or pay a commission. Do you have a duty to invest your clients' money in the no-fee mutual funds? "No." Do you have a duty to inform your clients that a no-fee option is available. "Yes." Then follow your client's instructions. See Section IV.C. If the company retaliates, contact the SEC; you may qualify for a whistleblower bounty. See Section VIII.Q.5.

25. Investment Advisor Forwarding Investments to Other Advisors. You are an investment advisor with number of clients. The highest rate of return you can achieve is to invest your clients' money with an investment fund manager who routinely generates higher returns than other forms of investment. This investment fund sends confirmation of trades and an annual audit by an outside

accountant. As the manager of a "feeder fund," do you have a duty to disclose to your clients your delegation of investment decisions to another fund? "Yes." Do you have a duty to investigate the bona fides of the fund you are feeding? "Yes." If you think the fund is a Ponzi scheme, pull all of your investments. See Madoff, Section VIII.S.6.

26. Executive's Improper Relationship With Employee. Federal and state laws require employers to take prompt remedial action to eliminate a hostile work environment. For years, some CEOs got away with improper sexual relationships with employees with no adverse consequences to the CEO. This often required Directors to turn a blind eye to the behavior. More recently, CEOs have been fired or asked to resign for sexual misconduct with employees. Formerly CEOs often left with large severance packages. More recently some companies have been firing their CEOs for cause, which jeopardizes their severance benefits. Some directors are beholden to the CEO for their Director position, but the Directors owe the corporation a duty of good faith and ordinary care and must put the best interest of the corporation first. You are a director. The CEO is godfather to your first child. The CEO has violated company policy against sexual activity with employees. What do you do?

27. Executive Private Misconduct (Publicly-Traded Company). You are a director of a publicly-traded company. The CEO of the company is well-known, and has "become the face of the company." There are rumors that the CEO engages in behavior outside the workplace that members of the public would find highly objectionable if the behavior became known. What do you do? Since the company is publicly-held, as a director you must consider securities regulations that require the public disclosure of information that could affect stock price. As a director you owe a fiduciary duty to the company to protect shareholder value but also a legal duty to the public to inform them of risks to the stock price. So you face a dilemma, having to weigh the loss from losing the CEO's skills against the loss resulting from a bad reaction among the public. The best option is to cause the CEO to stop the objectionable behavior and have the CEO clean up past messes. If s/he can't or won't be persuaded to do so, then the board of directors faces the prospect of publicly disclosing the objectionable behavior, generating publicity that will actually bring about the harm to the company. Many companies in that situation fire or have the CEO retire without explanation. As a result, the adverse information may trickle out to the public instead of flooding out, thereby limiting the impact of the public's reaction, and the company can defend against a public backlash by showing that it acted responsibly and should not be blamed for the CEO's bad conduct. If the CEO was in fact essential to profitability, the company may suffer a downturn due to loss of the CEO's business acumen, but that loss is easier for the Board to justify to shareholders than the failure to advise the public of a risk associated with the CEO's private conduct and having the situation develop into a scandal, a stock drop, and a possible SEC fine or referral to the Department of Justice.

28. Executive Private Misconduct (Privately-Held Company). Same as Example 27, except that the company is privately-held, not publicly-traded, so that the Securities Acts of 1933 and 1934 do not apply. The director has a fiduciary duty to the shareholders, but no duty of disclosure to the public. The dilemma is still present, however, when public awareness of the CEO's private behavior might draw bad press, consumer boycotts, loss of clients, etc. Should the company enjoy the current profit stream in hopes that the CEO's private behavior will never be known publicly, or at least will not become known until after many profits have been earned? Under TBOA § 21.401(b) a director may consider

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E N D

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